



# PERSPECTIVES ON THE MAKING MARKETS WORK FOR THE POOR (M4P) APPROACH



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## FOREWORD

An estimated 2.6 billion people live on less than \$2 a day. Over a billion lack clean water; 1.6 billion lack electricity and 3 billion lack access to telecommunications. This represents huge unmet needs. As many of the world's poor live in areas with limited state service provision they must rely on private markets for their livelihoods. As consumers, poor men and women rely on markets to meet their needs for food and essential services. As employees or producers, they sell their labour or products in these markets. But these markets are often difficult or costly to access for poor people. These markets may be informal, uncompetitive and may not meet the needs of the poor effectively.

More widely, the world's poor are not well integrated into the global economy and do not get access to its benefits. In *Development as Freedom*, Amartya Sen describes participation in economic interchange as a basic part of social living and argues that economic freedoms are closely tied to political and social freedoms. The poor often lack these freedoms.

Making Markets Work for the Poor (M4P) is an approach to poverty reduction that donors such as the Department for International Development (DFID) and the Swiss Agency for Development and Cooperation (SDC) have been supporting over the past few years. The central idea is that the poor are dependent on market systems for their livelihoods. Therefore changing those market systems to work more effectively and sustainably for the poor will improve their livelihoods and consequently reduce poverty. More accessible and competitive markets enable poor people to find their own way out of poverty by providing more real choices and opportunities. Markets that function well have wider economic benefits too. They stimulate investment and encourage firms to innovate, reduce costs and provide better quality jobs, goods and services to more people. The involvement of poor people in economic growth is the best way to get people out of poverty and represents the exit strategy for aid.

The last few years have seen an upsurge of interest in market development approaches amongst aid agencies. Alongside M4P there is UNDP's *Growing Inclusive Markets*, the IADB's

*Opportunities for the Majority* and the IFC's *Next Four Billion*. Amongst businesses, there is growing interest in social investment, sustainable business practices, fair trade and engaging with the *Base of the (Economic) Pyramid*. Although terminology and emphasis may differ, all of these approaches see a market-based economic engagement with the poor as essential for sustainable development.

In order to improve the understanding and uptake of market development approaches and to consolidate existing experience, DFID and SDC have commissioned a series of three documents on M4P. Aimed at agency and government officials, consultants, researchers and practitioners, these together provide a comprehensive overview of the approach in theory and practice.

The *M4P Synthesis* paper explains the essence of the M4P approach – its rationale, including evidence of impact, and key features in implementation. *M4P Perspectives* (this document) introduces the conceptual underpinnings of M4P and explores its application in different fields including finance, agriculture, water, labour and climate change. These first two documents have been sponsored by SDC. The *M4P Operational Guide* (sponsored by DFID) provides a substantial operational resource on how to implement M4P, including an overview of good practices, common management challenges and the main lessons from experience.

Development of these documents was led by a team from The Springfield Centre. They were assisted by advice and comments from Marshall Bear, Gerry Bloom, Richard Boulter, Don Brown, Jean-Christophe Favre, Tracy Gerstle, Alison Griffith, Justin Highstead, Joanna Ledgerwood, Marc Lundy, Luis Osorio, Alexandra Miehlebradt, Mark Napier, Kate Philip, David Porteous, Peter Roggekamp, Prashant Rana, Hugh Scott, Dominic Smith and Jim Tomecko.

All of these documents are also available in electronic form at [www.M4Pnetwork.org](http://www.M4Pnetwork.org). We hope you find them helpful in meeting the challenge of developing market systems that benefit poor people.

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## INTRODUCTION

This collection of papers is part of a series of three documents on the Making Markets Work for the Poor (M4P) approach. The *Synthesis* presents the essence of M4P – its strategic rationale, key principles and the main features in its implementation; the *M4P Operational Guide* seeks to provide an accessible operational resource to help put the M4P approach into practice.

The purpose of this document (*M4P Perspectives*) is to explore in more detail specific issues associated with M4P and potential areas of development endeavour where M4P may have application. In doing so it seeks to demonstrate both the conceptual context for M4P, much of it emerging from developments in economic thinking, and the value-added which M4P can bring in practice.

Paper 1 is concerned with mapping out the relations between different strands of thinking in economics and M4P. The remainder of the papers deal with the application of M4P to specific market systems or issues. In each case they establish the relevance of these markets/issues for the poor and then focus on the M4P perspective on key challenges within these. Papers 2, 3 and 4 deal with M4P in relation to the factor markets of finance, labour and land; Paper 5 focuses on agriculture, the main livelihood source of many of the poor but vital to them whether as producers, labourers or consumers. Paper 6 concentrates on water – a field often seen as a merit good where consumption not only serves the individual but impacts on the wider economy and society. Finally, Papers 7 and 8 deal with M4P in relation to important development issues which are not conventionally seen as market systems but where the M4P lens can add value. Paper 7 focuses on the political markets guiding government decision-making and therefore impacting across a wide spectrum of fields and Paper 8 highlights the M4P perspective on the series of markets associated with climate change.

These papers seek to present a first indication of the wider depth and relevance of M4P. They cover market systems for economic factors, for merit goods, for key sectors and for critical issues such as political decision-making and climate change. They are not comprehensive – there are other fields where an M4P perspective has utility (such as education, health and other specific products and services) which are not covered here. They represent, therefore, an initial platform which will be added to by other perspectives papers as M4P develops further.



## PAPER I: M4P AND ECONOMICS

### Introduction

M4P provides a framework for understanding economic systems and guiding actions to improve the way in which those systems serve the poor. It has emerged from observation of changes in the real world and from agency experience. It has also been influenced by newer economic theory and research. As a framework rather than a philosophy in its own right, it draws upon and seeks to operationalise the more pragmatic insights of various strands of economics to address development challenges.

The purpose of this paper is to map out the relations between economic thinking and M4P. While the *Synthesis* contains a summary of the economic rationale for M4P, the objective here is to set out its conceptual origins. It first offers a brief reminder of the importance of markets in economics and, in doing so, sets the context for the rest of the paper. Second, it highlights the centrality of exchange in economics and, third, the limitations of conventional economics. Finally, it identifies a number of different schools of economic thought that have influenced the emergence of M4P thinking and practice.

### A brief reminder: the truth about markets

In his book *The Truth About Markets*<sup>1</sup>, the economist John Kay recounts an anecdote from the visit of the former Soviet premier, Nikita Khrushchev, to the United States in 1959. Khrushchev and his aides were dumbfounded when they visited a supermarket: they believed that the shelves had been specially stocked for their arrival. Tim Harford develops the tale further, imagining Khrushchev asking his US hosts “*who is in charge of the supply of groceries in California?*” Such a question may seem comical, but as Harford points out “*the answer – nobody – is dizzying*”.<sup>2</sup>

Kay explains the ubiquity of markets as a central organising principle of modern economies and their superiority over centralised planning in terms of their “*disciplined pluralism*”: the ability of diverse producers and consumers to make hundreds, thousands or even millions of decisions a day and to rapidly self-correct – a cycle of “*experiment, failure and fresh experiment*” – in a way which the centralised planning, with which Khrushchev was familiar, finds impossible.

Because the world is complicated and the future is uncertain, decision-making in economic systems is best carried out through a series of small-scale experiments, frequently reviewed, and in a structure in which success is followed up and failure recognised but not blamed. Market systems did not succeed because business-people are cleverer than politicians. They succeeded because disciplined pluralism is more innovative and responsive to people’s needs than centralised planning.

Centralised structures cannot cope easily with a reality of economic life: that it is difficult to determine what the right thing to do is. The best recourse is to try many things on a small scale and see which few work. However, pluralism conflicts with uniformity. If government genuinely allows pluralism and decentralised authority, variability in the quality of what is provided is inevitable. It is tempting to argue that everyone should receive ‘the best’, but the consequence is that ‘the best’ will not be very good.

Disciplined pluralism tends to run contrary to the natural instincts of most political leaders. When governments make economic policies, their inclination is to suppress pluralism – to find the big idea – and to override discipline, often favouring new ventures that the market will not accept or old industries which the market has already rejected. That is why the record of government economic intervention, even in rich states, is generally poor.

## PAPER 1: M4P AND ECONOMICS

However Kay also emphasises that market economies are not about harnessing greed. Market economies succeeded because they established disciplined pluralism by putting in place a diversity of mechanisms which govern the behaviour of market players. Markets are never “free”.

This is not to deny that self-interested materialism is an important feature of economic life. Economic systems based on appeals to work for the common good will fail. But self-interest is necessarily hedged in by complex institutions of modern economic, social and political life – formal regulation and implicit rules, mechanisms of reputation and coordination, instincts and structures of cooperation, feelings of solidarity. Markets only function as part of a social, political and cultural context.

Economic motivations are therefore complex and not necessarily consistent. The study of human behaviour is an empirical subject. It cannot rely solely on *a priori* assumptions. Still less should it rely on introspection and *a priori* assumptions that do not correspond to experience. The best starting point is to expect behaviour to be adaptive – that people will behave in a way they are normally expected to in the circumstances in which they find themselves. This expectation will sometimes be false. Economies would not develop otherwise. The multifaceted institutions of the market economy are constantly evolving. Government is an agent in that evolution, not a bystander; but government cannot dictate the process and should not seek to.

### The centrality of exchange to M4P and economics: trade or trade off?

Market development is about markets, so that is our starting point. Markets are mechanisms for exchange and are at the heart of both M4P and conventional economic thought:

*“The market mechanism, which arouses passion in favour as well as against, is a basic arrangement through which people can interact with each other and undertake mutually advantageous activities. In this light, it is very hard to see how any reasonable critic could be against the market mechanism as such.”<sup>3</sup>*

Exchange is about human interaction. As our hunter-gatherer ancestors moved beyond isolated self-subsistence they began to engage with others: they began to exchange. In fact exchange or reciprocity predates even this time and occurs beyond the human species. For example, in the field of sociobiology reciprocal altruism has been shown to be common within and between many species of flora and fauna. For instance, some species of bats ‘lend’ each other favours, such as sharing surplus food, in the expectation of a returned favour in the future when they are short of food themselves.<sup>4</sup> Exchange permits specialisation, fostering more efficient use of scarce resources, and thus increases welfare.

Exchange – and therefore mechanisms for exchange – is not just about commercially traded goods and services (ie buying and selling of a product for a money price). Exchange can take a variety of non-monetised forms: barter (eg two sheets of roofing for one goat), promises or *quid pro quo* arrangements (eg an IOU – I’ll help you harvest your rice today but will expect you to help with mine next week) and even gifts. Gifts are more difficult to understand as a form of exchange because giving does not appear to involve any reciprocity. The ‘price’ of exchange is not easy to identify at first glance. However, when someone gives a gift they typically expect something – often social – in return. This might be the goodwill of the recipient, social status, acquiring favour; expectation of future reciprocation or perhaps compliance with social convention (eg avoiding the embarrassment of turning up to a dinner party without a gift for the host). There is a calculus of decision-making involved in the giving of a gift: what people are prepared to give is a function of who they are (eg their level of resources or status) and that of the recipient (how important they are to the giver).

Conventionally such non-monetised forms of exchange have been regarded as outside the realm of markets. Increasingly however, in economics and in the real world, the understanding of what constitutes a market and the applicability of concepts of exchange which underpin markets are far broader than they have been in the past.

The diverse forms of exchange described above are now seen as integral to real-world markets. More importantly, non-monetised exchange may be governed by the same basic economic rules as any other form of exchange. For exchange to occur there has to be some form of supply (ie seller; provider or giver) and demand (ie buyer; consumer or recipient); the price of exchange affects people’s decisions about whether to trade or not.<sup>5</sup>

In this sense exchange is not so much about trade as trade-off. Understood in this broader way – as a means for examining how people and societies make decisions about the allocation of scarce resources and consequently how these decisions affect welfare – economics is being applied in diverse fields ranging from criminal science to environmental protection. The conceptual and analytical power of economic theories about exchange and trade-offs is being applied to provide a more rigorous understanding of the underlying motivations and incentives that govern human behaviour. In order to do this, however, economists have had to move beyond narrow assumptions of self-interest to understand what shapes human interaction: *“only through widening of the usual assumptions [is it] possible to begin to understand the obstacles to advancement encountered by minorities”.*<sup>5</sup>

Thus, the poverty reduction agenda of M4P and the welfare agenda of economics overlap. M4P and economics are both concerned with how welfare can be improved through exchange: how people can become better off given scarce resources.

<sup>3</sup> That is not to claim that all gifts conform to quasi-market exchange principles. There can be genuinely altruistic motivations for non-monetised (and even monetised) exchange, eg ‘lending’ money to a relative with no expectation of repayment. From an M4P perspective, it is important to take into account how developing markets can ‘invade’ this space (eg reduction of inter-familial financing as a result of increasing access to formal borrowing) and how this might affect behaviour.

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For example, in M4P the access frontier (see Good Practice Note 5.3 in the *Operational Guide*) defines “the maximum proportion of people in a society who could access a product or a service, given the current configuration of costs and market structure. The access frontier is clearly affected by regulatory as well as technological considerations, which will affect what is supplied, at what price, to which consumers in a market.”<sup>6</sup> The access frontier has parallels with economic concepts such as production possibility frontiers and Edgeworth Boxes for utility maximisation.

### The limits of markets and conventional economic thought

Whilst there is little disagreement about the centrality of markets to economics, there is more discomfort about the extent to which economic theory can be applied to the real world. In particular there are well-documented concerns about the applicability of conventional economic theory (ie neo-classical-Keynesian) as a basis for real-world policy-making and decision-taking. In a similar vein, there are concerns about how far market-oriented approaches can be applied to the context of the poor:

These concerns are partly ideological and partly a genuine response to the proximity of conventional economic theory and the market-based policy prescriptions applied by development agencies and governments during the 1980s and 90s (and still prominent today). This is best typified by the so-called Washington Consensus of reforms to “stabilise, privatise and liberalise” markets. The efficacy of such prescriptions has been examined in detail and does not bear repeating at length here.<sup>7,8</sup> In short, such policy prescriptions are now regarded as rigid and formulaic and their efficacy has been found to be mixed. Significantly, while these macro-economic prescriptions gained widespread acceptance, micro-economic aspects of reform were often neglected. Nevertheless they too have come to be associated with neo-liberalism and ‘market fundamentalism’, an association which often extends to market development specifically.

In a rush to discard conventional economic theory and policy there is a risk of ‘throwing the baby out with the bath water’. These prescriptions were indeed narrow and the economic thinking upon which they were based did not reflect the state of economic knowledge. The market development approach itself is partly a response to the narrow, formulaic prescriptions of many economic reform efforts. However, policy-makers would be foolish to ignore the power of the concept of exchange or reciprocity which lies at the heart of conventional economic theory. Therefore it is necessary to briefly examine some basic features of conventional economics<sup>b</sup> and the criticisms levelled against it before going on to explore how wider economic theory and the M4P approach responds to them, laying out a broader and more realistic representation of economic thinking and

of markets. In doing so, we will make a shift from markets to market systems as understood within M4P.

Markets are defined narrowly in conventional economics theory. The conventional economic view of markets is as a *deus ex machina* which will find a price which clears supply and demand. The setting of prices is seen as the central function of markets and social welfare is optimised in perfectly functioning markets (after Pareto). ‘Perfect’ here means that markets are assumed to be completely competitive and adjust prices instantaneously to achieve economic equilibrium (after Arrows and Debreu). More specifically, equilibrium theory assumes markets are characterised by a number of conditions:

- *Atomcity*: where there are a large number of buyers and sellers in a given market – each so small that their actions have no significant impact on others – there are no monopolies or monopsonies. Sellers are ‘price takers’, meaning that the market sets the price that they must choose.
- *Homogeneity*: where goods and services are perfect substitutes, meaning that there is no product differentiation – all sellers offer an identical product.
- *Rationality*: sellers aim to maximise utility and buyers aim to maximise profits.
- *Perfect information*: all buyers and sellers have complete information on the prices being asked and offered in other parts of the market and are able to evaluate the utility that will be derived from a transaction.
- *Equality of access and no asset specificity*: all sellers have access to factors of production and those factors do not suffer from ‘asset specificity’, ie they are perfectly mobile and transferrable between alternative uses.
- *Freedom of entry and exit*: any seller may enter or exit the market as it wishes – there are no barriers to entry.
- *Individual buyers and sellers act independently*: the market is such that there is no scope for groups of buyers and/or sellers to come together with a view to changing the market price – collusion and cartels are not possible.
- *No externalities*: only the parties involved directly in a transaction benefit from that transaction – third parties are not impacted upon (positively or negatively) by the economic decisions of others.

Conventional economics does recognise that these conditions do not always hold and as a consequence markets fail. ‘Market failure’ occurs for a number of reasons.

<sup>b</sup> By ‘conventional economics’ this paper refers to economic theory as commonly taught to economics undergraduates in many western universities. John Kay (see References) refers to this as the “*American Business Model*” school of thought.

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First, an agent in a market can gain market power, allowing them to block other mutually beneficial gains from trade from occurring. This can lead to inefficiency due to imperfect competition, which can take many different forms, such as monopolies, monopsonies, cartels or oligopoly.

Second, the actions of an agent can have positive or negative externalities, which are innate to the methods of production, or other conditions important to the market.

Finally, some markets can fail due to the nature of certain goods, or the nature of their exchange. For instance, goods can exhibit the attributes of public goods or common-pool resources, while markets may have significant transaction costs,<sup>c</sup> agency problems,<sup>d</sup> or asymmetry of information.<sup>e</sup>

The underlying cause of market failure is often seen as a problem of property rights. An agent's control over the uses of their commodities can be imperfect, because the system of rights which defines that control is incomplete. Typically, this falls into two generalised rights – 'excludability' and 'transferability'. Excludability deals with the ability of an agent to control who uses their commodity, and for how long – and the related costs associated with doing so. Transferability reflects the right of an agent to transfer the rights of use from one agent to another, for instance by selling or leasing a commodity, and the costs associated with doing so. If a given system of rights does not fully guarantee these at minimal (or no) cost, then the resulting distribution can be inefficient.

As a result of these failures, markets can be incomplete or dominated by the powerful, transactions can be costly and information inadequate. Conventional economic theory suggests that these market failures generate 'public goods' requiring compensatory intervention by government.

Criticisms of conventional economic theory stem not from the fact that it makes too many simplifications, because any theory is always an abstraction and is built on simplifications, but from the fact that the simplifications made are too distant from the real world that the theory is trying to describe. These simplifications or assumptions have always been accepted as unrealistic but the scale of their significance has tended to be underestimated. The emphasis on mathematical models in conventional economics – built on similar assumptions – has also been criticised for furthering its flight from relevance, making it a "*means to escape from reality rather than a tool to help understand it*".<sup>9</sup>

For example, under the most simplistic definition and assumptions of theory, firms and other forms of economic organisation (eg hierarchical relations within large organisations) would not exist – since 'perfect' markets do not require them, just many perfectly

informed and rational buyers and sellers. This patently does not reflect real world markets.

Critics point out that these failures are not exceptions but the norm; they describe the prevailing reality of markets. Market failure is therefore too pervasive and static a concept to be useful, prescribing a fixed role for government which assumes perfect government is the antidote to imperfect markets: "*The traditional private-public good dichotomy is unlikely to provide an effective or useful guide to policy-makers or a sufficient basis for understanding...*"<sup>10</sup>

### From markets to market systems: markets as complex social, political and economic constructs

Many strands of economic thought examine some of the simplifications or assumptions of conventional economics, the results of which – taken together – help develop a more nuanced and realistic picture of how markets work. Some of these strands build directly on conventional theory, others don't. M4P draws on these various strands of economic thinking in its understanding of market systems as complex social and political, as well as economic constructs.

As Sen points out:

*"The problems that arise spring typically from other sources and include such concerns as the adequate preparedness to make use of market transactions, unconstrained concealment of information or unregulated use of activities that allow the powerful to capitalise on their asymmetrical advantage. They have to be dealt with not by suppressing markets, but by allowing them to function better and with greater fairness and with adequate supplementation. The overall achievements of markets are deeply contingent on political and social arrangements."*<sup>11</sup>

This section briefly examines the following major strands of economic thought and links them to M4P:

- Institutional economics
- Economics of information
- Behavioural economics
- Public choice economics
- Evolutionary economics
- Market microstructure

In doing so, it retains a strong emphasis on the concept of exchange and motivations for exchange: a central focus of M4P is on understanding and working with such incentives.

<sup>c</sup> The cost incurred in making an economic exchange.

<sup>d</sup> The situation where individuals ('agents') who are placed in control of resources belonging to another party ('principals') use their delegated authority over those resources to serve their own interests rather than the interests of the 'principals'.

<sup>e</sup> The situation where one party to a transaction has more or better information than the other party.

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## Institutional economics

M4P's view of market systems as multi-function, multi-player arrangements builds directly on institutional economics (Figure 1). Institutions are understood as the constraints imposed by society; the explicit or implicit rules of that society. A market is one such institution: a set of rules which govern exchange. Institutional economics asserts that markets are much more than price-setting mechanisms: in fact prices are the outcome of the way in which markets work, which in turn is shaped by how markets reduce transaction costs – the costs of exchange.<sup>12</sup> Transaction costs are distinguished from the costs of producing a good or service, which would be the same regardless of the buyer. Transaction costs will vary uniquely for each buyer-seller exchange and they take two main forms:

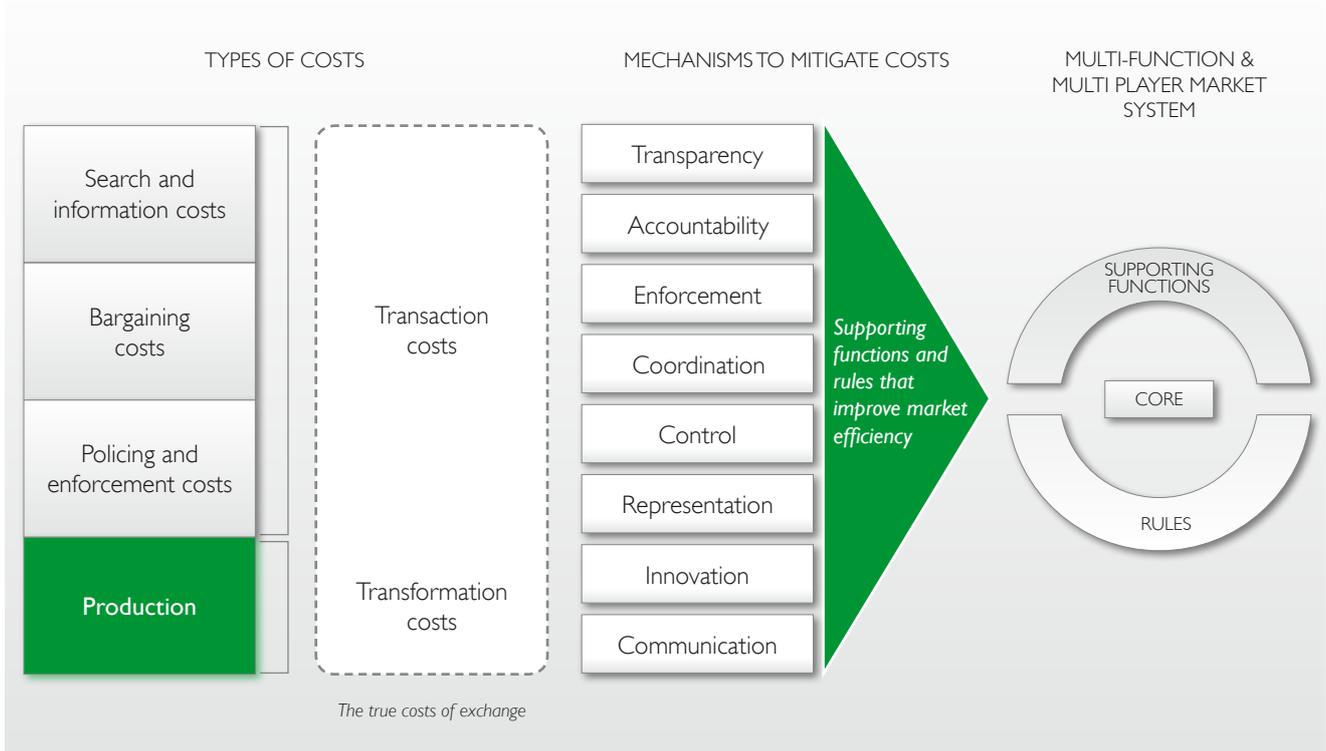
- Costs incurred before the transaction or *ex ante* costs – searching for buyers and sellers, bargaining to reach a 'deal' and contracting the deal.
- Costs incurred after the transaction or *ex post* costs – monitoring and enforcement to ensure that a deal is fulfilled as contracted.

The size of these costs relative to the underlying transaction and their distribution between buyer and seller determine the nature of the market in a good or service. M4P recognises that these costs can disproportionately affect the poor's ability to participate in markets.

Unlike conventional economics' *deus ex machina*, institutional economics sees markets as created constructs: "Markets are institutions that exist to facilitate exchange; that is they exist to reduce the cost of carrying out transactions."<sup>13</sup> For M4P this understanding is vital as it implies that markets can be altered – to make them work more favourably for the disadvantaged.

In focusing on a variety of endogenous factors that influence the way in which markets work – the rules of the game – institutional economics has a strong political economy dimension and relates to a range of other strands of economic thought, specifically economics of information, behavioural economics and evolutionary economics. It also relates to the "growth diagnostics" of Rodrik et al.<sup>14</sup>

**Figure 1**  
Transaction costs and the multi-function, multi-player market system



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### Economics of information

The economics of information studies how information affects behaviour. Information has economic value because it allows individuals to make decisions that yield higher expected utility than they would obtain from choices made in the absence of information.

Unlike conventional theory, information is recognised to have special characteristics in comparison to other goods, making it prone to asymmetry between different parties: information is easy to create and disseminate but hard to trust and control and can influence many decisions. Information asymmetry can create market inefficiencies such as adverse selection and moral hazard, where economic agents with more information can exploit their position relative to those with less information.

A variety of economists, most notably Joseph Stiglitz<sup>15</sup>, have analysed various information-related inefficiencies, their effects on incentives, and mechanisms which overcome information problems such as screening and signalling. Such mechanisms relate to institutional economics and its emphasis on the ability of markets to reduce transaction costs, such as search costs. The importance of information in information-constrained developing country contexts, and how these can be overcome, is central to the M4P approach. For example, in M4P market 'supporting functions' often relate to information.

### Behavioural economics

Behavioural economics seeks to unpack the concept of rational *homo economicus* to better understand how human factors (eg heuristics – basing decisions on rule of thumb; framing – the way a problem is presented to a decision-maker affects action taken) influence the decisions of (socio-) economic agents and explain so-called “*market anomalies*”, ie outcomes which do not conform to conventional theory.<sup>16</sup>

Behavioural economics draws on psychology and examines the importance of perceptions, incentives and motivation in determining decisions. This relates strongly to M4P's emphasis on political economy and understanding and working with the incentives of market players. In understanding that market players can 'learn' more efficient behaviour it also suggests that markets can be changed. There is also evidence that some patterns of behaviour are suboptimal but cannot be learned or unlearned, hence there is new emphasis on 'nudging' consumers towards better outcomes by framing choices in ways which make the optimal solution more likely to be chosen. This relates to supporting functions, such as mechanisms for transparency, disclosure or consumer education, in M4P.<sup>17</sup>

### Public choice economics

In public choice economics, economic tools are applied to study problems that conventionally are regarded as within the realm

of political science. It applies the concepts of exchange and motivation to examine, for example, the behaviour of voters, politicians and government officials and how they interact in a socio-political system to achieve certain ends given scarce resources. Like M4P, public choice economics seeks not only to explain the status quo ('what is') but also to identify problems and suggest how a system could be improved by changes in rules and supporting functions ('what might be').<sup>18</sup> M4P applies a similar framework of exchange, rules and supporting functions to examine fields of a more social or political nature, be that the provision of water, housing or investment climate (see Paper 7).

### Evolutionary economics

Evolutionary economics draws on biology and focuses on interdependency, competition and change within market systems. It is significant because it seeks to move beyond the static analysis of conventional economic theory and examine the reasons for dynamism in systems, emphasising the process of change inherent within economic development. It explores the transformation, not of raw materials, but of ideas and knowledge, which determine the way a 'system' works. It therefore has many parallels with the M4P approach, for example the concept of “*creative destruction*” (after Schumpeter), and is consistent with M4P's catalysts for change and “*disruptive innovation*”.

There are also important links with M4P (and institutional economics) in terms of the dichotomy between 'ceremonial' and 'instrumental' factors, where 'ceremonial' relates to patterns of past activity or precedents (crudely, institutions) and 'instrumental' relates to the technological imperative and future consequences (crudely, innovations).<sup>19</sup> Furthermore, in highlighting the evolutionary nature of markets, evolutionary economics recognises that it is essential to have mechanisms that can sustain dynamism (eg for selection, generation of innovation and variation, transmission and replication, etc) which is very similar to M4P's emphasis on multi-function and multi-player systems, the importance of a sustainability analysis and a view of markets moving towards greater complexity and sophistication over time.

### Market microstructure

Market microstructure theory has emerged primarily from the field of financial markets and is “*the study of process and outcomes of exchanging assets under a specific set of rules... [it] focuses on how specific trading mechanisms affect the price formation process*”.<sup>20</sup> It recognises the different nature of specific markets and consequently the market structure and design – including supporting functions and rules in M4P terminology – needed to underpin those markets, for example price formation and price discovery, transaction and timing costs, trade intermediation, information and disclosure and rules and regulations. Like M4P, market microstructure theory endeavours to understand 'what makes markets work', recognising that markets are not generic.

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### Summary

The strands described above are by no means exhaustive, but they have in common an attempt to develop a more sophisticated understanding of economic exchange in the real world. This is precisely what M4P tries to do in its view of market systems, incorporating a variety of forms of commercial and non-commercial, monetised and non-monetised elements – firms, hierarchies, gift exchange – into a broader understanding of what is meant by ‘market’.

M4P recognises the importance of understanding the alignment of key market functions and players and the incentives and motivations of those players, as the key to understanding why markets are currently suboptimal. It uses this understanding as the basis for trying to identify ‘what might be’ – to stimulate sustainable changes in market systems that are more pro-poor.

As in economics, M4P also seeks to apply market systems concepts more broadly. If we recognise the centrality of human interaction and exchange to social and economic development, and that exchange is governed by a wider system, we can see that the M4P framework need not be confined solely to the world of business and commerce, but has wider relevance to fields of a more social nature. Whilst controversial to some, this reflects a trend to apply economic thinking to fields that are traditionally regarded as non-economic.

Finally, although M4P draws from the strands of economic thought described above, it recognises that any economic model is a simplified construct of reality – real-world market systems are not models. There is no universal set of rules for economic development. Markets are highly context-specific and economists and M4P practitioners alike need to analyse them rigorously and open-mindedly on a case-by-case basis if they are to understand and change them.

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## PAPER 2: M4P AND FINANCIAL SERVICES

### Introduction

This paper focuses on the application of M4P to financial services. It first establishes the importance of financial services in relation to growth and access. It then highlights a number of key issues in developing financial services markets and views these through the 'lens' of M4P. In doing so it outlines the value of M4P in relation to clarity of analysis and guidance for intervention. It concludes with comments on the applicability and limitations of M4P in financial services markets.

### Importance and relevance to the poor

Financial markets are central to the overall performance of economies and to their ability to reduce poverty. Financial markets can reduce transaction costs, facilitating the exchange of goods and services and enabling more efficient allocation of resources. When functioning well, financial markets provide the basis for growth and development, especially for the poor who, with fewer resources, may be more dependent on them to access liquidity and protect their savings. Conversely, financial markets that are not working well inhibit exchange and deter and distort investment. Poorly functioning financial markets hamper the development prospects of low-income people specifically and of economies generally – in extreme cases severely.

Financial markets in various forms are pervasive in economies. In providing a means through which individuals with a surplus can transfer funds to those with a shortage, financial markets facilitate the intermediation of savings into investment allowing consumption smoothing and funds for investment. They generate information on potential investment options that guides decisions as to the most productive allocation of resources. Through credit and insurance services, people's capacity to diversify and manage risk is enhanced and entrepreneurial behaviour and economic dynamism is encouraged. At an aggregate level financial markets provide a means through which scarce capital can be mobilised, nationally and internationally, and used for substantial investments. Specialist financial markets, for example housing finance or stock exchanges, enable people and firms to acquire assets as a basis for growth and/or higher incomes.

The obvious importance and centrality of financial markets has been one key reason why they are a focus for governments' and development agencies' attention. In relation to poverty reduction, financial markets are important in two related ways: growth and access.

Financial markets can be a powerful driver of economic growth – the most important determinant of poverty reduction. There is clear evidence to illustrate that a stronger financial system, by allowing resources to find their most efficient use, contributes significantly to growth.<sup>1</sup> At a firm level, limited access to finance is frequently cited by entrepreneurs as a major constraint to business performance.<sup>2</sup> Stronger financial systems are closely associated with new enterprise formation, growth and innovation. In particular, better-functioning financial markets tend to create new opportunities for those who previously had limited access, for example small firms – whose use of external finance is typically half that of larger firms (between 15% and 30% according to the World Bank's *Investment Climate Surveys*).

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Financial services used by poor people may be a direct contributor to poverty reduction. Safe savings services encourage people to accumulate usefully large sums which may allow them to plan their investment and consumption beyond the day to day. Access to appropriate forms of working capital encourages personal and business investments. Insurance services help to provide protection from income or expenditure shocks. Bank accounts allow people to receive remittances cheaply and safely. Use of these types of formal financial services is frequently regarded as a stepping stone to full inclusion in the mainstream economy.

Informally, of course, the poor often have their own financial institutions – savings clubs, funeral insurance or money guards.<sup>3</sup> However, the risks from the use of unregulated and informal mechanisms are often relatively high – for example, survey work in Africa found that many more clients in the informal sector reported that they had lost some of their savings, compared with the formal sector.<sup>4</sup> These factors have made the development of formal financial services for the poor a key public policy priority. In practice, the empirical evidence supporting a focus on the poor *per se* is slightly ambiguous (see below), but the wider benefits afforded by inclusion are acknowledged widely. For example, in South Africa, “access to financial services is an ID card, establishing economic citizenship”.<sup>5</sup> In general, expanding the access frontier for financial services is a core policy objective shared by governments and development agencies.

### Key challenges in developing financial markets: the M4P perspective

The central relevance of financial services to the task of poverty reduction has raised a number of critical issues and dilemmas for development agencies and governments.

For each of these, M4P, as an approach that is about understanding and then acting to change markets, offers either improved clarity in analysis or guidance for intervention, ie it is both about what agencies do and how they do it. M4P's value-added stems from, among other features:

- developing a transparent view of a market system and of the functions (core transactions, rules and supporting functions) and players within it;
- building interventions on the basis of a detailed understanding of markets and the poor within them;
- identifying underlying systemic constraints (and therefore distinguishing between symptoms and causes); and
- placing sustainability at the heart of the intervention process.

### Modernism and activism: which path to follow?

Many of the debates in financial services circles over how to act to promote more inclusive and better-functioning financial sectors are summarised in the “*modernism – activism*” debate (a phrase coined by Honohan and Beck).<sup>5</sup> These two perspectives on reform can be characterised as follows:

- *Modernism*: this perspective emphasises the importance of creating an appropriate enabling environment for large-scale finance, especially appropriate macro-economic management and the information, judicial, contractual and accounting frameworks impinging on finance. Encouraging competition is seen to be important and the role of government is regarded as limited. Efforts at reform often involve the development of suitable ‘best practice’ – often taken from higher-income economies. In developing a sound functioning market system for finance, modernists argue that the conditions for improved services for the poor will emerge.
- *Activism*: this perspective stresses reaching out directly to priority but excluded groups – low-income households, agriculture, small business, etc. A variety of special interventions are likely to be favoured – restrictive legislation, protection for consumer rights and support for a small number of quasi-commercial or community providers, such as village savings and loan associations.<sup>6</sup> A feature of past prescriptions has been interest rate controls to ‘protect’ the poor from the effects of untrammelled usury but this is less common now. In promoting separate measures for the poor, activists argue that a relatively laissez-faire approach will not address the problems of the excluded quickly, if at all.

### The M4P perspective: grounding interventions in the market system (now and in the future)

The modernist and activist views, while substantially different, share a number of features. The modernist view sets out a vision of how financial services should operate, emphasising mainstream private sector providers and the state in an enabling role as the designer and enforcer of key rules. While in general this might be considered a valid view of the future, in practice its institutional prescriptions tend to be:

- imported from international experience and fail to take adequate account of local context and the poor within this (eg the need to change deposit regulations to encourage providers for low-income groups); and
- rather formulaic and theoretical, failing (again) to appreciate the need to adapt to local constraints. For example, to play a more active role in promoting product development when providers' innovation record is weak or to build financial literacy programmes into market systems when a substantial proportion of would-be customers have little or no experience of formal financial services.

<sup>3</sup> Kennedy Bungane, Director at Standard Chartered Bank quoted in *Banking for change*, David Porteous with Ethel Hazelhurst, Double Storey, 2004, South Africa.

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Activism on the other hand tends to:

- respond to symptoms of weak performance directly rather than considering underlying causes;
- promote a 'do it ourselves' attitude that may be less patient in identifying and working with potential local partners, but does permit flexibility in initiating innovative new services. This is especially the case in weak environments where constraints are more severe and pervasive and light touch approaches to facilitation are less likely to succeed;
- support direct delivery – if not of services then of other supporting functions (such as product development, technical or marketing support) – often at a high cost;
- see longer-term market system sustainability as a distant concern – the implied view of the future is one with separate institutions for the poor and with no obvious way in which these can be mainstreamed.

An M4P perspective allows the more positive features of each of the above approaches to be adopted and their limitations to be addressed. It builds on a strong understanding of the local market and institutional context and of the poor within this – this is its starting point. It focuses interventions on the systemic constraints impinging on financial markets and it has no restriction on intervention type other than that these are consistent with pursuit of a sustainable vision of the future. It thus combines the overall strategic modernist analysis with the flexible operational means of activism to shape interventions appropriately.

### Growth or access: which is an appropriate focus for poverty reduction?

The evidence supporting a positive causal linkage between financial services' development, growth and poverty reduction is relatively strong. However, the arguments supporting a positive relationship between access and poverty are less well founded. Intuitively and anecdotally, financial services appear to be important in helping low-income households manage their lives better and plan a path to escape poverty. Yet there is mixed and limited evidence to link access with an improvement in household welfare. Indeed, finance may be more poverty-reducing when it is used by non-poor but still excluded people. In the context of formal usage rates of 10-30% in low income countries (compared with over 90% in the OECD), this group still makes up a sizeable segment of the population and it is argued that they are better able to use credit for productive purposes and thus contribute to growth.<sup>7</sup>

This efficiency versus equity debate has been given greater urgency in recent years by the spread of entitlement/rights-based arguments to finance; the view that basic finance, much like water or children's education, can be seen as a merit good and that policy-makers should aspire to provide universal access.<sup>8</sup>

### The M4P perspective: acknowledging how poor people benefit from financial services

M4P recognises that poor people can benefit from market development in a number of ways. In financial services this might be as direct consumers of formal services, for example as savers or as borrowers. Although evidence of direct poverty-reducing impacts is mixed, there are strong economic and social reasons for supposing that more inclusive financial access promotes a more cohesive and productive basis for other development goals.

However, financial services often impact most forcibly on the poor not in their capacity as direct consumers but indirectly through the labour market. More effective SME or agriculture finance can improve output and labour productivity and allow higher incomes for the poor as labourers/employees. Indirect effects may be less immediately tangible but they are often more important.

One corollary of this acknowledgement of the different routes to 'make financial markets work for poor people' is that M4P encourages choice and plurality in financial markets. Rather than focusing attentions on one (or one type of) provider, diversity and competition is encouraged. In particular, although 'providers for the poor' may be important, mainstream financial players are seeking to downscale to 'smaller' clients – for example, 50% of credit for the unbanked in Mexico comes from department stores. Inevitably this serves the most able and resourced of the excluded (and not the poorest) but is likely to provide the basis for larger-scale and more sustainable development.

In addition, as cash transfer schemes have become more popular among governments and donors as a means of getting resources directly to the poorest, so the financial services which may be provided as part of making the transfers (into an account for example) or linked to them (such as access to credit for productive purposes) are also receiving more attention.<sup>9</sup>

### How can subsidies be used to promote access?

The constraints preventing poor households from using financial services may be of various kinds – physical remoteness, arduous documentation requirements, inappropriate product design and delivery mechanisms, etc. Overcoming these problems and extending access dramatically often requires some public subsidy – initially at least. The question is: subsidy for what and for how long?

Conventionally, subsidies have been used to support the delivery of services to poor populations through pro-poor finance organisations – microfinance institutions (MFIs). Discrete, organisation-specific support for MFIs has been the main focus of development agencies for the last two decades. In

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that time the number of MFI clients (of organisations reporting to the MicroFinance Summit) has grown to 113m.<sup>b</sup> Yet, there are just eight countries where the proportion of the population covered by MFIs is more than 2%<sup>10</sup> and, although a precise figure is not available, only between one-quarter and a half of MFIs are financial sustainable.

Concerns over the efficacy of MFI-focused financial services development – both in terms of outreach and sustainability – has been one reason for the new emphasis on ‘inclusive financial sectors’<sup>11</sup> and, with this, renewed questioning of the purpose of subsidies to MFIs. Given the inherent high unit cost of delivery to poor households, do subsidies need to be general and long-term in duration? Should they be focused on organisational delivery or could they be aimed at the specific factors – for example, products, information, services, technology, etc – that hinder ‘normal’ commercial outreach?

### *The M4P perspective: using subsidies to extend the access frontier*

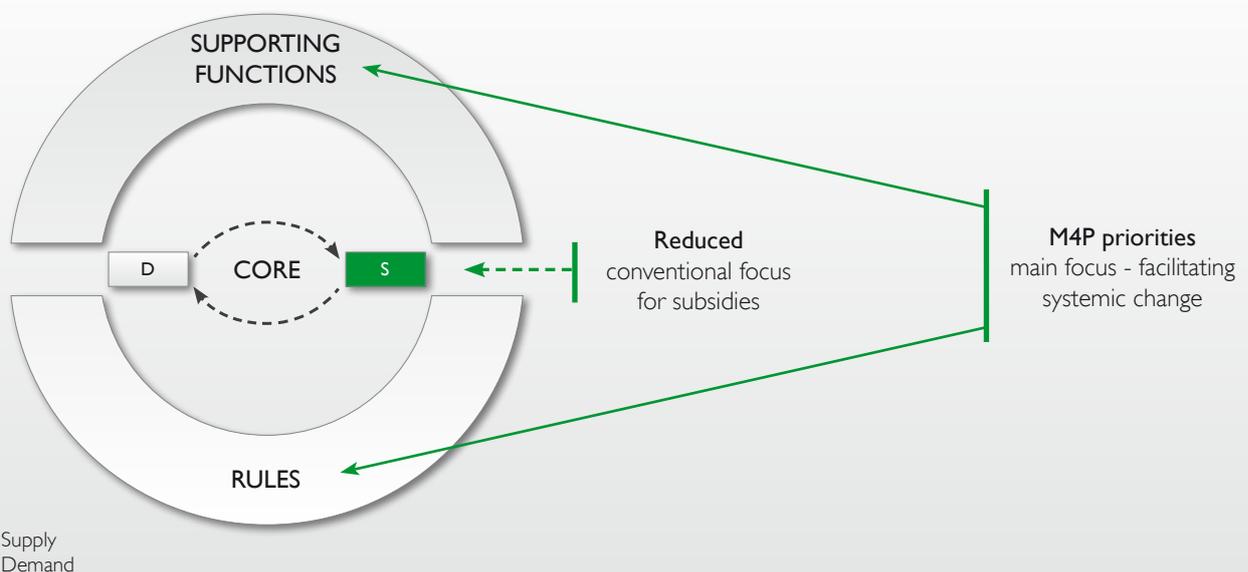
The success of MFIs can be assessed both in terms of the numbers of people benefiting from their services and, arguably more importantly, through the role they have played in changing global perceptions of the poor – from beneficiaries of charity to discerning consumers. In so doing they have helped to mainstream the poor, to bring them to the attention of ‘normal’ market players and to lay the basis for more fundamental change. However, beyond this, because of their limited outreach and widespread continued dependency on external subsidies, the wider impact of MFIs has been more questionable. M4P recognises the achievements and limitations of MFI-focused development and its approach to subsidies emerges from this context.

In M4P, the primary purpose and role of subsidies is clear: short-term and catalytic aimed at overcoming systemic constraints, developing market functions and in pursuit of a future picture of market sustainability. In practice this means that subsidies:

- are often aimed at constraints in the supporting functions and rules surrounding a core market (Figure 1) – for example, in the development of information, innovation and consulting services or the rules related to provision for low-income groups; and
- seek to develop sustainable provision mechanisms for these – rather than deliver directly.

In refocusing subsidies, M4P is aiming to extend the realistic frontier of access for financial market systems – defined by the existing level of knowledge, information and technology, etc. In this context, subsidies aim to create the space and opportunity to crowd-in more players (Figure 2). Direct subsidies may of course still be justified, especially in the weakest markets, and some argue that for basic bank accounts – which may be the point of entry to the formal sector and where finance has merit good characteristics – there is a justification for continued subsidy. But the overall direction of subsidy is clear; facilitating the market system’s development rather than supporting the operations of selected organisations.

**Figure 1**  
The key focus of interventions in financial services in M4P



<sup>b</sup> This represents the largest MFIs only reporting to the Microcredit Summit in 2006. The actual number is likely to be noticeably larger than this.

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**Figure 2**  
The access frontier<sup>12</sup>



### What should be the main elements in an 'environment that enables' effective financial services?

The 'holy grail' in financial services development is the creation of an environment that promotes the development of effective, inclusive and sustainable services. The main elements in such an environment are a key consideration for governments and agencies. In particular, what rules/regulations should be developed? How should these be enforced? And what information 'infrastructure' should be developed?<sup>13</sup>

The regulatory context is set by a number of 'rules' and the processes through which these are enforced – for example prudential regulation, anti-money laundering legislation and consumer protection – aimed primarily at protecting depositors and maintaining the stability of the financial system. An emerging challenge is the extent to which these rules can be adapted to reflect access objectives and the advance of technology-enabled services such as m-finance.<sup>6</sup> Furthermore, the regulations and enforcement mechanisms surrounding credit in particular – such as the performance of commercial courts, supervisory bodies, accountancy standards and land registries – impacts hugely on the performance of the sector. The information infrastructure for financial sector players can take the form of formal organisations such as credit bureaux, business consultants and consumer education programmes and, informally but still important, information on product ideas and processes.

The relative importance of rules versus information may vary – although it has been argued that, in a context where rules and enforcement are often difficult to change quickly, improving the information context is a more immediate and practical target for change. But clearly, both are important.

### The M4P perspective: bringing clarity to systemic change in financial markets

There is greater recognition that scale and sustainability in financial services requires change throughout the financial system. However, what systemic change means in practice is less clear.

M4P's market system framework provides a means through which improved transparency and clarity can be brought to bear on financial systems and therefore to the task of development. Beyond the core of the market – delivery of services from providers to consumers – the wider market system can be considered under the headings of rules and supporting functions – providing the market with its capacity to sustain change over a period of time. A range of possible rules and functions will be of more or less importance depending on the context, in each case focused primarily on risk mitigation, transparency, efficiency and cost reduction and innovation.

Many supporting functions will themselves be service markets – for example process, product and efficiency services offered through consultants. These can be assessed and developed in the same way as financial services markets as a whole. Indeed, it is necessary to do so if agencies, having appreciated the dangers of distortion and dependency in the financial services market, are to avoid a similar effect in these interconnected markets.

### What should be the role of government in promoting pro-poor functioning financial markets?

The centrality of finance in economies and the large externalities associated with it make government involvement necessary and important. But debates continue over what that role should be.

Direct government provision of services, although (in general) less common than before, still takes place and is considered important – especially in relation to savings. Government-directed credit through state banks is also still prominent, although the scope for political interference, delinquency and wider market distortion is widely recognised and few observers espouse this as 'best practice'.

Government's role in developing and enforcing an appropriate regulatory environment for financial markets is considered generally to be their highest priority, since it is essentially a role that only they can play. Less clear is whether governments should seek to influence the 'informal rules' that shape financial players' performance – for example through 'ideal' targets for access.<sup>14</sup> It is also unclear what role governments should play in the development of services associated with information, new technology or financial education. These are often undertaken as private services but, it might be argued, have sufficient public goods characteristics to merit government's continued involvement.

<sup>6</sup> The different experience of mobile banking in Kenya and South Africa bears testament to the importance of appropriate regulations. In the latter country, relatively restrictive regulation has curtailed competition and scale; in the former a relatively free regulatory environment has allowed major development, although its unregulated nature also raises risks for consumers.

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### *The M4P perspective: clarifying the role of government*

M4P requires that clarity is introduced in relation to the functions in the market systems and with respect to who plays (and pays for) these roles both currently and in the future. M4P does not provide a specific prescription on what roles government should play but in setting out a transparent framework it does offer a basis for more open scrutiny and analysis of roles.

This is particularly useful in considering what roles government should play in the future. The key principles underpinning the roles government should play – consistent with core competence, capacity and incentives – are well-known but still there are considerable differences between the roles of government in different contexts. Government's role with respect to the range of supporting functions is often most difficult to ascertain. Increasingly many of these functions – information, credit checking, product development, technology support, human resources – are provided by the private sector. Arguments can be made for a government role either as a temporary facilitator or more permanently. The advantage of M4P is that it forces these roles to be justified transparently and provides a platform for collective analysis and discussion between government and its stakeholders.

### Conclusions

The above arguments illustrate the relevance of M4P to the financial services market. M4P provides value first by offering clarity in analysis – a transparent means through which governments and development agencies can examine the overall market system and their own role in developing it. And second, given this clarity, by providing guidance for interventions.

M4P does not provide any unique insights into the many detailed technical debates in financial services relating to, for example, the specifics of regulations or of information requirements. It does, however, present a strategic framework within which these technical analyses can take place and within which they can be used. Moreover, since M4P is currently being used successfully in financial services market development in a variety of places, there is increasingly strong evidence for its relevance and applicability.

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## PAPER 3: M4P AND LABOUR

### Introduction

This paper focuses on the application of M4P to labour markets. It first establishes the importance of labour markets to growth and poverty reduction. It then discusses a number of key issues in developing labour markets and views these through the 'lens' of M4P. In doing so it outlines the value of M4P in relation to clarity of analysis in complex markets and shaping more pro-poor labour market outcomes.

### Importance and relevance to the poor

Labour is an important factor of production and labour force quality is recognised to be a vital determinant of competitiveness and growth: "labour force quality has a consistent, stable, and strong relationship with economic growth".<sup>1</sup> The relationship is a virtuous one: a quality labour force is an ingredient of competitiveness and growth, and growth provides the resources and incentives for societies, firms and individuals to invest in labour quality.

Strong global GDP growth (5.2% worldwide in 2007) has led to an increase in people in work <sup>a</sup>: 3bn people aged 15 years and above are estimated to be in work, a 1.6% increase from 2006 and a 17.4% increase since 1997, with Asia accounting for the majority of this increase. Productivity levels have been increasing more than employment levels. The global unemployment rate in 2007 remained constant at 6%.<sup>2</sup>

Labour is the principal asset of most poor people.<sup>3</sup> One way in which the poor can benefit from pro-poor growth is through their participation in the labour market. For many agencies therefore, overriding concerns are whether the poor have access to some form of employment and, consequently, the ability of developing countries to absorb growing numbers of new entrants into the labour market. For example, between 2005 and 2015 an estimated 106 million new entrants will join the rural labour force alone.<sup>4</sup>

However, developed countries' preoccupation with levels of unemployment in their own countries does not accurately reflect the reality of employment conditions in developing countries. Lacking the comprehensive welfare provision and social safety nets of developed countries, the poor cannot afford to be unemployed. They tend to be 'underemployed'<sup>b</sup>: the poor pursue a diversity of economic activities – often informal – in order to secure a livelihood. A key challenge for agencies is to understand how the poor participate in labour markets which differ markedly from those in developed countries (and even between and within individual developing countries).

Currently the 'working poor', ie those who do not earn sufficient to lift themselves above the US\$1 a day poverty line, are estimated by the International Labour Organisation (ILO) to number 486.7 million globally. Over one billion do not earn enough to lift themselves above the US\$2 a day line.

A second area of concern for agencies is the terms of the poor's participation in labour markets. These are concerned with, *inter alia*: levels of remuneration (eg minimum wages), working conditions (eg working hours, health and safety conditions), security of tenure (eg regulations concerning dismissal) and access to mechanisms for representation and redress (eg

<sup>a</sup> The ILO defines the expression 'in work' as all people employed according to the ILO definition, including the self-employed, employed, and employers, as well as unpaid family members.

<sup>b</sup> Underemployment is typically seen to include: sub-optimal productivity with land, labour, tools and inputs at workers' disposal; involuntarily working less than full-time; high-skilled workers taking low-skilled work; and overstaffing.

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rights of organisation and collective bargaining), as well as the elimination of forced and child labour. Most notably these are encapsulated in the notion of “*decent work*” promulgated by the ILO. Whilst most governments and agencies support core labour standards in principle, there is frequent disagreement about the extent to which they can be applied and enforced universally within labour markets in developing countries, and the effects of their application on access to employment and on economic growth.

A final consideration for agencies seeking to promote more effective labour markets for the poor is the changing ‘world of work’. Increasing levels of globalisation or integration, rapid technical progress and changing demographic trends impact on the way labour markets work around the world. As a result, patterns of work are emerging which differ considerably from the long-held ideal of formal life-long employment. These changes place new demands on labour, in terms of skills, mobility and adaptability. Agencies and governments are challenged to better understand the complexity of labour markets: the fact that there is no such thing as a homogenous labour market; the interconnection between labour markets and markets for other factors, goods and services; and – most critically – how the poor participate in labour markets.

It is not possible to cover such complexity within this short paper. Its focus therefore is on summarising key challenges in labour market development and the M4P perspective on them.

### Key challenges in developing labour markets

The centrality of labour markets to people’s livelihoods means that agencies and governments are confronted with a number of issues which can often be politically sensitive. These sensitivities can sometimes influence judgement and action.

M4P aims to bring impartiality to these difficult issues and to offer improved clarity in analysis and guidance for shaping more pro-poor labour market outcomes. This typically means:

- a better understanding of labour markets and reasons for the poor’s exclusion or disadvantaged position;
- stronger recognition of derived demand for labour and interconnected markets;
- a transparent and more pluralistic view of the labour market system, incorporating a greater diversity of functions and players, to enhance regulation, skills, information, mobility and representation in a manner that is suitable for developing country contexts.

### **Rural and urban labour markets and the migration ‘problem’**

Poverty is typically regarded as a rural problem. The poorest countries are predominantly agrarian and 75% of the world’s poor live in rural areas (883m people at US\$1 a day poverty level). Therefore, rural labour markets – and within this, agriculture – have historically been regarded as important for agencies and governments. Growth in agriculture is believed to be – on average – at least twice as effective in reducing poverty as growth outside agriculture. Agricultural growth reduces poverty directly, by raising farm incomes, and indirectly, by generating employment and reducing food prices.<sup>5</sup>

The reality of agriculture in developing countries is that annual returns per worker rarely exceed US\$750 (gross, before input costs).<sup>6</sup> Deshingkar and Farrington estimate that in South Asia, while agricultural labour underpins rural livelihoods, it is only available for two to three months a year.<sup>7</sup>

Agriculture is therefore only one part of the story of rural labour markets. Non-farm rural employment<sup>c</sup> typically accounts for between 20% and 50% of employment and 20-90% of income in developing countries.<sup>8</sup> In Bangladesh between 1987 and 2000 the proportion of workers involved directly in agriculture halved in response to greater rural non-farm opportunities.<sup>9</sup> Therefore rural labour markets are about a mixture of agriculture and non-farm livelihood activities.

The other significant dynamic in rural labour markets is migration. Limited agricultural returns, combined with new opportunities as a result of improved infrastructure and communications, have marked rises in migration. For example, in China rural–urban migrants increased from 26m in 1998 to 126m in 2004. The patterns of migration have also changed: there is a slowing of permanent migration and increasing levels of temporary or ‘circular’ migration. In Bangladesh 10% of rural migrants go to other rural areas, less than 25% to other countries and 66% to urban areas. Most of these return to their villages at the end of the working season; 80% of income is derived from outside the village. In Andhra Pradesh in India 40% of villagers commute daily to urban centres.<sup>10</sup>

Although rural poverty rates tend to be substantially higher than urban rates, it is increasingly recognised that poverty is not solely a rural phenomenon. UN-HABITAT estimates that between 2000 and 2030 2bn people will be added to urban areas of developing countries. Africa is experiencing the world’s most rapid rate of urbanisation.

In this context, the ability of urban labour markets to absorb swelling urban populations is a key concern for agencies and government. Consequently, they have frequently sought to limit migration on the one hand and stimulate employment

<sup>c</sup> Non-farm typically refers to activities that are not *primary* agriculture, forestry or fisheries. It does include trade or processing of agricultural products and services related to agriculture, forestry or fisheries (ie *secondary* and *tertiary* activities).

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on the other, through active labour market programmes (such as training, public works programmes, micro-enterprise development, job subsidies and job search assistance schemes) in both rural and urban labour markets. However, evaluations show that *“it is extremely difficult to address problems of large scale unemployment through active labour market programmes”*. If such programmes are to be effective they have to be targeted to specific groups on the basis of strong analysis. Even so, pay-offs tend to be modest: job search assistance or employment services appear to be more cost-effective than other labour market interventions.<sup>11</sup>

### **The M4P perspective: building support functions to expand choice**

M4P recognises the importance of a perspective which looks beyond labour markets. Demand for labour of the poor is essentially derived from the demand for goods and services they are involved in producing and is linked to the performance of the wider economy. The labour market is also closely related to other factor markets, such as land and finance. Consequently, the labour market's poverty-reducing effects are inseparable from the effectiveness of measures to improve the wider economy and to strengthen pro-poor growth patterns in both rural and urban contexts.

Most significantly, this means that M4P interventions are often indirect: initiatives to strengthen other factor and product markets in turn impact on the operation of labour markets. Market choice and analysis is crucial therefore. In pursuing market development strategies governments and agencies need to identify markets with pro-poor opportunities and ensure that their interventions do not unduly encourage unwarranted substitution of capital for labour.

Employment patterns in agriculture are not homogenous. For crops or livestock which require ample land, farmers typically rely on family labour because the supervision cost of hired labour is often too high. Conversely, those that require less land are more amenable to factory-style operations and tend to see higher levels of hired employees, eg horticulture, floriculture, aquaculture, pigs and poultry. There is greater scope for employment generation in these higher productivity activities.

Strengthening non-farm markets and links between rural and urban areas are also of critical importance. Processing, trading, distribution and other ancillary services, such as transportation, are important to raise agricultural productivity, but are also a source of employment in their own right. A key priority of M4P intervention is often these kinds of supporting functions around core agricultural markets.

Another key area of focus stems from the recognition that migration is inevitable and important. Interventions are required to strengthen market functions which can enable migration, not artificially restrict it. Migrant labour is a compensating mechanism used by disadvantaged households and is a vital dimension of addressing rural poverty. For example, the daily wage of a migrant worker in India is between 47% and 76% higher than wages in their village of origin.<sup>12</sup> In Bangladesh the proportion of families receiving remittances in 1999-2000 was 21%; in 1987-88 it was only 11%.<sup>d 13</sup>

Migration can also free up agricultural markets. It allows those who are less willing or able to pursue productive agriculture to move into alternative livelihoods, releasing resources for those who are more motivated or capable. For example, Afsar identifies a link between migrant remittances, land purchases and levels of land tenancies; migration stimulates land tenancy, providing additional access to land for land-poor households.<sup>e</sup>

The emphasis of M4P intervention is to recognise that for poor people their livelihoods are often multi-locational. The capacity of the poor to shift livelihoods is therefore critical and evidence suggests that networks and contacts are critical to achieving this. According to Deshingkar and Farrington, interventions therefore need to ensure that people have *“an environment where they can make choices”* rather than clinging to own-account production in situ, which has often been the implicit focus of rural development: *“mobility needs to be supported through the development of migrant-friendly services”*.

M4P intervention priorities (Box 1) include: mechanisms to reduce the costs and risks faced by migrants (eg information, transportation, insurance and tenancy); ensuring entitlements to state services are portable; and promoting the efficiency and security of income remittances. These interventions must be complemented by significant improvements in rural education to enable the transition into more skill-intensive employment and successful migration.

### **Box 1 Interventions consistent with M4P priorities**

For example, China has now removed requirements for migrants to have permits to move to cities and Vietnam has eased its registration rules. In India mobile ration cards are being piloted in Rajasthan whilst in Madhya Pradesh, DFID is funding a migrant support programme to enhance information about work opportunities and improve skills to increase migrants' bargaining power.

<sup>d</sup> It is estimated that every hectare of cultivated land adds an average of 16% to annual household income. Every month of migrant labour adds an average of 7% to annual household income p.a. That is to say, two months of migrant labour is equivalent to the contribution of one hectare of cultivated land (the average land-holding of migrant households).

<sup>e</sup> Very poor households, however, may continue with a level of agricultural activity even if its productivity is low and higher potential non-farm opportunities are available, as a means of ensuring food security.

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### Dualistic labour markets

Labour markets in developing countries are commonly believed to be dualistic. They are segmented between those workers in formal employment enjoying high wages and benefits mandated by legislation and those employed informally who lack job security and related benefits. The latter category includes (a) the self-employed; (b) waged workers working for informal firms; and (c) contract workers who do not receive a regular wage but are paid on commission or percentage, piece rate or fixed contract.

The informal sector is typically characterised in terms of its ease of entry and exit, its reliance on indigenous resources, family-operated enterprises, small scale, labour intensity, use of adapted technology, skills acquired outside the classroom and non-compliance with regulations. Concerns about the informal sector tend to centre on the issues of the 'protectedness' of workers and the size and legality of employers.

A key debate is the extent to which the informal sector is merely a mechanism – like a sponge – for absorbing residual labour which cannot find work in the formal sector, or whether it is an efficient and dynamic sector in which workers choose to participate.

- The sponge argument is that in developing countries the rapidly expanding labour force cannot be wholly absorbed by the more productive and remunerative formal sector and consequently workers end up in the informal sector as a last resort. This results in pronounced 'insider-outsider' segmentation: for two similar employees, the insider in formal employment will receive a comparatively higher wage (and benefits) than the outsider in the informal sector.
- The alternative view is that the informal sector is a dynamic source of entrepreneurship. There are sound reasons for workers to prefer informal employment in the face of inefficiency and rigidity in the formal sector: Restrictive labour regulations and taxes raise the cost of entry to the formal sector; low levels of education and productivity in the formal sector depress earnings. Consequently the opportunity cost of being informally employed is reduced. Research<sup>14</sup> from Mexico found that 60-70% of the informally self-employed preferred their status to formal employment as it brought them greater independence and higher earnings: *"Earnings differential and patterns of mobility are consistent with much of the informal sector being a desirable destination and with the distinct modalities of work being relatively well integrated. There is little evidence to support the traditional dualistic view as the principal paradigm through which informality should be viewed."*<sup>15</sup>

Government and agency responses have tended to focus on formalising the informal sector; often through prohibition of informal activity and support for formalisation. However there is no clear evidence that increasing or decreasing formalisation improves or worsens the welfare of the poor.

### *The M4P perspective: reducing segmentation and increasing mobility*

The M4P perspective is that informality is a reality. The informal sector accounts for over half of employment in many developing countries. The bulk of new employment has come from the informal sector, with women accounting for 60-80% of informal sector employment. The informal sector *"is not a transitory phenomenon in the development process... it is recognised that formal and informal sectors will cohabit and are very much interlinked in subtle and complicated ways."*<sup>16</sup>

Formality and informality co-exist in different proportions in different countries and within countries. Different sets of institutions can create different types of informality, encompassing that which is voluntary and involuntary and workers of diverse calibres in terms of occupation, skills and remuneration.

The priority focus of M4P intervention is to reduce exclusion by strengthening labour market systems to provide the poor with choice, mobility and capacity to build their livelihoods in response to a changing spectrum of opportunity.

M4P's starting point is understanding the dynamics, institutions and incentives of specific labour markets and the nature of the poor's livelihoods within those labour markets (and markets connected with them). In particular, to differentiate between the symptoms and causes of informality and segmentation, and investigate whether segmentation results in outcomes which are suboptimal for the poor:

Labour market analysis and information is therefore critical to this objective, but typically lacking in developing countries. This inhibits effective decision-making by policy-makers, employers and workers. For example, labour force surveys tend to assess primary occupation only and ignore secondary activities in the informal sector. M4P intervention is based on realistic analysis of labour markets, but also seeks to improve the ability of the market system to conduct appropriate labour market research and information provision in the future – ie, a supporting function of the market.

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More specifically, this means understanding:

- **Market dynamics:** In particular labour force growth relative to economic growth. If the proportion of formal sector workforce is increasing as a proportion of total workforce as a result of growth, the proportion of the labour force engaged in involuntary 'sponge' informal activities declines, leaving a more vibrant and productive informal sector intact and reducing segmentation. Conversely, if formal sector employment is reducing as a proportion of overall workforce, involuntary informal activity increases to absorb a growing residual labour force, increasing segmentation.<sup>f</sup>
- **Underlying causes of segmentation and its effects on the poor.** Segmentation may arise for a number of reasons:
  - State support. For example urban workers in China, usually employed in state and collective sectors, have preferential status as a result of restrictive residents' registration laws which restricts competition from rural migrants.
  - Organised workers. For example in South Africa, organised labour is powerful as a result of strong links between political parties and trades unions. The union premium on wages is high and has risen in spite of rising unemployment. Informal sector wages are approximately 60% of those in the formal sector. Similarly, the wages of private sector teachers in India are approximately half of (politically powerful) public sector teachers, despite evidence that private teachers are more effective in terms of higher academic results achieved.<sup>g</sup>
  - Economic forces. Larger firms, due to their managerial style or technology employed in production, require committed, quality workers and can pay a premium, often reinforced by their monopsonistic power in the labour market.
  - Distribution of political influence. Urban residents typically earn more, partly as a result of better opportunities, but also as a result of stronger political voice.
- **Incentives:** The relative costs and returns of participating in the formal sector versus those of informal sector activity. Evidence suggests that higher calibre workers tend to enter the informal sector voluntarily and get higher returns in the informal sector than in the formal sector. Lower calibre workers tend to be involuntarily employed in the informal sector as a result of market segmentation. For example, in Brazil there is high mobility between sectors: 50% of informal workers in any given year will be formally employed the following year.

The focus of M4P intervention is not to support blanket formalisation of the informal sector. Intervention needs to be driven by a clear understanding of why specific labour markets

are not working for the poor; in particular, the efficiency of labour markets and the extent to which informal activity is voluntary or involuntary. A key priority is to reduce labour market segmentation and increase mobility by reducing the costs of entry into the formal sector rather than penalising informality with a view to reducing it. In addition to improving labour market research and information, this may entail strengthening market system functions which assist in enabling mobility and graduation towards formality: for example, recognising informal associations and promoting access to functions or facilities, such as property tenure, which can serve as stepping stones to formal recognition.

### Security versus flexibility

Perhaps the most polarised debate in relation to labour markets is centred on the issues of security of employment and the flexibility of the workforce. In an increasingly competitive and integrated world, there is pressure on economies, firms and their workforces to be as flexible and efficient as possible. An excessively regulated or rigid labour market is regarded as inhibitive to competitiveness (see, for example, the World Bank's *Doing Business* assessments).<sup>17</sup> Conversely, there is a concern that the rights and conditions of workers have been eroded as a result of global competition and excessive deregulation of labour markets (see, for example, the ILO's critique of the *Doing Business* indicators).<sup>18</sup>

Conventionally, 'pro-labour' interventions have focused on the ratification of core labour standards by developing countries and their incorporation into employment protection legislation. This is often accompanied by large-scale information campaigns to raise awareness and support to organised labour. 'Pro-business' interventions focus on support to developing country governments to conduct regulatory analysis and reform aimed at streamlining employment protection and liberalising the labour market.

### The M4P perspective: alternative ways to improve standards

Sharply divided ideological debates tend not to deliver benefits to the poor. Reality is inevitably more nuanced. The M4P approach is concerned with the effectiveness of markets. Inappropriate regulation is often a cause of market outcomes which do not serve the poor, but improving those markets does not always mean deregulation: it often means better regulation. Equally, M4P recognises that labour is important to the poor and is concerned with improving the poor's access to labour markets and their terms of engagement within labour markets. However, in weak market situations it is not always possible or desirable to impose labour standards in a formulaic manner.

<sup>f</sup> Examples and data are from Ruffer & Knight, 2007.

<sup>g</sup> This is also an example of a different manifestation of the insider-outsider problem: protection of (relatively well-off) workers at the cost of affordable or appropriate goods and services for (poorer) consumers.

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The main concern of M4P is to promote access to employment and overcome exclusion as a result of insider-outsider problems. In developing countries a characteristic of many markets with protective legislation is that they often favour insiders at the cost of outsiders. These markets tend to deliver favourable terms to the minority to the detriment of the majority, an advantage that is vociferously defended by the privileged (and often powerful) minority. Parallels can be drawn with the provision of water: supply to the formal and middle-income sectors is subsidised whilst the informal and poor pay substantially more per unit consumed. Some forms of labour market regulation can have this characteristic.

For example, unemployment in Croatia is high and rising; in the 15-24 age group the unemployment rate is over 40%. The problem is symptomatic of slow job creation, which in turn is a manifestation of barriers to entry to new firms and expansion of existing firms. Strict employment protection legislation (EPL) increases the cost of formal sector labour and job creation is slowed by uncompetitive unit labour costs. EPL in Croatia is much stricter than in countries with flexible labour markets (and low unemployment), such as Hungary. Relatively high wages are not explained by higher productivity or by payroll taxes. They result from wage pressure exerted by insiders – workers with protected, secure jobs and in a strong bargaining position – employed in large state-owned or privatised enterprises. By inhibiting job turnover, strict EPL hinders productivity improvements and ‘protects’ existing employees at the expense of the continual stream of new entrants into the labour market.<sup>19</sup>

Clearly, poor working conditions and exploitation are prevalent in developing countries. An M4P approach challenges governments and agencies to understand why those conditions exist and think realistically about how they can be addressed.

This partly entails assessing the extent to which regulation actually achieves objectives of promoting access to better work for the majority. Intervention should support labour standards and codes of practice whose direct and indirect effects are understood and carefully judged from a pro-poor perspective.

M4P recognises that in most developing countries only a small proportion of workers are formally organised and protected<sup>h 20</sup> and the capacity of government to enforce employment protection legislation, even when it exists in the statute books, is often limited. It is not simply a question of importing standards and practices from developed economies.

M4P seeks to promote ‘right-sized’ solutions which offer better prospects for effective and sustainable implementation and which might serve as stepping stones towards more sophisticated labour market regulation in future.

These might focus on improving accountability and transparency in labour markets and raising awareness of workers’ rights through non-regulatory mechanisms. This might entail trying to change the mindsets of employers and their representatives (including the informal sector) about the business case for better employment conditions, or strengthening workers’ representatives organisations (again, including the informal). However it might also focus on developing supporting functions such as information provision, advocacy and scrutiny by third parties, for example the media (Box 2).

### Box 2 Improving labour market functioning by media development

In 2003 British American Tobacco (BAT) faced a major problem with its outgrowing scheme in Uganda. More than 25,000 small-scale farmers were producing increasingly poor quality and yields. What BAT’s senior management in their Kampala headquarters did not know was that the relationship between farmers and BAT buyers in the field had broken down completely.

Farmers accused the buyers of widespread rent-seeking that reduced their incomes, making tobacco an unprofitable crop. Farmers were opting out of tobacco growing, potentially destroying a supply chain vital to the incomes of rural communities.

A local commercial radio station uncovered and investigated the story. It ran and recorded a village-based debate on the issue. Despite threats of violence from local BAT buyers the station persevered and ran a series of programmes on the issue. The station followed up the story by travelling to Kampala and presenting its findings to BAT’s senior managers. Their response was immediate. An enquiry was undertaken and within a year BAT had restructured its operations, in the process making the majority of its field staff redundant. BAT altered its policy on communications, investing in local radio as a means of both conveying information to their outgrowers and providing platforms to allow the outgrowers to discuss issues and problems. Interest in tobacco growing has been rejuvenated, with farmers tripling the income they make from tobacco. The number of outgrowers has increased to 47,000 and tobacco quality has risen.<sup>21</sup>

<sup>h</sup> South Africa has the highest rate of unionised labour (34%) of any developing economy; the level of organised labour is much lower than this in other countries. The OECD average is 43%.

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### Skills development

In the modern world of work, skills are regarded as a passport to success – people are required to work smarter, not just harder. Workers need to be flexible, adaptable and mobile, which means that they need to acquire and maintain skills throughout the course of their working life – ‘life-long learning’. Education systems in developing countries, however, have struggled to keep up with this need for dynamism, in terms of relevance to the needs of the labour market as well as achieving the coverage that expanding labour forces require.

A conventional response has been to see this as a problem of scarce resources. Improving education, it is argued, requires massive increases in public funding. Agencies have provided billions of dollars to developing countries to fund education (the Commission for Africa recommends US\$7-8bn per year). Some observers are concerned about the efficacy of this approach, partly in terms of the long-term sustainability of finance and partly because funding *per se* does not necessarily lead to reform and performance improvements in education systems.

*“The accepted wisdom is wrong. It ignores the reality that poor parents are abandoning public schools en masse, to send their children to ‘budget’ private schools that charge low fees – perhaps one or two dollars per month, affordable even to parents on poverty-line wages. In the shanty towns of Lagos, Nigeria, for example, or the poor, rural areas surrounding Accra, Ghana, or the slums of Hyderabad, India, the majority of schoolchildren – between 64 and 75 per cent – are enrolled in private schools. Even in remote areas of China, huge numbers of private schools exist off the official radar.”*<sup>22</sup>

Tooley’s research indicates that these private schools for the poor are superior to government schools: teachers are more likely to be teaching when called upon unannounced in their classrooms; private schools are generally better equipped with drinking water and toilets; academic achievement (based on testing of 24,000 children) is much higher, at a fraction of the per-pupil teacher cost. Teacher’s salaries – the largest recurrent expense of most schools – are approximately a quarter to a third lower in private schools than in government schools.

Similarly, there are concerns about the coverage, relevance and sustainability of systems for vocational skills development (ie post-school education). Many existing systems are failing to serve large parts of the potential labour force, particularly young people, the disadvantaged and the informal sector, or to equip workers for the new realities of work. For example, the OECD’s 2008 African Economic Outlook<sup>23</sup> surveyed 35 countries and found that formal *“technical and vocational skills development systems in Africa suffer from a shortage of qualified staff, obsolete equipment, ill-adapted programmes and weak links with the job market. Very few countries emphasise skills development in the informal sector, the largest employer and source of training in Africa.”*<sup>24</sup> The research also indicates that private sector training

and, particularly traditional apprenticeship in the informal sector, predominates: the formal system typically accounts for less than 5% of trainees.

Reforms of vocational skills development are partly inhibited by ideological concerns. As with mainstream education, in spite of emerging realities on the ground many view education as a universal ‘right’ which should always be publicly provided, not entrusted to the private sector.

There is also a perceived tension between ‘quality’ and ‘quantity’. Conventional vocational skills development systems have been geared to comprehensive and intensive courses, usually of a lengthy duration, academically oriented and delivered by formal public training centres (usually in urban areas), of ‘high quality’ and often modelled on developed country models. The outreach – ‘quantity’ – of such courses is limited by their cost and public budget constraints. There is a concern that in seeking to expand access to vocational skills courses quality is diluted.

### *The M4P perspective: exploring better public–private alignment of roles*

The M4P perspective is that a heterogeneous workforce cannot be served by a homogenous system of education delivery. Reforming skills development systems so that they work better for poor people means stimulating systems to become more pluralistic, decentralised and responsive to the demands of the labour market and to offer different products relevant to the requirements of different user groups, through diversified delivery systems and more appropriate mechanisms for certification, governance and finance. This typically entails government shifting from a comprehensive role as legislator, standard setter, curriculum setter, financier and monopoly provider to a more focused role, establishing the framework for service provision, ensuring standards and providing targeted finance to the most disadvantaged groups.

The first challenge is understanding how specific labour markets work, and how vocational skills systems need to meet the needs of those labour markets more effectively and better serve poor people in – or potentially in – those labour markets.

This means understanding the informal sector. Poor people in the informal sector need skills, but their pattern of work and the way they learn is often different from those in formal education or employment. Poor people cannot devote lengthy periods of time to full-time learning; they often need to study after they have completed a full day’s work or at intermittent intervals. Moreover, poor people often acquire skills on the job, which are not recognised by formal systems of occupational certification. Based on this understanding, a variety of different functions need to be reformed and players re-aligned (Box 3):

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- Product development needs to be 'right-sized' to better reflect the needs of poor people. This doesn't mean a reduction in quality *per se*, but it does mean courses which are less academically oriented and structured more flexibly to reflect different patterns of work and styles of learning: for example, modular courses offered outside normal working hours. Work placements are also important.
- Delivery needs to be decentralised and diversified. Flexibility and close engagement with employers is not easily achieved within rigid public sector hierarchies. Increased levels of localised service delivery, which permits autonomy and accountability to users (students and employers) are essential. This is often achieved through greater private sector provision, be that for-profit or non-profit. Increased choice and competition between training providers is usually desirable.
- Certification of skill needs a more competency-based approach, assessing and certifying skills acquired on the job, rather than relying on completion of formal courses.
- Coordination mechanisms which bring together employers, service providers, workers' representatives and governments to identify critical skills gaps and enhance the relevance of skills development to the labour market.
- Standards and quality control. The public nature of education requires that government set an appropriate framework of standards, performance benchmarks, measurement and information provision, to allow users to scrutinise service providers.
- Diversification and innovation in finance. Reforming and extending skills development systems inevitably demands additional resources: it is necessary to expand resources within the skills development system. M4P is careful to distinguish between temporary, transitional costs and recurrent costs. It may be legitimate for agencies to contribute to the transitional costs of reform but if agencies cover recurrent costs, sustainability problems are likely to be encountered. Recurrent costs need to be met within the system. Given public funding constraints, this typically means increasing contributions from users (students and employers) and other forms of revenue-raising by autonomous service providers. Government may need to continue to provide some form of finance for delivery, particularly for the most disadvantaged, but do so in a more targeted way – eg vouchers – to build their sovereignty as consumers over a choice of service providers.

### Box 3

#### Reforming the vocational education system in Peru

In Peru, government recognised that it couldn't expand outreach in its vocational education system to disadvantaged groups with its existing monolithic structure. A more autonomous and multi-party system was required, encompassing service providers, service users, employers and government.

The Ministry of Education permitted a pilot initiative implemented by an SDC-funded project to test a different approach. Government training centres were given greater autonomy to deliver training and to pursue revenue-raising activities, creating incentives for centre managers and students alike. Governing bodies were established for training centres which included representatives of local industry, workers and civil society. A recruitment search and placement function was also developed within centres, which required the participation of the Ministry of Labour.

The existing vertical hierarchy was transformed to a more decentralised structure, incorporating a network of autonomous training centres, with centres supported by the project encouraged to support other centres across the country. Government's role in the system was more narrowly focused on standard setting, coordination and finance.

After eight initial pilot training centres, another 60 centres adopted the approach and a further 200 initiated reforms along similar lines. Post-training employment rate of students (300,000 trained per year) increased from 28% to 53%. Job placement was also a success, with 100,000 placement requests a year, 75% of which were matched. The successful pilot became the blueprint for the Ministry of Education's reform of the vocational skills development system.<sup>25</sup>

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### Summary

Because labour is the key asset of the poor, for M4P to be generally relevant to the lives of poor people it is vital that it has application and utility in relation to how they can use their labour more effectively in labour markets. The above arguments illustrate the relevance of M4P to the labour market and the general ways in which it can offer value, first by offering clarity in analysis – a transparent means through which governments and agencies can examine the overall market system and their own role in developing it – and second by providing guidance for interventions.

More specifically, M4P offers insight into how steps can be taken to build support functions, to reduce segmentation and increase mobility, to use alternative means of improving standards and to explore improved alignment of public–private roles in the labour market system. Examples show the types of benefits that can be achieved by utilising the M4P approach and the potential for further large-scale change from more widespread application.

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## PAPER 4: M4P AND LAND

### Introduction

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This paper focuses on the relevance and application of M4P to land market reform. Land is a complex issue. It often goes to the root of social, political and economic structures and processes. It is an emotive issue with deep psychological resonance for many. Land is central to the livelihoods of the poor, and central therefore to the poverty reduction challenge. This paper considers the role land plays in the livelihood strategies and outcomes of the poor. In this context, it then concentrates on three specific dimensions: access, security of tenure, and interconnectedness with other market systems. The relevance and application of M4P is explored at each juncture.

### Importance and relevance to the poor

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Economic growth is faster in countries where the initial distribution of land is more equally shared, and growth tends to accelerate and be more inclusive when people can access land fairly and efficiently, and when land tenure is secure. Put simply, land is fundamental to the livelihood strategies of the poor.

Three-quarters of the world's poor live in rural areas and are largely dependent on agriculture, whether for subsistence or sale. Access to land, and conditions that determine access, strongly influence the returns in agriculture, which in turn is the key factor in determining livelihood outcomes. Agricultural growth and poverty reduction depend significantly on increasing agricultural productivity. There is widespread evidence that, whether a tenure system is communal or individual, freehold or leasehold, farmers are more likely to invest in their land – and achieve productivity gains – when they have secure land rights.

Land is not only a key determinant of household welfare; it often constitutes the main element in households' asset portfolios. In Uganda, for example, land is estimated to constitute 50-60% of the total asset endowment of the poorest households.<sup>1</sup> Labour is the other main asset of the poor. Those households with access to land are generally better placed to make the most productive use of their labour.

For land reform to have a significant impact on poverty reduction it must be part of a broader process of political, social and economic change, rather than a narrow intervention simply to redistribute land (Box 1). The pace of land reform cannot reasonably run ahead of advances in other related areas, especially the provision of infrastructure (water, power and communications) and services to small-scale farmers (credit, input supply, marketing and adaptive research). Nor can it run ahead of the capacity of governments to play appropriate roles in different, related market systems.

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### Box 1

#### Linking land rights to agricultural reform and rural development <sup>2</sup>

The poor can only realise the benefits of more equal land distribution and secure land tenure if they can also participate in wider development through:

- better access to input and product markets, including savings and credit;
- appropriate technologies for higher, sustainable productivity;
- education and the skills to use the new technologies;
- opportunities to diversify both within and beyond agriculture;
- for the landless, being able to access land;
- improved tenancy and sharecropping arrangements;
- protection of rights and development of opportunities for agricultural workers;
- equitable opportunities for private sector development, eg in high-value crops for export;
- better terms of trade for developing country agricultural producers.

### Key challenges in developing land markets: the M4P perspective

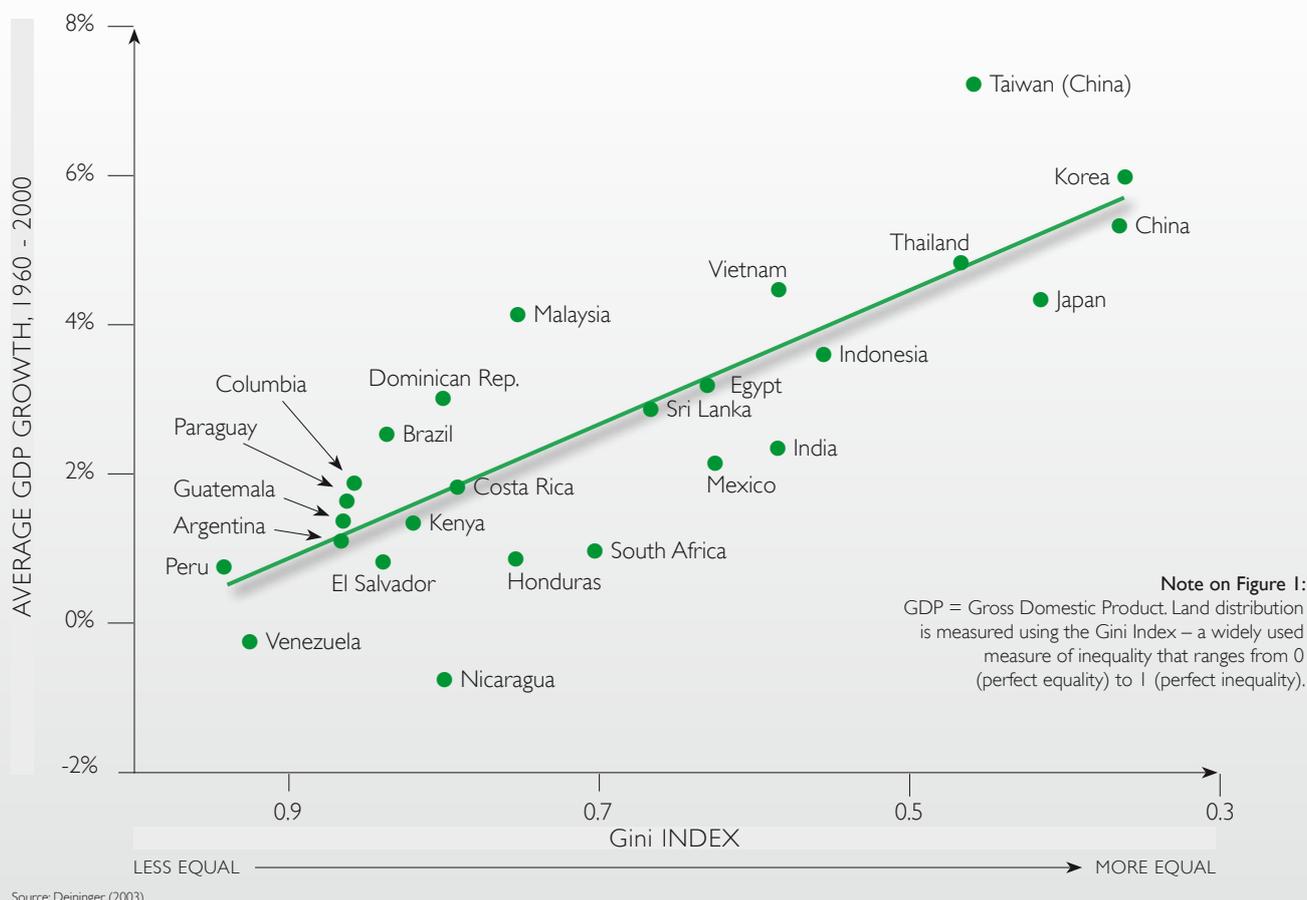
Given the breadth and complexity of issues linking land, livelihoods, growth and poverty a comprehensive discussion is beyond the scope of this paper. The focus here, therefore, is on summarising key challenges in land market development, and the M4P perspective on these:

- access to land;
- security of land tenure; and
- the interconnectedness between land and other markets.

#### Access to land

Patterns of land allocation affect the efficiency and growth of agricultural production. Figure 1 confirms that between 1960 and 2000, countries that had a more equal distribution of land tended to be characterised by higher levels of economic growth. This fact, combined with the social and political importance of land, has motivated governments in countries where, often for historical reasons, access to land was highly unequal, to intervene in the functioning of markets through land reforms that aimed to equalise the ownership distribution of land.

**Figure 1**  
Initial land distribution and economic growth, selected countries (average GDP growth, 1960-2000) <sup>3</sup>



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Interventionist land reform involves the transfer of ownership from a ruling class to tenant workers. Hence, it is not surprising that most large-scale land reforms are associated with revolts (Bolivia), revolutions (Chile, China, Cuba, El Salvador, Mexico, Nicaragua, Russia), conquests (Japan and Taiwan [China]), the demise of colonial rule (eastern India, Kenya, Mozambique, Vietnam, Zimbabwe), or the end of major wars (Hungary and much of Eastern Europe). Attempts at land reform without such massive political upheaval have rarely succeeded in transferring much of a country's land or have done so extremely slowly because of a lack of political commitment to provide the funding to compensate owners.

Land reform might be born from revolts and revolutions but the process of reform is often long and complex. Maintaining political commitment and consistency in reform processes is a key and constraining issue. Over time, land reform can become a lever for securing political support, whereby land is used to reward the party faithful. Issues of equity, efficiency and welfare are lost or at least confused.

Recognition of the limitations of land markets in an environment characterised by multiple weaknesses in other factor markets has prompted some policy-makers to impose restrictions on their operations. For example, access to working capital (eg to acquire inputs) is, in part, dependent on initial wealth. Therefore, differential access to finance will often result from inequitable land holdings even if land markets are operating efficiently.

### *The M4P perspective: aligning poverty reduction objectives with strong analysis*

Ultimately, M4P is a process that is concerned with 'outcomes' and takes an evidence-based approach to determining which form of solution delivers the best poverty-reducing results in any given situation. Inequity, power relations and weaknesses in related markets (particularly credit) are all strong rationales for intervening actively to reallocate land-holdings. However, whilst there have been some successes, there have also been many failures and the observed impact on poverty of land reform has often been limited.

An M4P perspective might observe that much of the inequality in land ownership distribution actually has its origin in interventions motivated by political/social justice concerns which view 'markets' in a suspicious or hostile light. In spite of, or perhaps because of this, policy-makers have often assumed that markets will not be able to help correct, and may even reinforce or worsen, pre-existing inequalities in land access or ownership. However, three main factors are changing these perceptions:

- State allocation of land is often highly politicised with many government-sponsored land redistribution programmes

failing to meet expectations. This suggests that, at least in some situations, government's role in land market systems may be as problematic as any other 'failures'.

- Administrators may be unable to observe producers' agricultural ability and thus give land to households that are unable to make the best use of it. Recent evidence from a number of countries suggests that rental markets transfer land to the poor and more productive.
- There is evidence that, even in situations where land was successfully redistributed, constraints on the functioning of markets may limit beneficiaries' ability to realise the full gains from such reforms by transferring their use or ownership rights.

Given the importance of land access for the efficiency of agricultural production and household investment incentives, how land is distributed and the way in which markets for land function has important implications for food security and income growth, and thus the broader development process at both the household and the national level. However, if land generally is important, it is less clear which land markets matter most, for example sale and ownership, rental or sharecropping.

For land sales markets, the land markets principle of 'willing buyer-willing seller' is one promoted by DFID and many other agencies. This is a perfectly legitimate principle supportive of basic personal freedoms and rights. However, if one accepts a starting position of inequality in ownership and structural imperfections in inter-connected credit markets then it is clear that whilst there may be many 'willing' buyers amongst the poor, there won't be as many 'able' buyers!

Of course, in reality households access land through a variety of mechanisms – not just land sales. Rental markets and sharecropping, in particular, often provide an opportunity to adjust to credit imperfections in a flexible way with at most moderate productivity losses.<sup>4</sup> For example, in Colombia findings show that sales markets did not increase access to land by producers who were more productive and who own less land. However, the same research findings showed that land rental markets did increase such access.

This picture is highlighted further from recent research in China which found not only that, in terms of quantity, rental markets have become more important than administrative reallocation, but also that markets tended to transfer land to more productive and poorer households.<sup>5</sup> In other words, land markets were better than bureaucrats in transferring land to poor and more efficient producers – those with small land endowments and high levels of agricultural ability. The implication is that land markets can – and do – contribute to higher productivity and greater equity.

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Sharecropping/share-tenancy is a particular form of land rental market. Much tenancy legislation is rooted in a misconception that share tenancy is necessarily inefficient and that landlord–tenant relations are inevitably exploitative. A substantial literature now corrects these misconceptions.<sup>a</sup> Share-tenancy often represents an efficient ‘second-best’ response to missing, thin and imperfect markets for land, credit, labour, management, information, and insurance. Further, it often performs some important functions which would otherwise have to be fulfilled by other institutions (social protection for example). It is neither necessarily inefficient nor a barrier to the adoption of new technology. Tenancy contracts are often part of a series of interlinked, interdependent contracts in a number of factor markets (land, labour, credit). They are not necessarily exploitative, but where they are, owing to the unequal bargaining power between agents, attempts to ‘fix’ relations in one sphere can lead to compensatory shifts in other contracts to leave tenants worse off overall.<sup>6</sup>

In light of this, and as a result of weaknesses in credit markets, accessing land through rental arrangements will generally offer the following benefits:<sup>7</sup>

- 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 sub-letting (or alienation) of the land.

By putting the poor at the heart of the development process, an M4P approach would seek to understand opportunities and constraints for the poor to access land. Often this means moving beyond understanding economic transactions to analysing informal and deep-rooted social conditions and institutions. From this position of enhanced understanding, an M4P approach would seek to intervene sensitively and pointedly to improve the flexibility, efficiency and equity of land access.

### Security of land tenure and productivity links

As shown above, access to land is a necessary, but not sufficient, step for increasing land productivity. Security of tenure is critical in shaping people’s incentives to invest in land. People only make efficient private investments if they believe that they can reap most, if not all, of the benefits that accrue from their investment.

There is considerable consensus among economists that better land rights lead to better outcomes. In fact, a large literature on land tenure and investment demonstrates that higher levels of tenure security (though not necessarily formal title) will lead to greater investment by households.<sup>b</sup> The empirical evidence is not conclusive, though, on which dimensions of land rights are crucial. Is ownership of land the most important, or is it the ability to transform land into working capital that matters?

Evidence from Vietnam sheds some light on this matter. Land reform has been an important thrust of the progressive ‘Doi Moi’ policy since 1986. In 1988, the collective land system was abandoned in favour of private ownership. While land remains the property of the State, rights to use the land were assigned to individuals over a period of up to 15 years. In 1993, a modified land law was enacted that increased lease term, and ensured that land-use rights could now be inherited, transferred, exchanged, leased and mortgaged.

It might be expected that the additional land rights conferred by the 1993 law would induce households to undertake more long-term investments on their land. One way of measuring this is by looking at the allocation of land between annual crops and multi-year industrial or fruit crops, which typically require large investments upfront and yield returns only after a few years. Results confirmed this hypothesis, showing a statistically significant increase in the proportion of total cultivated area devoted to multi-year crops. Further results showed that households in highly registered provinces increased their proportion of irrigated area by about 20% as compared to those in low-registered areas. What the results could not show – yet – is the returns on these investments and their poverty-related impact.<sup>8</sup>

Much of the literature has focused on showing the links between investment and security of tenure. However, insecure tenure, ie the risk of losing land if specific actions are undertaken (such as rental or migration), is also likely to impact on households’ decision-making on investments. Uncertainty about whether or not plots will be possessed in the future is likely to reduce investment incentives and behaviour:

For example, migrant labour is a compensating mechanism used by disadvantaged households and is a vital dimension of addressing rural poverty (see Paper 3 on M4P and labour). The situation in India, where the daily wage of a migrant worker is 47%–76% higher than wages in their village of origin, is typical. It is important for income generally, and in diversifying the source of income (ie mitigating income risks of agriculture). However, the threat of land loss undermines the ability of the poor to pursue this important livelihood diversification strategy.

<sup>a</sup> See for example Otsuka, K, and Hayami, Y *Theories of Share Tenancy: a critical survey* (1988); or Inderjit Singh *The Great Ascent: the rural poor in South Asia* (1990).

<sup>b</sup> See for example Soule et al. *Land tenure and the adoption of conservation practices* (2000).

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### *The M4P perspective: grounding actions in local realities*

As confirmed above, informed by institutional dynamics, M4P promotes a real and practical understanding of the way poor people do, or should, better interact with markets. This perspective is particularly important in the context of security of land tenure.

In 1975 the World Bank issued a definitive policy paper on land reform.<sup>9</sup> Its major recommendations were: (a) formal land titling as a precondition of “modern development”; (b) abandonment of communal tenure systems in favour of freehold title and sub-division of the commons; (c) widespread promotion of land sales markets to bring about efficiency-enhancing land transfers; and (d) support for land redistribution on both efficiency and equity grounds.

With history and hindsight, the Bank has realised that the almost exclusive focus on formal title in the 1975 paper was inappropriate, and that much greater attention to the legality and legitimacy of existing institutional arrangements is required. This recognition of the role and power of institutions, particularly informal and cultural norms, in shaping incentives is central to the emergence of M4P as a concept.

In customary systems – strongly characterised in Africa – legal recognition of existing rights and institutions is generally more effective than premature attempts at establishing formalised structures. Legally recognising customary land rights subject to a determination of membership and the codification or establishment of internal rules and mechanisms for conflict resolution can greatly enhance occupants’ security.

Adams<sup>10</sup> (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 (eg dry season grazing reserves).

Customary land tenure arrangements are often characterised as leading to a relatively equitable distribution of land but also as relatively inefficient. Such inefficiency might be caused by small and fragmented plots, land allocations taking place for reasons other than capability, and rigidities in transacting land rights. However, they might equally be rooted in weaknesses in supporting functions impinging on land such as weak market information, low levels of technology and unreliable inputs.

In short, it should not be assumed that the inadequacies of tenure laws and/or administrative support constrain livelihoods in practice. Rather, an M4P perspective would be that land tenure reform should be responsive to a thorough understanding of the livelihood strategies of those it is intended to benefit.

As confirmed above, land rental and sharecropping markets are also important mechanisms through which the poor gain access to land. 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). However unfair and inefficient the distribution of land ownership or use rights, an active land rental market or strong tradition of sharecropping may go a significant way towards improving both the efficiency of land use and the quality of opportunities available to the poor.

Rental markets have often had a low profile in the consideration of land markets and land access, and there are few examples of reforms to liberalise land rental markets. However, recent evidence points towards a positive effect, suggesting that the concerns of critics may be less relevant empirically than often thought. In Mexico, abandonment of rental restrictions in the constitutional reform of 1992 had a positive impact on productivity, land market activity, and equity rather than the predicted wave of land sales and destitution.<sup>11</sup> A key reason behind this improvement in household welfare was that the reforms enabled people to participate in off-farm labour markets safe in the knowledge that their land was protected.

Transaction costs in land markets can be prohibitively high, particularly for the rural poor.<sup>c</sup> In India, transaction costs in land sale-purchase have been estimated to be up to a third of the total value of the land being transacted.<sup>12</sup> Such high costs go a long way to explaining why so many land-holders do not hold effective title to their land. In addition to the high costs of levies, other factors can raise transaction costs. In Vietnam, one study showed that many land users failed to register transactions because they were unaware of the dangers of informality: “one household purchased a plot even though the seller refused to transfer the formal title. Other households bought land already mortgaged to a bank and, therefore, were unable to register the transfers.”<sup>13</sup>

M4P promotes poverty solutions which are evidence-based and grounded in local realities. Recognising alternative ‘non-formal’ forms of land access and tenure is a start. Working pragmatically with local rights holders, authorities and other stakeholders to strengthen and codify existing systems is a next step. Reducing transaction costs, through improving knowledge, information and enforcement will also be a critical element of successful reform to improve the practical functioning of the land market system.

<sup>c</sup> Transaction costs might typically include formal items such as registration fees, stamp duties and surcharges, and informal items such as bribes to expedite transactions, fees to informal land valuers, etc.

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### Land and interconnected markets

As mentioned above, for land reform to have a significant impact on poverty reduction it must be part of a broader process of political, social and economic change, rather than a narrow intervention simply to redistribute land. Land is connected with many other markets and the functioning of one market can strongly influence the functioning of another. Credit markets are particularly important. Anecdotal evidence suggests that the success of many land reform projects is often linked to access to credit.

To quote the Peruvian economist Hernando de Soto (2000), *“In the midst of their own poorest neighbourhoods and shanty towns, there are trillions of dollars, all ready to be put to use ... [Yet] because the rights to these possessions are not adequately documented, these assets cannot readily be turned into capital, cannot be traded outside of narrow local circles where people know and trust each other, cannot be used as collateral for a loan, and cannot be used as a share against an investment.”*

De Soto outlines numerous reasons why, in some countries, the poor have been unable to secure formal title for their land assets, including exclusion from the legal process by elites, the complexity of formalisation procedures and the high costs of undertaking these processes. He estimates the volume of ‘dead capital’ held by the poor at \$9.3 trillion globally and identifies six ways in which formal land title and land administration systems can transform the value of their land assets (Box 2). Consistent with the notions expressed above, government land titling programmes are often considered a critical instrument for increasing access to credit among the poor; and wide scale land-titling has become a popular policy prescription for alleviating credit rationing in developing countries.<sup>14</sup> Feder and Feeney<sup>15</sup> claim that *“the most commonly recognized benefit from legal titling of land is the use of those secure ownership rights as collateral to solicit credit”*.

### Box 2

#### De Soto’s six “property effects” of formal land title and land administration systems<sup>16</sup>

- (a) Formal land titles have an abstract economic value, valid in a wide range of contexts, which untitled physical assets alone cannot have (*“Fixing the economic potential of assets”*).
- (b) With a national system of formal land title, economic value implicit within land title has generic worth recognised consistently throughout society (*“Integrating dispersed information into one system”*).
- (c) Formal title gives land-holders legal protection to their land rights from the state but, due to legal mechanisms for forfeiture of title, also creates pressure to honour commitments (*“Making people accountable”*).
- (d) As formal title signifies the abstract economic value of land, more flexible use of assets is possible – eg issuing shares in property, using property to gain access to capital (*“Making assets fungible”*).
- (e) Formal property systems join land users into networks through which their assets can be assembled into more valuable combinations (*“Networking people”*).
- (f) In addition to protecting ownership, formal land title systems that record and register transactions give greater confidence to parties seeking to participate in the market (*“Protecting transactions”*).

So, in an era of land titling reform motivated by credit market improvements, a key question is whether distributing property titles to squatter households does in fact encourage lenders to use low-income housing as collateral?

The evidence on this point is neither clear nor definitive but research in Peru<sup>17</sup>, De Soto’s home country, is insightful. This considered the evidence from a nationwide programme of land titling and reviewed whether access to land title increased access to credit for the urban poor. Among the key findings were the following:

- Despite the distribution of over 1.2 million property titles, credit rationing is still a key feature of the micro-lending environment.
- Post reform, 34% of titled households remain fully rationed out of the formal credit market.
- A limited reduction in overall credit rationing and financial market inequalities for the urban poor associated with titling programmes.
- The bulk of the reduction in credit rationing that was achieved was associated with one particular lending organisation, the publicly funded Materials Bank that supplies in-kind loans of housing construction materials.

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- No effect of formal property ownership on approval rates of private sector lenders. However, conditional on receiving a loan, titled households enjoy private sector interest rates an average of 9% lower than households without title.

These mixed results show that titling efforts will not automatically make collateral-based lending viable for the majority of formal-sector credit providers. They support a view that land titling efforts need to be coordinated and linked with reform in financial markets.

### *The M4P perspective – interconnected markets and coordinated reform*

Central to the concept of M4P is the notion that markets are interconnected and interdependent. The M4P framework supports a co-joined analysis of interconnected markets. What are classed as supporting functions (say, credit) in one market (say, land) are of course often markets in their own right. By applying a common framework to analysing and pursuing change in different but connected markets, M4P can bring clarity and coordination to reform efforts.

One example of this is the experience of DFID in South Africa.<sup>18</sup> In 2002 DFID funded the FinMark Trust, as a programme to “make financial markets work for the poor”. FinMark researched the dynamics of credit and urban housing markets, among other sectors. Central to this analysis was the recognition that land market issues were undermining efforts of improvement. Hence, LandMark, a sister programme tasked to “make land markets work for the poor” was established as a specialist unit to deepen research, insight and action in land market issues – working in coordination with its sister organisation FinMark, which continued to engage and address constraints from the financial markets perspective.

This concept of interconnected markets extends, of course, to many other markets. Flexibility in land markets should allow families with excess labour to connect with those lacking in labour but relatively abundant in land. The level of development of agricultural product markets will strongly influence the incentive to invest in land. More fundamental perhaps is the link between land and ‘public’ investments – in education, in physical infrastructure, in telecommunications.<sup>d</sup> Some might argue that investment in urban infrastructure, upgrading, and social programmes may have more effect on informal settlements than titling.

The key point for agencies is that action on land will only be effective when it forms one element of a broader process of reform. *“If poor people are to exercise newly acquired land rights, they need a range of support services. Only when they have access to information, affordable legal advice, methods of dispute resolution*

*and access to markets, credit and agricultural opportunities, will they feel empowered to claim their rights and to turn these into improved livelihoods.”*<sup>19</sup> This paper argues that M4P can provide an organising framework, to promote coherence and consistency to such multifaceted and multidimensional reform challenges.

### Conclusions

Land is highly emotive and highly political. Successful land reform requires long-term political and social commitment. However, as demonstrated in this paper, land markets are highly relevant in the reform equation. Reform that does not put the poor, and poverty reduction impacts, at the centre of its agenda threatens to miss an opportunity to enhance welfare and equity, and at its worst can further entrench people in their poverty reality.

Successful reform recognises and responds to realities on the ground. Formalisation processes of land tenure are important, but they should build on existing structures and systems, rather than importing external models whose application is too costly and complex for most poor people where customary processes may matter most in practice. By recognising economic, political and social institutions, and offering an organising framework for understanding and managing change, M4P is highly relevant to such land reform challenges.

Land reform conducted in isolation from wider reform processes will not maximise its poverty reduction potential. Building on the concept of interconnected markets, M4P can certainly offer much to help agencies and governments ensure coordination and consistency when pursuing complex and multifaceted reform initiatives. For governments in particular, M4P offers clarity on the different and more effective roles they can play in developing land market systems rather than direct land transfer.

<sup>d</sup> ‘Public’ investment does not necessarily mean the state in a role. State roles in relation to, for example, regulation, skills, information and standards might be equally valid.

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### Introduction

This paper focuses on the application of M4P to agriculture. It first establishes the importance of agriculture to poverty reduction; in particular, the relevance of agriculture to poor people in their capacity as producers, labourers and food consumers. In this context and given a number of other key trends, it then identifies five issues which need to be confronted in developing agriculture market systems and views these through the 'lens' of M4P. Finally, it concludes with comments on the applicability and limitations of M4P in agriculture markets.

### Importance and relevance to the poor

Agriculture markets' relevance to poor people stems from several factors.<sup>a 1</sup>

- A key source of income: although countries are becoming more urbanised, the majority of people still live in rural areas and poverty remains a predominantly rural phenomenon. Three-quarters of the poor are to be found in rural areas and for them, either as smallholder producers or through the labour market in working for others, agriculture is by far the most important livelihood activity. To a large degree, agriculture is 'where the poor are'.
- The basis for economic development: agriculture is the largest sector in most low-income countries, for example averaging 34% of GDP (up to 80% in the poorest countries) and 64% of employment in Africa. This level of dependence reduces as economies develop (comparable figures in Asia are 20% and 43% respectively) and agribusiness (processing and distribution) assumes more importance. Nonetheless, the 'classic' economic model of surpluses generated by agriculture forming the foundation for wider development still holds true for most economies.
- The basis of pro-poor growth: growth from agriculture is typically 2-3 times more effective in reducing poverty than non-agriculture-based growth. Even as agriculture develops from staple to higher value-added crops, it is relatively labour-intensive and pro-poor in its impact. Growing wealth disparities between urban and rural areas – and the associated social tensions – provide a further rationale for an agriculture focus.
- A major part of the poor's expenditure: food constitutes a major proportion of the average household budget of the poor. Many poor households can spend three-quarters of their total budget on food. Higher food prices can result in reduced nutritional intake, with subsequent deleterious effects on welfare.

How agriculture market change affects the poor specifically depends on their particular situation. In practice, especially in rural areas, there is considerable heterogeneity in the livelihood strategies of the poor: Many households have more than one source of income with some more reliant on selling labour and others on their own production. Overall, more of the poor are net buyers of food than net sellers but this varies with context: only 8% of the Bangladeshi poor are net sellers but in Morocco the figure is 35%. Net sellers benefit when productivity gains outweigh price reductions; net buyers benefit from lower food prices provided that these exceed wage reductions. Productivity gains and lower food prices can therefore be regarded as positive from a poverty-reducing perspective but the precise impact of agriculture market change on the poor depends on the extent to which they are producers, labourers or consumers.

<sup>a</sup> Unless otherwise stated, background data is from the World Development Report 2008, *Agriculture for Development*.

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### Some key trends

The obvious importance of agriculture for the poor sets part of the context for examining the key issues facing agriculture's development. A number of other general factors and trends also need to be recognised.

- The differing productivity record: productivity has grown considerably in some regions and stagnated in others. Asia's productivity has grown almost three-fold in 40 years but in Africa growth has been a modest 30%.
- The growing share of world output from developing countries: this has risen to 54% as countries increasingly use their competitive advantage to move into value-added products serving their own populations and export markets.
- Lower public investment: spending on agriculture as a proportion of public spending has declined to 4% (2004) from 6.9% (1980) in low-income countries. External assistance for agriculture has also fallen – to 3.5% (2004) of all aid from 18% (1979).
- The agriculture-environment axis: concerns over climate change and environmental degradation are focusing more attention on agricultural practices and sustainability.
- The growth of supermarkets: although their share of food retailing currently varies (eg 75% in Brazil and less than 3% in India) as personal incomes rise, supermarket growth is a global trend with major implications for suppliers.
- The multiple and interconnected nature of agriculture markets: as the global agriculture industry has become more complex, it is clear that we now need to refer to multiple, interconnected markets rather than a single unitary agriculture market system. Markets for outputs range from specific products to commodities. More complex are the spectrum of input and service markets impinging on farmers and other players in agriculture value chains, including, for example, seeds, fertiliser, water, land, finance and transport as well as (formal and informal) knowledge and information services.

### Key challenges in developing agriculture markets: the M4P perspective

The central relevance of agriculture to the task of poverty reduction has raised a number of critical issues and dilemmas for development agencies and governments. For each of these, M4P, as an approach that is about understanding and then acting to change markets, offers either improved clarity in analysis or guidance for intervention; ie it is both about what agencies do and how they do it. M4P's value-added stems from, among other features:

- developing a transparent view of a market system and of the functions (core transactions, rules and supporting functions) and players within it (Figure 1 offers a simplified view of the agriculture system, using the M4P market system construct);
- building interventions on the basis of a detailed understanding of markets – including interconnected markets – and of the poor within those markets;
- identifying underlying systemic constraints; and
- placing sustainability at the heart of the intervention process.

The focus here is on issues in the agriculture sector that have a specific M4P perspective and are not the subject of other perspective papers. For example, the wider and important questions of market access and trade restrictions (in particular by high-income economies) are not addressed. However, it should be said that demonstrable actions to improve market development in the ways described below are likely to bring about an environment that supports more liberalised (and fairer) trade and more effective international actions. And finance, labour and land markets are all critical for successful agricultural development but are dealt with elsewhere (Papers 2, 3 and 4). The issues highlighted here deal with inputs, prices, information, coordination and the environment.

#### How can input markets be made to work better?

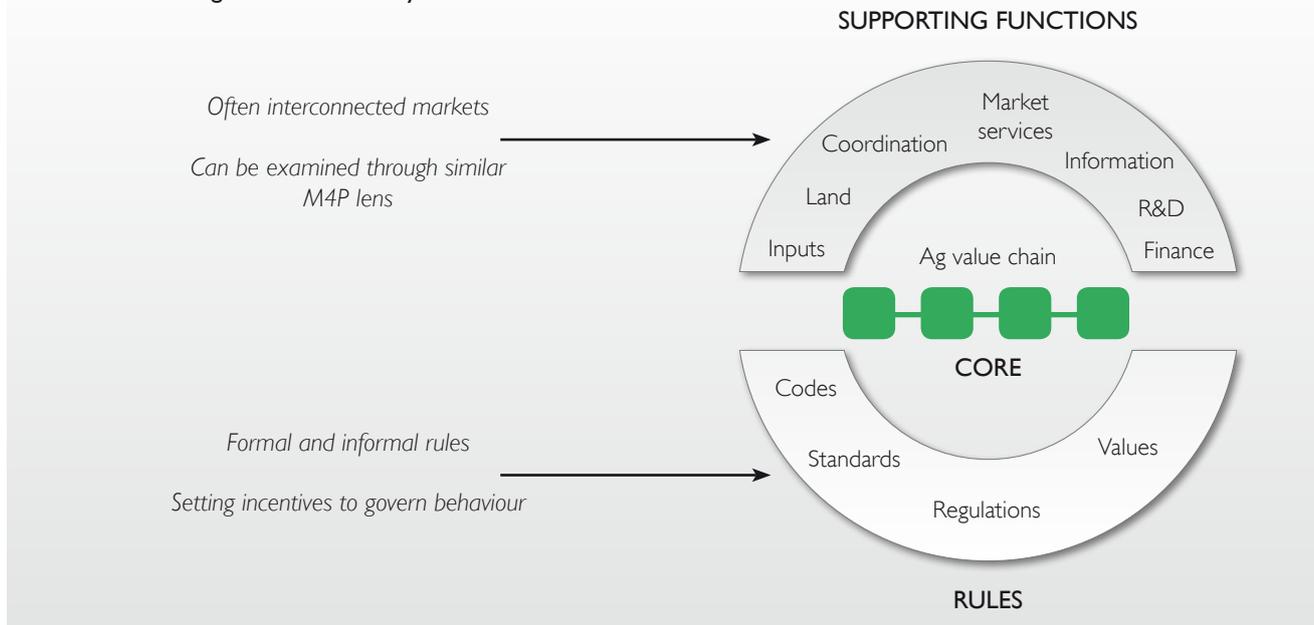
Appropriate use of inputs is key to higher productivity in agriculture. In particular, better use of high-quality seeds and fertiliser results in significantly higher yields. For example, the 'yield gap' in maize – ie the difference between average performance and that achieved in demonstrations – is typically 3-5 times. Much of the green revolution's success in Asia was based on improved supply of inputs and the absence of any comparable 'revolution' in Africa – where conditions are more varied and difficult – has long been a source of frustration. How to stimulate greater supply and use of inputs remains a core development challenge.

One common response to this challenge is to subsidise the consumption of inputs. The rationale here is that input markets don't work effectively because of the:

- production and price uncertainties associated with rain-fed agriculture;
- risks inherent in new technologies; and
- difficulties in supplying to geographically diverse smallholder farmers.

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**Figure 1**  
Schematic of the agriculture market system



The resulting relatively high costs and risks provide both efficiency and welfare reasons for government support. In the past, governments have controlled the distribution of inputs directly but the high costs of parastatal operations and their openness to manipulation by special interests has reduced (or eliminated) their role.<sup>2</sup> Yet subsidies for the supply and consumption of inputs are still common and are increasing in some instances. 37% of the Zambian agriculture budget goes directly to subsidies. In India the figure is 75% – up from 40% in 1979. And the Malawian government (with donor support) is implementing an extensive programme of maize seed and fertiliser subsidy through retailers – reducing the price to one-third of the previous value. Initial evaluations suggest that the subsidy has led to an additional 300-400,000 tonnes of maize production, worth far more than the \$70m subsidy cost.<sup>3</sup>

### *The M4P perspective: focusing on constraints and sustainability*

The key question to consider in assessing the efficacy of subsidies is, how do they contribute to the development of more effective, inclusive and sustainable markets (the M4P acid test)? This general position is especially relevant in relation to input subsidies where – in an almost formulaic manner – it is possible to generate spectacular short-term output gains by directing more inputs into cultivation and believe (wrongly) that this is equivalent to longer-term development.

In this light, it is clear that sustainable markets are often not the real goal of subsidies. Fertiliser subsidies, for example in India, are a favoured politicians' instrument to woo farmers' votes and their longer-term impact is a secondary concern. More legitimately

perhaps, fertiliser subsidies are seen to be an effective means of offering welfare (reducing the cost of production and the price of food) to the poor. However in providing the subsidy in this way rather than allocating food stamps/vouchers to poor consumers, for example, subsidy is directed into the heart of the input supply market, and so impacts on the price signals and incentives shaping supplier and farmer behaviour. The thrust of the welfare ethos is therefore felt directly by players in the input market rather than by food consumers.

An M4P perspective on agriculture input supplies has a number of features. First, the starting point is a more detailed assessment of the systemic constraints impinging on the market, on both demand- and supply-sides. Subsidies are a blanket intervention that encourages supply and consumption but does not focus on specific factors that prevent the market from working – for example, poor supply-side practices or a lack of risk-taking innovation or of information – or that disguise flaws in interconnected markets such as finance or land.

Second, interventions to promote the market are based on a vision of how it should work sustainably in the longer term. If direct subsidies are genuinely seen to be a continuing feature of the market this has to be justified (on a welfare basis) and provision set aside for continued public finance. If subsidies are seen to be a short-term stimulus to a longer-term 'subsidy-free' vision, the pathway through which this may happen needs to be laid out rather than presented as a distant (often disingenuous) aspiration.

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Third, direct transaction-focused subsidies are used with caution and for a clear purpose. Placing financial subsidies at the heart of the transaction in a market system is inherently more invasive, especially if they are of a significant size and duration. An M4P perspective is certainly not opposed to consumption subsidies *per se* but it is cognisant of their potential to encourage market players into a 'comfortable' pattern of behaviour that expects subsidy to continue rather than to stimulate innovation; ie it can be dependency-creating rather than catalytic.

### How can price instability be reduced in agriculture markets?

A characteristic problem affecting many agriculture markets is price volatility. In conditions of substantial information and power asymmetry, producers sell to traders in spot markets. Prices commonly fluctuate from one harvest/year to another causing a boom-bust/shortage-glut pattern of production. For example, record grain harvests for Ethiopian farmers in 2001 were followed by an 80% price collapse in 2002.

Farmers taking decisions in these situations on what and how much to produce and what prices to seek are likely to be risk-averse and make poor decisions. The prevailing uncertainty and variability in returns is a disincentive to investment and innovation and a major barrier to agricultural development. In response to this problem, governments traditionally played a direct role in the procurement of food staples. Their role is now more restricted to establishing emergency reserves, following widespread acceptance of the inefficiencies of government as a buyer. Governments have also sought to be direct providers of price information but the results here have also typically been disappointing. In recognition of these limitations, there are now more varied efforts to develop improved market information systems.

### The M4P perspective: strengthening private sector-led services

The above experiences have taught that the apparent certainties of the past – for example that price information is a 'public good' to be delivered by the state – were chimeras that have no legitimate place in the future. The challenges ahead are concerned with the development of market information and pricing systems that recognise the different roles to be played by different players. For example:

- Longer-term contracts between farmers and buyers – either retailers (supermarkets) or contract farmers.
- Private commercial media – such as radio – presenting public price information.
- Internet-and phone-based services such as rural kiosks or SMS messaging services.
- Market mechanisms such as commodity exchanges offering futures and options contracts and a means to smooth production and price variations.

The private sector is often best placed to play the lead role in developing these services, with the capacity and incentives to develop them successfully. However, often the introduction of the services represents substantial change and may require external assistance.

However, at the centre of many of these innovations are roles which can only be played by public organisations, either business membership organisations (BMOs) or, more likely, government. New mechanisms for buying and selling, for example, can only be developed when set in a context of appropriate rules and standards.<sup>b</sup> And, while mechanisms for delivering price information should be increasingly through the private sector, the collection of 'official' prices is a public function. M4P helps to provide a framework within which to develop these new public-private collaborations to mitigate the problems of price instability.

### How can the flow of technologies, ideas and knowledge to agriculture be improved?

The pace of change in global agriculture is increasing. The rate of technology and process development and adaptation increased significantly in the 1980s and 90s – even compared with the green revolution decades (the 1960s and 70s). Clearly, processes of innovation and change will continue to be important in the future as an inherent part of the market system. The challenge is to ensure that this extends to include those producers who have not discernibly improved performance.

Technology development involves both (a) genetic development of new breeds and, as important, their 'maintenance' against disease resistance, and (b) process and management improvement relating to agriculture practices – such as the development of zero tillage (used in almost half the arable land in Latin America). In most low-income economies, developments originate in public R&D centres funded by governments (and/or donors). Unlike high-income economies, where potential markets are larger and there is intellectual property rights (IPR) protection, private R&D is rare. Traditionally also the dissemination of new knowledge to users has been promoted through public extension services.

Recent trends indicate that public R&D has languished in many countries and often accounts for less public expenditure than either extension services or input subsidies. Yet, while the returns on R&D investments are high, the efficacy of extension services is widely questioned. Indeed, the training and visit (T&V) public extension system supported in up to 70 countries in the 1980s and 90s is acknowledged to have largely failed.<sup>4</sup>

<sup>b</sup> The exit of the state from a dominant purchasing role in many countries was not successful because the 'privatisation' process created a vacuum which was not filled by appropriate public rules and standards to shape behaviour.

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### **The M4P perspective: recognising complementary public and private roles**

Developing a more effective environment for knowledge generation and application requires more efficient allocation of roles and collaboration between different players. A key priority for government should be basic R&D – a public role that really only it can play – as a supporting function to processes of knowledge transfer. An M4P perspective would urge the prioritisation of these roles and placing resources here rather than in more politically expedient private input subsidies or in public extension.

The core role of delivering knowledge services is more problematic: who has the incentives and capacity to play this role effectively? Publicly funded and delivered extension services do not appear to be the answer but there is no immediate, simple alternative. In practice, successful mechanisms for knowledge delivery are likely to involve a variety of arrangements of public and private players with varying combinations of financing (who pays) and provision (who does) and information available from a variety of sources. This might include:

- Input suppliers' networks with retailers becoming information hubs as well as input providers – as in Bangladesh and Cambodia.<sup>5</sup>
- An expanded role for BMOs, with public funding, in developing improved information networks – eg the wool-growers association in South Africa.<sup>6</sup>
- Improved information through large–small sub-contracting supply relationships.
- More informed and accessible 'how to' information through commercial media.<sup>7</sup>
- For more established agri-business, the emergence of specialised consultants.

Although there is an array of promising initiatives it is clear that there are no standard, one-size-fits-all models that are universally applicable. In each case, successful knowledge delivery is likely to be led by private players; government's role increasingly should be to develop knowledge and actively manage working relationships with private providers.

### **How can coordination be improved throughout the agriculture market system?**

An inherent tension is increasingly apparent in agriculture sectors. On the one hand, more output is in specialised value-chains, in national and international markets with exacting quality and performance standards. On the other hand, agriculture is still often characterised by large numbers of independent (low-income) smallholders. A critical issue is how this group can participate in value-chain based growth.<sup>8</sup>

For this to happen, effective coordination mechanisms need to be developed to manage the interface between these two worlds – small-scale/traditional and large-scale/sophisticated – and to reduce the transaction costs of dealing with small-scale players and increase their bargaining power. Coordination may be necessary, for example in relation to buying inputs, selling products, accessing knowledge and information, complying with standards and negotiating over market rules.

Currently, the effectiveness of coordination – and the means through which it is pursued – varies considerably. The collapse of state-controlled systems has left a vacuum in many countries. BMOs are widespread in most countries, drawn together precisely to address coordination issues. However, their wider record is mixed with different levels of capacity and performance. In addition, there are increasing examples of large firms linking with smallholders through different mechanisms.

### **The M4P perspective: improving coordination through BMOs and business linkages**

M4P recognises coordination explicitly as a key supporting function but does not offer any blueprint as to how this should be achieved. Clearly, there are still strong arguments for supporting the development of BMOs for farmers – locally and nationally. However, in doing so, agencies have to be aware of the uneven record of 'support' for BMO development. Where BMOs succeed, it is usually on the basis of strong and competent leadership; where these qualities are absent, BMOs can be captured by vested interests and sink into dependency and dysfunction. The 'rules' for engaging with BMOs (see Good Practice Note 5.6 in the *Operational Guide*) apply in agriculture as they do elsewhere.

Coordination through more innovative business models in value chains is a more recent and perhaps promising development. This might include, for example, new business models for contract farming and for product buying which include information and advice. But corporate players are under increasing pressure to develop more inclusive business models that still deliver value-added for them and their stakeholders. How to achieve these relationships without demoting them to 'corporate charity' remains a challenge. Moreover, the extent to which building smallholder groups is a wider public or narrower private role is a grey area. Engaging with lead firms to encourage this type of innovation is a key focus for M4P (see Good Practice Note 5.7 in the *Operational Guide*).

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### How can agriculture be developed in an environmentally sustainable manner?

Agriculture's output and productivity achievements have often been at the expense of the environment. Intensive production can reduce soil fertility, deplete water resources and increase the soil concentration of nitrates and pesticides. In extreme cases, the very productivity gains achieved through intensification are now under threat from the environmental degradation caused by it. Where agriculture has been expanded into new geographic areas, this has often been at the expense of habitat.

For individual farmers, one key problem is the lack of incentive to change. They may be motivated to address problems directly affecting their own performance but wider externalities related to, for example, pollution, resource depletion, biodiversity, carbon emissions and disease are not their immediate concern. Exacerbating this basic problem is the characteristic weakness in the institutional environment in developing and enforcing rules or supporting collective action to address externalities and force a change in behaviour.

### The M4P perspective: building incentives and institutions to support change

The critical question posed in M4P is what is required to induce change in market players' behaviour. This means considering the incentives and capacity for change and in turn the rules and supporting functions impacting on market transactions. In a complex situation, a number of areas of change are suggested through M4P.

- Using the price mechanism to incentivise change: farmers are unlikely to change practices until the beneficiaries of change – consumers and wider society – pay/compensate them for doing so. New mechanisms such as Payment for Environmental Services (PES)<sup>9</sup> – which has been used primarily by water users to pay for forest conservation – and carbon payments (see Paper 8) potentially offer an efficient process of influencing farmer decision-making.
- Refocusing R&D to better environmental practices: the development of new technologies and management systems that can offer farmers the capacity to change.
- Institutional development: supporting individual incentive and capacity change, developing institutions to enforce rules locally and organisations to take the collective steps required to, for example, manage resources more efficiently.

### Conclusions

The above arguments illustrate the relevance of M4P to agriculture. M4P provides value first by offering clarity in analysis – a transparent means through which governments and development agencies can examine the overall market system and their own role in developing it. And second, given this clarity, by providing guidance for interventions.

The agriculture market system is obviously large, multifaceted and complex. There are no simple, panacea-like approaches to its development. M4P does not provide any unique insights into the many detailed technical debates in agriculture but it does present a strategic framework to address the overarching strategic and operational issues of incentives, roles, structures and mechanisms. Moreover, since M4P approaches are currently being used in different aspects of agriculture market development, its relevance and applicability have a strong practical basis.

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## PAPER 6: M4P AND WATER

### Introduction

This paper focuses on the application of M4P to increasing access to improved water services.<sup>a</sup> It first elaborates on the scale of the problem and the wide-ranging poverty implications resulting from a lack of access to improved water services. Key issues – of increasing physical access, of affordability and of service quality – are discussed in the context of the main challenges in meeting the Millennium Development Goals (MDG) targets on water access. The value of M4P in organising a response to each of these challenges is presented. The paper concludes with comments on the applicability and limitations of M4P in increasing access to improved water services.

### Background – scale of the problem, and links to poverty

In the 1990s the number of children killed by diarrhoea – the result of unsafe water and sanitation – exceeded the number of people killed in armed conflicts since the Second World War.<sup>1</sup> Inevitably it is the poorest and most marginalised sections of society that suffer the most. Poor women and children spend much of their time collecting water rather than working or going to school. In Pakistan half of girls drop out of class just because schools do not have latrines.

Theoretically, every living being has access to water (if they did not, they would be dead!). What matters are the conditions of this access – how much, at what price (monetary and opportunity cost), at what level of quality, and so on. Lack of access to improved water services impacts on many dimensions of poverty, as expressed by the MDGs. Lack of access to water and sanitation can impact negatively on education targets, as above. Since clean water and sewage treatment are critical to controlling the spread of infectious and parasitic diseases, lack of access to improved water services directly undermines ambitions for improved health targets.

Improving the health and education levels of the workforce is a critical factor for increasing productivity, which in turn builds the national competitiveness that is so crucial in delivering sustained long-term economic growth. The contention that growth is highly contingent on the state of human capital in a country is clearly demonstrated in empirical growth literature.<sup>2 3</sup>

The link between income poverty and non-income poverty is clearly a two-way relationship – a virtuous circle.<sup>4</sup> Pro-poor growth delivers greater resources for investment in non-income aspects of poverty, in turn building human capital, supporting productivity growth and fostering the higher competitiveness essential for sustained long-term economic growth.

Econometric reassessments of the three largest reductions of rural poverty accomplished over the last 30 years (China, India and Indonesia) are unanimous in attributing a large role to infrastructure investment. Water provision is a central part of this equation. Infrastructure sectors support the productivity of the poor in a variety of ways. Infrastructure reduces risks in productive private investment, it supports more efficient trade promotion, and it is critical in mitigating natural disasters. However, increasing access to services – particularly energy and water – is particularly important in building the human capital of the poor, which in turn allows them to participate in, and benefit more directly from, growth processes.

<sup>a</sup> The focus in this paper is on water for individual consumption rather than for irrigation or business purposes.

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Improved access to water also has immediate poverty-reducing benefits. A detailed study in Argentina<sup>5</sup> found that child mortality fell 5-7% in areas that increased access to water services overall. The effect was greatest in the poorest areas; it was estimated that child mortality fell by 24% in the poorest municipalities because of a reduction in the number of deaths caused by infectious and parasitic disease.

### Delivering the MDG targets: access, affordability and responsiveness

MDG 7: "Ensure Environmental Sustainability" sets the 2015 target to "reduce by half the proportion of people without sustainable access to safe drinking water". Responding to this call to action requires progress be made in the three inter-related elements of access, affordability and service responsiveness.

#### Access

More than 1bn people still lack access to clean and safe water. This figure has held fairly constant for decades, in spite of the fact that almost 97% of fixed water distribution infrastructure is in the hands of the public sector. Given the scale of the problem, and the scale of the resources required to address the problem, harnessing the skills, expertise and finance of the private sector is often a matter of necessity. Equally, it is highly likely that organised community structures will feature as part of the solution, just as users themselves will, in respect of the fees they pay being reinvested in improved and extended provision.

The debate over private participation in water provision is typically polarised and heated. Opponents often argue that water is a basic right, and not a commodity to be traded. They are concerned that the poor will lose their rights if they have to pay for water. These debates are not new – just as the role of the private sector in water provision is not new. In London private companies supplied water for more than 400 years with little government restriction on entry. By the 19th century, 95% of London residents received piped supply from private companies and a majority had direct home connection. However, in 1818 the (private) Grand Junction Water Company (London) rejected accusations of profiteering and issued notices rebutting "attempts to mislead and prejudice the public", stating that the company directors were in fact operating "at great loss to themselves".<sup>6</sup>

An in-depth report on independent water and sanitation providers in ten African cities<sup>7</sup> confirmed that over 75% of the urban poor get water directly from a range of private but small independent providers. Sanitation services are in most cases provided exclusively by such providers. In rural areas, where network infrastructure is often not economically or technically viable, the poor are almost exclusively reliant on private providers for improved access to water.

If access to improved water services is the key policy issue, then debate must focus on how best to achieve this. There is no single uniform solution; improving access requires partnerships that maximise resources from the public, private and community sectors.

#### Affordability

In terms of affordability, the poor pay more. How much more depends on a number of factors. Table 1 shows findings from a recent major study in Africa which confirms that those without access to networked provision pay more than those who do ... and this means the poor.

Often smaller water providers operate informally and are unrecognised by the state. The risks of this illegitimacy tend to be reflected in their investment and pricing patterns, whereby returns are sought in the shorter term and the tariffs set are based on higher average rather than lower marginal costs of production. Licensing and regulating such providers can result in much better terms being offered, and often such non-networked provision is the only viable option. So, even where the full-scale economies of networked services can't be achieved, opportunities are there for ensuring that the poor get a better deal.

Subsidies are a major discussion point within the debate on affordability. However, the poor-pay-more pattern is often intensified when network prices, through subsidy, are offered at below an economic price. Not only do the poor pay more to start with, but the fact that subsidy goes to those already networked means that the poor face a double disadvantage. For example, in Panama poverty is primarily rural, but IDAAN (the national water utility) operates almost exclusively in towns. Only 16% of IDAAN's customers live below the poverty line. Nevertheless, at least two-thirds of IDAAN's customers are subsidised.<sup>8</sup>

**Table 1**  
**The poor pay more: networked versus non-networked water provision**

Method of provision	Price in US\$ per m <sup>3</sup>	Difference
Door to door	2-6	
Standpipe	0.6-1.5	Four times less
Home tap	0.3-1.0	Six times less

Source: Collignon, B & Vezina, M (2000)

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If the poor are paying six times more now (Table 1), doubling the network tariff would still mean that they are paying three times as much as others. However, the additional revenues raised through increasing the network tariff could be invested in expanding access and connectivity. From a poverty reduction and welfare distribution perspective, access matters more than price. As confirmed in one major study on the distributional impact of privatisation in Latin America<sup>9</sup>, “*even if prices did go up, their effects were dominated by the corresponding increases in access that occurred in the bottom or lower half of the distribution*”.

### Service responsiveness

Growth research of the 1990s highlighted the importance of the quality of countries' economic institutions in responding to emerging needs and developing new opportunities. For example, the low quality of infrastructure services provided in areas that have already been connected to the network is a problem at least as serious as the limited extent of networks; in 2004 one-third of rural infrastructure in South Asia was estimated to be dysfunctional.<sup>10</sup>

The key issue that emerges, for water and for other infrastructure sectors, is how to develop organisational hierarchies that focus all bodies effectively on efficient, innovative and higher-productivity service provision (whether this is a networked utility or small informal operator). Incentives to more efficient customer service and to continuous innovation can be ensured much more easily in many aspects of infrastructure provision and operation by recourse to competition among independent suppliers under light government regulation.

New institutional alternatives to the traditional public sector infrastructure monopoly include private provision (across the full spectrum of agencies from multinational companies to street-level water vendors), commercially operated public sector provision, and user partnerships. All of these should provide an element of competition. In these circumstances, the government's role is to concentrate on effective delivery of the many services that it alone can provide, and to ensure pro-poor regulation of private, commercial and community delivery of the other services.

In some cases those approaches may involve large foreign private investment, but in almost all they are likely to increase, to some degree, the role of the private sector; domestic and foreign, in direct management of maintenance and operations, with effective performance incentives.

Small local providers (private companies or community-based organisations), which have generally been disregarded at the time of water company concessioning (despite the sizeable role they have often been playing), may be particularly important because of the time it will take to extend central supply networks. Accustomed to working in a competitive environment, the more experienced of these providers are often more enterprising than the state utilities in designing their works, services and collection procedures to fit the particular needs of their clients.

### The M4P perspective: how to respond to the challenge of increasing access to improved water services

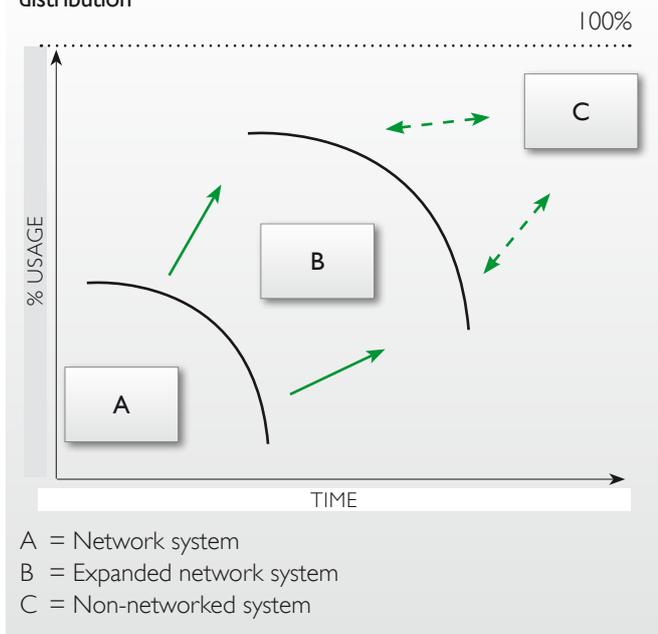
Access, affordability and responsiveness are all critical determinants for the delivery of improved water services. For each of these determinants, M4P, as an approach that is about understanding and then acting to change market systems, offers either improved clarity in analysis or guidance for intervention. It is both about what agencies do and how they do it. M4P's value-added stems from, among other features:

- developing a transparent view of a market system and of the functions (core transactions, rules and supporting functions) and players within it;
- building interventions on the basis of a detailed understanding of markets and the poor within them;
- identifying underlying systemic constraints (and therefore distinguishing between symptoms and causes); and
- ensuring that sustainability is at the heart of the intervention process.

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A central concept in M4P is the market access frontier (Figure 1). A number of challenges and perspectives central to M4P emerge from this.

**Figure 1**  
Access frontier for network and non-network water distribution



### Pushing out the access frontier – a systemic response

As shown in Figure 1, often the potential exists to push out the access frontier for networked water services to currently unserved or underserved consumers. Too often this challenge is relegated to a narrow technical solution of liberalisation and regulation – setting service standards on coverage for the utility. However, as shown clearly in various studies, the challenge of extending access can be quite involved and complex. Getting the right skilled and incentivised providers, operating under a progressive regulatory framework which is governed by a professional and progressive regulatory system, is necessary, but not sufficient. Extending access requires a range of other 'solutions':

- Technologies – extending access often requires new and lower-cost technical solutions, for example, condominal technology.
- Billing and collections – extending access means taking water to new communities about which the utility may have no credit information, understanding or relationships. This lack of information can lead to reduced service responsiveness. Finding innovative ways to 'get into' communities is important if services are to be well targeted and efficient.
- Community engagement – even with lower-cost technologies, connection charges can still be prohibitively high. Depending on the technology being used, there may be opportunities for lowering the cost of connections to communities willing to invest their labour in return for a discount.

- Financial services and building supplies – in order to access piped water, many dwellings require investment and upgrading. New kitchens, bathrooms and related appliances are necessary. Access to finance is important to pay for these investments. There might be a role for microfinance here, or perhaps engagement with building supplies merchants to offer new ranges and 'deals' to lower income consumers who are soon to be connected.
- Education – increasing access to water must also be supported by initiatives aimed at changing perceptions and habits of consumers in favour of using more water, and using it appropriately.

The picture is quite complex. M4P offers a framework within which a range of market analysis tools that can be deployed effectively to gain insight into this more complete picture. A more complete picture supports more effective implementation.

### The importance of interconnected market systems

Networks benefit from scale economies and can therefore offer better value than non-networked forms of water provision. However, expanding network access is not always feasible, for technical, economic or service reasons. This might be the case particularly in rural areas and large-scale informal peri-urban slum settlements where much of the world's poverty is entrenched. In these cases access to improved water services will be through non-networked sources.

Studies in Dar es Salaam, Kampala, Mombasa and Nairobi (1998-99)<sup>11</sup> identified success factors of informal private water providers in water supply services. They can:

- respond to the dynamics of market demand, unlike monopolistic public enterprises;
- access peri-urban or informal settlement areas not covered by the public operator;
- be commercially-oriented;
- respond to market needs in densely populated areas by providing service options; and
- operate other parallel businesses.

These non-networked water markets are often competitive and dynamic. But equally often they are informal, unregulated and inefficient. As a framework matching multiple players, and multiple functions, M4P can also offer a useful tool for managing change in such markets.

Creating a more enabling environment which seeks to recognise, formalise and regulate players in these markets is critical. The benefits of a more fruitful engagement by governments with this market segment can realise many service quality and access benefits through:

- providers building the confidence to invest and expand their operations;

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- governments concentrating energies and resources towards governance and enabling (rather than direct providing) roles; and
- network providers focusing on improving their existing services.

Some water utilities have tried regulating the prices charged by water vendors, or challenging their rights to operate. This affects the viability of these smaller operators. United by a commitment to improved access, new partnerships need to evolve that put the poor at the heart of the process, and create new relationships that strengthen the coordination of players within and between different market segments.

For example, Mali's Water Advisory Unit offers member water users' associations a package of financial, management and training services in return for a fee paid for each cubic metre of water distributed by the association. This arrangement has been relatively successful, resulting in a reduction of unit operating costs by over half over a five-year period (1994-99) from about US\$0.70 to US\$0.30 per cubic metre. As a result of this connection between actors in different parts of the water market, poor consumers now pay lower prices, for better quality water which is more available than before.

### Incentives and capacities are critical

The relevant MDG sets a clear target to reduce by half the proportion of people without sustainable access to safe drinking water by 2015. Achieving this will require a multi-stakeholder response that harnesses the respective capacities, skills and resources of the public, private and civil sectors. New partnerships will need to be formed that are structured according to the respective merits and abilities of each stakeholder grouping, with the focus on delivery of results not ideology.

Progressive market liberalisation should not be confused with the non-transparent granting of long-term exclusive concessions to a small number of very powerful international water utilities overseen by weak national regulatory frameworks and regulators. Any liberalisation agenda should be guided by:

- balanced partnerships whereby roles and responsibilities are clearly defined and power relations are balanced between stakeholders;
- leveraging the expertise and skills of national as well as international operators;
- joining up segments of the market system, including networked and non-networked markets;
- the overriding goals of increased access, affordability and responsiveness.

The political economy of water – rights versus realities – is such that governments and development partners embarking on reform need to consider and to actively engage in building constituencies

for change. An M4P perspective would seek to identify key 'drivers of change'<sup>b</sup> and related analysis in seeking to understand such constituencies in order to smooth a pathway for reform.

### Putting the poor at the heart of the development process

M4P supports a people-centred approach to development. Involving and engaging the poor directly should be an important feature of public investment decision-making. All too often, though, the poor are not involved. This can mean that decisions are taken remotely and based on highly aggregated and generally poor-quality information. There are many examples where populations within communities have organised themselves to participate in the governance of an infrastructure provider (most often in the water sector). Similarly there have also been instances (albeit fewer in number) where populations have contributed capital to finance investments for system development.

For example, in Cambodia electricity customers have often contributed in advance to the costs of construction for system expansion (lines and transformers). In addition, at least 60% of village households agreed to pay house wiring and construction costs. In some cases, villages were so keen to have electricity that they collected funds among themselves to finance 100% of the distribution equipment.

M4P offers a sound basis for understanding the position of the poor and how they participate in and are affected by markets. By engaging the poor in analysis and intervention design, M4P solutions are often better targeted, more likely to be more responsive to needs and realities, and ultimately more sustainable.

### Subsidies: an approach to innovation and targeting

In merit goods markets, like water, where various externalities are more prevalent, there is a stronger need for public functions related to aspects such as regulation, social protection and health. In view of this, there may be a case for selective subsidies for water consumption. However, the many operational challenges of working with subsidies are well known. What is clear from research (and of course it depends on access patterns initially) is that poverty reduction and welfare goals are better served when subsidy is used in support of expanding access rather than in depressing prices for those already connected.

United by a clear access objective, underpinned by a detailed understanding of markets and a people-centred perspective, M4P supports innovative approaches to intervention – including the role of subsidies. Equally, with its focus on sustainability, M4P is concerned to ensure that governments budget appropriately for the inherited liabilities that recurrent subsidies will generate.

<sup>b</sup> *Drivers of Change*, an approach used by DFID, is a way of understanding the political economy of change and poverty reduction in developing countries.

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Innovative solutions do not always need to be planned, of course. Alternatively, by taking a more systemic perspective, and by stimulating genuine competition in merit goods markets, innovative solutions can emerge through this competition. Chile offers a seemingly successful example of a highly innovative approach to the promotion of new power connections which, within five years, raised rural electric coverage from 57% in 1994 to 75% in 1999, benefiting 113,000 households.<sup>12</sup> Concessions were awarded to the company offering the largest discount on the maximum allowable subsidy calculated by the government on the basis of the difference between estimated social and private returns for each project. The service expansion was thus co-financed by government (\$112 mn, out of its general budget), the private sector (\$60m) and the rural consumer.<sup>13</sup>

### Conclusions

Merit goods markets, such as water, are complex and detailed. Discussions and perspectives are as detailed as they are divergent. In this context, this paper attempts to capture a number of key themes and issues, and to demonstrate the resonance and relevance of M4P to each of these.

M4P does not provide any unique insights into the many detailed technical debates within the water sector. It does, however, focus debate on the objective of access and the relevance of markets to this goal. As a systemic multi-player, multi-function approach M4P offers a highly relevant strategic framework for agencies concerned with organising and progressing on the global challenge of increasing access to improved water services for more than one billion currently underserved people.

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## PAPER 7: M4P AND POLITICAL ECONOMY

### Introduction

This paper focuses on the application of M4P to understanding and intervention in the political economy - the processes, incentives and structures around government decision-making and reform. It does so through political markets, defined as the transactional relationship between, on the one hand, the poor being capable and able to *demand* – and on the other, governments being willing and capable to *supply*. As shown, the quality and efficacy of this transactional relationship determines development outcomes.

The paper first explores the importance and relevance of political markets to the poor and the general nature of imperfections in political markets that undermine transaction quality and contribute to poverty incidence. It then considers how an M4P perspective can support improved practice through taking a more systemic approach to reform.

### Importance and relevance for the poor

The effectiveness of the state is increasingly recognised as a key determining factor in whether or not successful development takes place. Effective states are those that are capable of helping business grow and ensuring the delivery of relevant services to their citizens. Effective states are those which are accountable and responsive to all of their citizens.

An example from India illustrates the point.

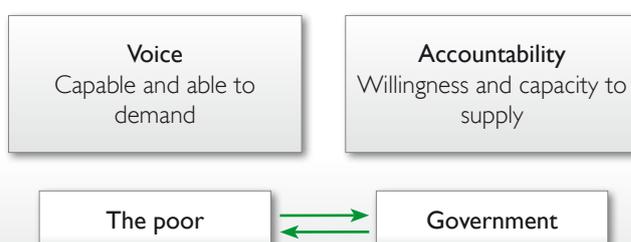
The Indian states of Kerala and Uttar Pradesh are states within one federal nation.<sup>1</sup> They are subject to the same constitution, laws and intergovernmental finance system, and are subject to the same election cycles. However, development outcomes in Kerala and Uttar Pradesh are quite different. Women born in Kerala can expect to live 20 years longer than women in Uttar Pradesh. Uttar Pradesh's infant mortality rate is almost six times higher than Kerala's. At the turn of the century, one in three girls in Uttar Pradesh had never been to school, as compared to universal enrolment in Kerala.

In terms of education and health services, public facilities in Kerala are likely to be regularly manned by teachers or physicians, well supplied and adequately maintained. This is not the case in Uttar Pradesh. If a public primary health centre is not attended for a few days in Kerala, people are likely to protest at the nearest district office. In Uttar Pradesh a rural school can be non-functional for years, with teachers absent or shirking but without any civic protest.

Effective states are those where citizens have the knowledge and power to make demands (*voice*), and those in positions of power have the capacity and will to respond (*accountability*). Enhancing citizen voice and accountability has increased in importance for agencies in recent years. Voice refers to the capacity to express views and interests and to the exercise of this capacity. Accountability exists when those who set and implement a society's rules – politicians and public officials – are answerable to the people who live under those rules.

A framework for voice and accountability is shown in Figure 1. The relationship between voice and accountability is clearly shown as one which is 'transactional' in nature.

Figure 1  
A transactional picture of voice and accountability



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The 'quality' of the transaction can be defined by the 'balance' between voice – poor people being capable and able to demand – and accountability – governments being willing and capable to supply. When this balance exists, as in the example of Kerala, transactional quality is high, and development outcomes are positive. In the case of Uttar Pradesh the picture is unbalanced, with resulting lower transaction quality manifested in more negative development outcomes.

The picture presented here is one of a political market. The core of this market is defined by citizens and governments, engaging in a transactional relationship where the actions of one party influence the actions of the other (and vice versa). When power relations are balanced, the market is perfect and transactional quality is high. When the market suffers from imperfections, transactional quality is affected and outcomes may well suffer.

Keefer and Khemani<sup>2</sup> argue that the observed differences in Kerala and Uttar Pradesh can be explained in terms of imperfections in political markets. Specifically, three political market imperfections were identified as important in the context of government incentives to serve the poor: lack of information among voters about politician performance; social fragmentation among voters manifested as identity-based voting; and lack of credibility of political promises to citizens.

In more general terms, political markets can be defined in relation to four key characteristics: incentives, rules, information and coordination.

### Incentives

Incentives are at the heart of transactional relationships. Politicians have an incentive to be seen to be delivering for their voters. Often this leads to a focus on the delivery of short-term outputs, rather than longer-term development outcomes. If politicians cannot take credit for their efforts to improve, say, teacher quality, they have no incentive to pursue this improvement and voters will continue to expect low-quality teachers.

Often underperforming states display the type of socially fragmented patronage politics as described above. Where politicians feel that certain groups of voters will not be swayed to vote for them irrespective of what reforms they make, their incentives are aligned to serve those who do and will continue to vote for them. The negative consequences of such dynamics of ethnic fragmentation and clientist politics are clear:

- "...ethnic diversity is negatively correlated with the provision of public goods such as the percentage of roads that are paved, efficiency of the electricity network, and years of schooling of the population."<sup>3</sup>

- "For cities in the US, shares of public spending on productive public goods – education, roads, sewers, and trash pick-up – are inversely related to the city's ethnic fragmentation."<sup>4</sup>
- "...higher levels of local ethnic diversity in Kenya are associated with sharply lower contributions to primary school funding and worse school facilities."<sup>5</sup>

### Rules

Sets of rules (that can be formally codified or informally understood) shape the roles, behaviours and expectations of social, political and economic actors. The fate of governance reforms depends on how existing formal and informal rules shape incentives for risk-taking in relation to reform, in contrast to the incentives they create for resisting reform and clinging to existing patronage systems.

Institutional change can have a ripple effect on political markets. For example, enforceable legal reforms might not only change the nature and structure of relationships between government and citizens, but also impact on the values (informal rules) impinging on people's perceptions and behaviour. Legal changes in relation to child labour and worker conditions become more effective when they permeate business and societal values; conversely legal change that is too distant from people's realities and values is likely to remain an unwelcome and often avoided compliance cost.

### Information

Information is the means through which the formal and informal rules impinging on people and organisations translate into incentives. Information helps to define incentives, and it also helps to sharpen incentives. Rules only work if people understand them, and have effective recourse to them.

The empowering role of information in shaping incentives in political markets is seen in various contexts:

- "...between 1933 and 1935 in the US, federal assistance to low-income households was greater in those counties where more households had radios and were thus more likely to be informed about government policies and programs."<sup>6</sup>
- "State governments in India are more responsive to declines in food production and crop flood damage via public food distribution and calamity relief expenditure when newspaper circulation, particularly in local languages, is greater."<sup>7</sup>

### Coordination

As mentioned above, information is central to stylising the way in which incentives are shaped and responded to. How information is collected and represented is also critical. Ultimately, only through an election process can information expressed by individuals send a clear signal to governments.

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However, for governments to listen and understand, information often needs to be collated, organised and channelled effectively to government.

Governments simply cannot listen to everyone all of the time. Hence, coordination functions and mechanisms become vitally important elements of political markets. Effective markets are those with institutional depth. Hence development agencies are increasingly recognising the importance of engaging with a wide range of channels to support the citizen-state relationship, including the media, the private sector, trades unions, political parties, citizens' watchdogs and parliamentarians. Yet often the actors involved in their programmes tend to be the 'traditional' partners such as international or national NGOs or the government (at national and local levels). For example, an analysis of grantee organisations of the BEST-AC programme in Tanzania<sup>a</sup> showed clearly that those organisations that were funded, or were likely to meet the requirements for funding, were the very same organisations that had already attracted donor funding.

Effective states are critical for improved development outcomes. Effective states can be defined by the quality of the transactional relationship between the state and its citizens. Transactions are defined by incentives, of citizens to demand the right things of government, and of government to respond appropriately to this demand. Incentives are defined by institutions, and made real by the strength of supporting information and coordination functions. All of these elements are central to the concept of a political market.

As with other market systems relating to more conventional commodities, products and services, M4P has the potential to strengthen political markets to make them more effective and inclusive.

### An M4P response to political markets

The above issues set the context for assessing the value M4P can bring to political markets.

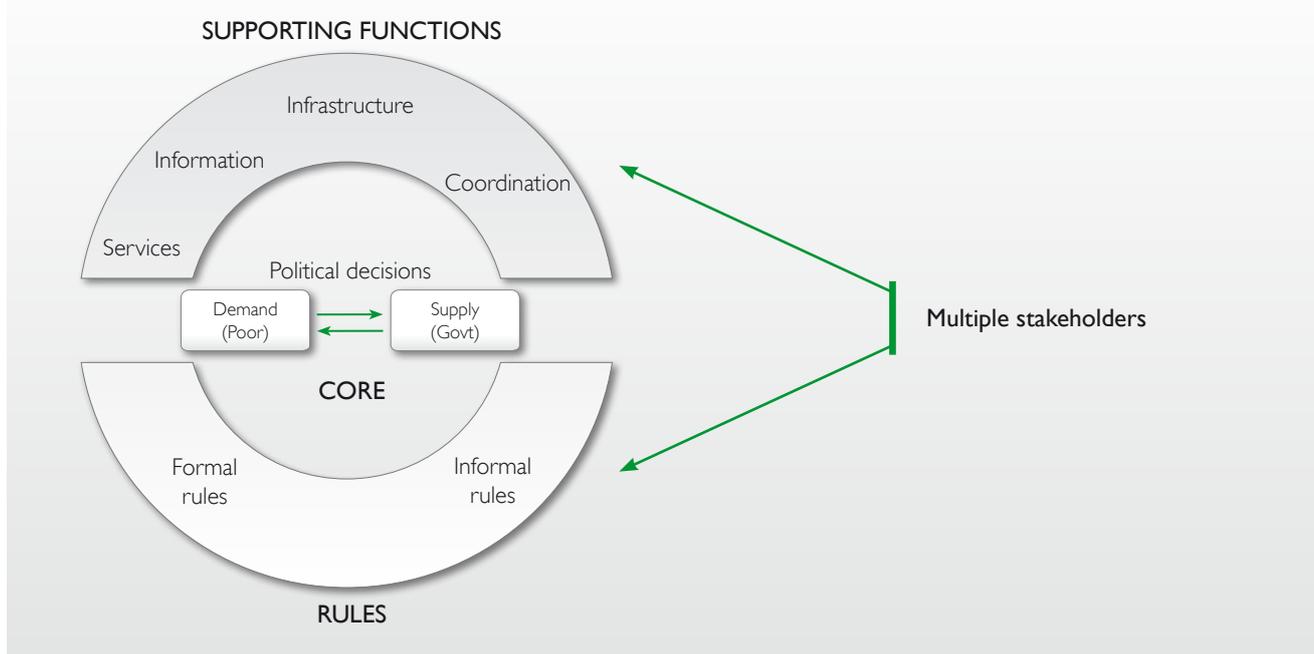
### A systems framework

M4P's strategic and organising framework can be applied to a basic picture of political markets (Figure 2).

The framework below is one which recognises that:

- markets are transactional in nature;
- transactional incentives are shaped by institutions, the informal and formal rules of the game;
- institutions are made real for core market players through the richness of the information, coordination and other supporting functions that serve as the connective tissue between core market players;
- there are multiple stakeholders in a political market performing a range of different roles in rule setting and delivering supporting functions.

**Figure 2**  
A political market system



<sup>a</sup> The Business Environment Strengthening for Tanzania (BEST) Programme aims at providing a more enabling environment for business in Tanzania. It is a multi-donor funded programme being implemented in collaboration with the Government of Tanzania. The programme was launched in December 2003.

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M4P clearly offers a relevant strategic framework for organising political market factors and for bringing clarity to interventions. Major thrusts of reform programmes can be represented broadly in this framework:

- Core market – a major thrust of political market reform is concerned with changing the structure of the core market. Decentralisation efforts have focused on putting in place structures that bring the source of the solution closer to the sources of the problem. Privatisation and liberalisation efforts are further attempts at changing core market structures.
- Rules – encouraging political competition through multi-party democratic processes has been a major thrust of rules changes. Equally, rules seeking to change or moderate rent-seeking behaviours in political markets continue to evolve.
- Supporting functions – many reform efforts have focused on strengthening and improving an increasingly wider variety of advocacy and dialogue mechanisms in support of identified drivers of change.<sup>b</sup>

### Understanding markets and analytical rigour

At the core of the market system are poor people and governments. The demand-side is represented by the concept of voice (of citizens), and the supply represented by the concept of accountability (of governments). M4P places a high premium on understanding markets and particularly the underlying causes (market imperfections) of disconnect between supply- and demand-side signals.

Focusing solely on either the voice or accountability side of the transaction is not enough. Unfortunately, as confirmed in Box 1, many agency initiatives do just this – with the focus placed either on voice (eg funding to create spaces for citizens' voice) or on accountability (eg an initiative to strengthen state capacity to respond).

#### Box 1

##### Donor focus on either voice or accountability

An analysis<sup>a</sup> of a sample of 90 interventions funded by the seven Development Assistance Committee (DAC) donors in ten countries over the last 5-10 years provides some insights on how 'voice and accountability' has been translated into development practice.

Players: the focus has been mostly on national NGOs (in 17% of the interventions considered) and government representatives at the central (21%) and local (17%) level. There has been relatively limited engagement of political parties, parliamentarians, citizens' watchdogs, community groups and the private sector which, combined, are involved in fewer than 10% of the interventions considered. State and non-state players have been only rarely involved in the same intervention.<sup>c</sup>

Through encouraging a focus on the relationship between citizens and the state M4P can help to bridge the divide between, on the one hand, those concerned with state building, reform processes and institutional capacity and, on the other hand, those with a more 'bottom up' perspective focusing on active citizenship, support for civil society and participatory approaches.

Taking a more coordinated and systemic perspective requires working not only with business and civil society organisations but also with and through government to better enable it to receive, understand and respond to improved advocacy.

Whether it is a cause, or an effect, of this situation, agencies also often fail to understand market imperfections in any detail. This lack of analysis is confirmed in the recent evaluation for the DAC referred to above, which reports that all too often donor-funded programmes demonstrate very limited articulation of the causes (rather than symptoms) of poor governance in different types of countries and of how societies and states are transformed. Rather than working from the existing reality, agencies tend to work back from a theoretical ideal, which sidelines any consideration of the incentives and constraints that shape behaviour.

M4P offers an organising framework within which tools for political, social and economic analysis can be used more effectively in presenting a more complete and systemic analysis than is currently the case.

### Interconnected markets

Interconnected markets are central to M4P. What are seen as supporting functions in one market can be seen as market systems in their own right. In relation to political markets for example, effective information and coordination functions are critical to a well-functioning political market.

The mass media are increasingly seen as a key source of information. Certainly, reforms to solve information problems in political markets should include reforms to free up the mass media. This central role of mass media in governance has become increasingly relevant to development over the past decade. In many developing countries government monopoly over the mass media has dissolved to allow the growth of diverse privately owned media industries. Mass media have become less and less a government mouthpiece and have begun to play a more important role in democratic government. This relatively recent change is illustrated by the dates of the launch of the first private radio stations in various African and Asian countries (Table 1). This liberalisation and diversification of mass media offers a new opportunity to tap into the potential of the media to become a positive driver of good governance.

<sup>b</sup> *Drivers of Change*, an approach used by DFID, is a way of understanding the political economy of change and poverty reduction in developing countries.

<sup>c</sup> See Elliott, D, Hitchens, R, Sulzer, M (2006); *Improving the environment for small businesses in Indonesia and Russia: Experiences from Swisscontact*; Making Markets Work for the Poor Case Studies Series; SDC, for a case of strengthening voice and accountability through such actors.

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**Table 1**  
**Radio liberalisation in selected countries – year of launch of first private radio station**

Mali	: 1991	Ghana	: 1995
Uganda	: 1993	Pakistan	: 1995
Zambia	: 1993	Kenya	: 1996
Sri Lanka	: 1993	Nepal	: 1997
Senegal	: 1994	India	: 2001
Tanzania	: 1994	Bangladesh	: 2006

Understanding the existing and potential role of the mass media in governance, and more specifically in bringing about reform in the business environment, is therefore important and timely. Recent research in Uganda<sup>9</sup> provides evidence that under the right conditions private media can perform more public functions – eg in relation to voice and advocacy – and can be a proactive driver of pro-poor reform initiatives. Making media markets work for the poor should be a key objective of voice and accountability reform processes.

With regard to coordination functions, much agency support for voice and accountability aims goes through advocacy organisations, of one kind or another. O’Neil has shown that such intermediaries were more likely to be international (with 62% of total funding) rather than national (with 38% of total funding) actors. Arguably in response to this, some agencies are trying to shift focus to supporting more home grown initiatives. DFID is one such donor which is increasingly supporting the competitive disbursement of funds to local advocacy organisations – be they trade unions, civil society or business membership organisations (BMOs).<sup>d</sup> However, as mentioned earlier, all too often such demand-side financing is not matched with interventions to support supply-side response.

Equally, there are question marks over the bluntness of the funding approach to advocacy. How sustainable will national advocacy movements be, if they are conditional on continued external donor finance? In the case of BMOs, members often undervalue the advocacy functions of their organisation. Initiatives aimed at improving voice – the capacity of the BMO to better make and express its demands to government – should also be concerned with translating successes into helping members to revalue advocacy functions and, accordingly, to pay more of the costs for them.

In the examples of media and advocacy given above, both are supporting functions in a more systemic view of political markets. Equally both can be seen as ‘markets’ in their own right, and a more systemic approach to intervention (beyond just financing at the core) should be followed by donors. M4P guides and supports such a perspective.

### Facilitation as the route to sustainable change

“Countries most in need of state reform are least able to implement it.”<sup>10</sup> This view is confirmed in 2004 World Bank Review of Development Effectiveness (World Bank),<sup>11</sup> which confirms that “...efforts have been more successful in countries where:

- they are politically stable;
- there is strong ownership of reform;
- the executive, the legislature, and the bureaucracy are working for common purposes; and
- the country has the administrative capacity to implement reforms.

*The Bank’s efforts have been less successful where one or all of these elements have been lacking.”*

An M4P perspective would suggest that reform approaches are based on a systemic view. The systemic perspective of M4P is one of multiple functions undertaken by a range of players. In this sense M4P offers a multi-function and multi-player framework. Efforts at reform need to look beyond ‘technical’ solutions that consider changes to market functions as sufficient. They also need to consider ‘institutional’ solutions, through addressing ‘who’ can / should perform the required market functions.

However, identifying what needs to happen, and being clear on who should do it, is only part of the solution. Understanding incentives that would support, or otherwise, those stakeholders playing a different role (and continuing to play this role after a period of intervention) is equally critical and one where M4P can offer insight. As confirmed in a recent multi-country review of DFID-funded economic governance reform programmes,<sup>12</sup> in spite of all activities having an appropriate strategic focus:

*“In general, a clear distinction between transactional and transformational (capacity development) objectives was not made in the specification of the objectives of project activities, and most activities did not clearly articulate how transformational impact was to be brought about.”*

Not surprisingly then, the findings confirm that support has often introduced better systems and procedures, but only in a minority of the cases was genuine capacity development and performance improvement identified. The root cause of this poor result was identified as lack of understanding of incentives within the target organisations (incentivising staff to play modified roles) and between government departments (recognising the validity of the new / expanded roles).

Agencies can only support national reform efforts. This requires facilitating change in others. At the heart of this facilitation challenge is the requirement to understand and respond to incentives. Whilst it is not always fully captured or codified, M4P

<sup>d</sup> DFID is funding an increasing number of challenge funds in various countries around the world. See [www.dfid.gov.uk](http://www.dfid.gov.uk) for more information on these.

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takes the facilitation challenge very seriously and is generating considerable insight into the process of successful facilitation. This experience could well support the facilitation challenges facing political market reform.

### Conclusions

The role of government is often critical to the performance of market systems; therefore the efficacy of the political decision-making process – in particular its responsiveness to the genuine needs of the poor – is a central concern. This paper has demonstrated that the process of political decision-making can be seen as taking place in political markets and can be viewed practically through the same M4P prism as other commodities, products and services with the poor as the demand-side and government as the supply-side in the core of the market.

How well political markets function is dependent on a number of factors; most importantly the appropriateness of incentives, information, rules and coordination. In this context, M4P can add value by providing a relevant systemic framework within which to assess the political decision-making process and the roles of different players within it; by highlighting the importance of interconnected markets (such as the media) in making political markets work more effectively and providing guidance for facilitators to act to bring about meaningful change.

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## PAPER 8: M4P AND CLIMATE CHANGE

### Introduction

This paper focuses on the application of M4P to the issue of climate change. While climate change does not refer to a specific market it is an environmental phenomenon that (a) subsumes within it a range of related market systems and (b) is perceived to have such potentially far-reaching, damaging implications for developing nations that it is of increasing importance to most development agencies and governments.

The paper first establishes the wider importance of climate change to global development and then focuses more specifically on its relevance to low-income countries and to poor people within them. In this context it then identifies three issues which are central to the climate change challenge and views these through the 'lens' of M4P. Finally, it concludes with comments on the applicability and limitations of M4P to climate change.

### Importance and relevance for the poor

Climate change stems from increasing greenhouse gases – or carbon dioxide equivalent (CO<sub>2</sub>e) – in the atmosphere caused by rising energy and non-energy emissions.<sup>a</sup> CO<sub>2</sub>e levels have risen to around 430 parts per million (ppm) from 280ppm at the start of the Industrial Revolution. Even with no increase in emissions (and they are growing), because of the time lags involved, this will grow to 550ppm by 2050.

At an aggregate level, climate change will result in lower economic growth. The Stern Report<sup>1</sup> estimated that action to stabilise at 550ppm would cost around 1% of global GDP annually. The total costs of not taking action, however (a 'business as usual' scenario), were estimated at equivalent to a 5-20% reduction in consumption per head. As well as the wider poverty-related problems emerging from lower incomes, climate change will cause:

- water shortages – a decline in the quantity and quality of water in many areas;
- decline in agricultural productivity – this will be especially apparent in more marginal areas of Africa (such as the Sahel) where lower production is forecast;
- inundation of low-lying areas – some countries, such as Bangladesh, may lose significant land area;
- more, and more intense, storms: changes in weather patterns will increase the preponderance of violent and damaging storms;
- degradation of the environment: loss of species and ecosystems will undermine specific economic activities as well as wider quality of life.

Some people and areas – especially those in higher latitudes – may benefit from climate change, for example from a longer growing season. But most people will experience a loss in their quality of life and the poorest countries and the poorest people will suffer most because of:

- *Geographical disadvantage*: the poor live in areas – tropical and sub-tropical – where there are fewer gains and more losses from climate change.
- *Dependence on agriculture*: the poor, typically, have higher dependence on agriculture as a source of income, so declining crop yields will impact on them relatively more than the average.
- *Greater vulnerability to change*: the poor are more at threat from natural disasters (which will increase) and less able – being more risk averse and with less information and lower capacities – to adapt their habits to new circumstances.
- *Dependence on growth-derived benefits*: growth has been the key driver of poverty reduction; a fall in growth will tend to impact disproportionately on the poor.

<sup>a</sup> Greenhouse gases comprise six main gases – carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons, sulphur hexafluoride – but for shorthand are referred to as carbon dioxide equivalent (CO<sub>2</sub>e)

## PAPER 8: M4P AND CLIMATE CHANGE

While there is considerable debate over the extent of climate change and how this will manifest itself in the future, the above represents a mainstream view and one with which most agencies and governments concur:

### Key challenges in addressing climate change: the M4P perspective

The ubiquitous nature of climate change (the weather!), the daunting nature of its scale and the uncertainties over its causes and manifestations add to the challenge of seeking to address it through concerted action. For some, the idea that the environment can be viewed and acted upon through the prism of market systems may appear bizarre or even offensive. Others point to the overarching importance of global political agreement – over for example emissions – as the core issue. Yet the Stern Report itself viewed climate change as “*the greatest and widest-ranging market failure ever seen*”. As in most markets, the effect of this market dysfunction falls most on those least able to take action to escape its consequences.

Taking Stern’s market failure as the starting point for this analysis, an M4P perspective is particularly important in addressing three related market systems:

- the carbon market;
- the market for more energy-efficient and environmentally friendly technologies and processes; and
- consumer markets.

For each of these, M4P, as an approach that is about understanding and then acting to change markets, offers improved clarity in analysis and guidance for intervention, ie it is both about what agencies do and how they do it. M4P’s value-added stems from, among other features:

- developing a transparent view of a market system and of the functions (core transactions, rules and supporting functions) and players within it;
- building interventions on the basis of a detailed understanding of markets – including interconnected markets – and the poor within them;
- identifying underlying systemic constraints; and
- placing sustainability at the heart of the intervention process.

### How can carbon markets be developed to operate more effectively?

Carbon markets have been created both voluntarily and through regulation to give value to CO<sub>2</sub>e (carbon for short) as a tradable commodity.<sup>b</sup> <sup>2</sup> In the more developed markets, buyers purchase certificates from sellers verifying defined reductions in CO<sub>2</sub>e from specific projects. From a development and environmental perspective, the rationale for the market is that it provides a means through which the externality of emissions can be internalised within markets. Carbon markets offer a more economical method

of reducing carbon emissions than, for example, investing in new plant and equipment. Typically, the cost of reducing one tonne of CO<sub>2</sub>e in industrialised nations is \$15-\$100. However, the cost of achieving a similar reduction in developing economies is often much less (\$1-\$4 per tonne), thus offering a reason for them to buy.

There are broadly two types of carbon market.<sup>3</sup> First, the compliance-driven market. This has been created by compliance requirements emerging from the Kyoto protocol under which industrialised country signatories have pledged to reduce their emissions by 5.2% in the 2008-2012 period relative to a 1990 baseline. Most carbon trade takes place the EU Emission Trading Scheme (ETS)<sup>c</sup> and the Clean Development Mechanism (CDM).<sup>d</sup> Second, but relatively small, are voluntary markets under which buyers and sellers exchange, on an offset basis but outside the provisions and regulations of official agreements. Much of this is dominated by forestry projects.

At first sight, growth in the carbon market appears impressive. In 2007 the market grew to a value of \$64 bn, more than twice its 2006 level, reflecting both increased volumes and higher carbon prices. However, beyond this aggregate positive picture there is a more complicated reality. Most emission trading is done within the ETS, by far the biggest market. CDM transactions, providing the main mechanism for developing countries, are dominated by China (three-quarters of transactions) with only 1% from Africa. Growth has come primarily from utilities or experienced operators using trusted and known technologies (eg industrial gases). In other words, as in any market, initial growth has come from the safest and most established players. The market has not advanced substantially to more difficult (and poorer) countries, smaller players and more innovative carbon-reducing technologies related to renewable energy and energy efficiency.

A number of reasons appear to lie behind the rather mixed performance of both compliance and voluntary carbon markets.

- High transaction costs of engaging in the market: the process through which projects can qualify to sell carbon is complicated, lengthy and expensive. It involves application to national authorities in accordance with a standard format, external inspection of proposals by accredited parties (designated operational entities [DOEs]) and external monitoring. The pipeline through which projects must pass takes 1-2 years. Delays tend to favour larger projects with healthy finances.
- Capacity constraints: becoming a DOE costs Euro 150,000 and is an 18-month process. There are few DOEs – they are a substantial bottleneck with projects reporting that it takes six months to engage them. On the project development side, there are limitations in the expertise available to develop new projects.
- Lack of transparency over reporting standards: in the

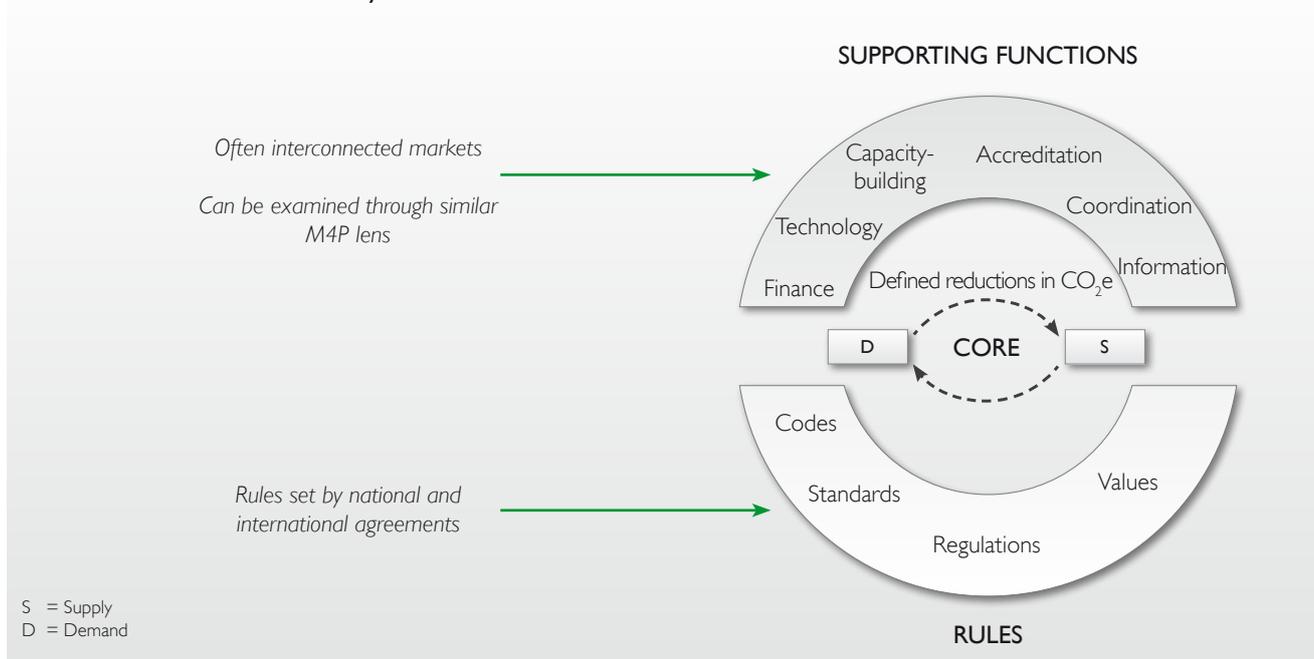
<sup>b</sup> Unless otherwise stated, data in this section is taken from *State and Trends of the Carbon Market 2008*.

<sup>c</sup> A so-called ‘cap and trade’ programme – regulated entities trade allocated allowances within a cap set by regulation. They can, however, purchase from buyers outside the cap.

<sup>d</sup> A project-based or ‘baseline and trade’ programme – offset credits from projects reducing CO<sub>2</sub>e emissions.

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**Figure 1**  
Schematic of the carbon market system



voluntary market there is a growing (and confusing) number of independently established standards. The resulting confusion over how carbon savings should be calculated tends to undermine the credibility of the market's 'currency' and therefore the market itself.

- An uncertain future: provisions under the Kyoto agreement last until 2012 but the nature of the regulatory framework beyond this is unclear. There is a widespread view that important mechanisms such as the CDM need to be reformed but until there is clarity on the nature of this reform, a cloud of uncertainty will continue to hang over the market.

### **The M4P perspective: bringing clarity to the market development task**

This strand of the climate change challenge is, in many ways, a direct market development task. Indeed, one of the key protagonists in the field – the World Bank's Carbon Finance Unit<sup>4</sup> – describes its role as that of market facilitator. Having been created through global regulation, the task facing agencies and governments globally is how to further develop this nascent market system. In this context, M4P appears to offer a number of benefits.

First, it offers greater clarity. A fundamental problem with the carbon market is its complexity. This creates immediate barriers both to potential participants in the market and to development agencies that instinctively feel they may have a role to play

but find the carbon market daunting and confusing. Figure 1 presents a rough schematic of the market. Clearly, the analysis above demonstrates that there are significant constraints related to both rules and supporting functions. Rules, by their nature, require action at a national or international level whereas more localised interventions are possible in relation to supporting functions.

Second, given a clearer picture of the overall market, it becomes easier to identify and define potential intervention areas that can contribute to a more functional system. There is currently widespread concern over the existing rules regime. In particular, there is tension between, on the one hand, the high transaction costs imposed (especially for poorer countries, generating the suspicion that rules are another form of trade restraint) and, on the other hand, the need for rigour and credibility in rules. As in other areas of global certification – such as food products – where similar tensions are evident, there is a need to explore workable compromises between these two concerns. Setting the right rules regime requires intervention at an international level initially and then nationally – and this is likely to be practical only for some agencies.

More immediately, the task of creating the right supporting functions in different countries has to be addressed. In addition to the limited number of DOEs mentioned above, many developing countries lack the infrastructure of brokers, advisors, consultants and financiers who are necessary to develop local

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markets. Their capacity is weak and their links with international providers limited. The capacity of national governments – ‘designated national authorities’ in the carbon market – is variable.<sup>5</sup> Information for potential project developers on how to develop viable projects that comply with international rules, and therefore can generate tradable carbon gains, is scant. These constitute interconnected service markets and, as in other sectors, are open to the same M4P analytical framework and rules for intervention. Key constraints to be addressed here include poor linkages, capacities and information. The challenge is to address these to stimulate new activity – requiring in many places active interventions – and to enhance the incentives and capacities necessary for a vibrant, sustainable market.

### How can markets for more energy-efficient and environmentally-friendly technologies be developed?

One of the main interconnected markets in the carbon market system (Figure 1) is that for more energy-efficient and environmentally friendly technologies. This includes technologies related directly to energy production – such as solar photovoltaic cells (for electricity generation), solar panels for water heating, wind, tidal and wave power, biomass/energy crops and heat pump technologies – and better use of energy, such as new industrial plant and domestic equipment. For climate change to be addressed (aided by and contributing to a functioning carbon market), a central challenge is to achieve more widespread development, adaptation, purchase and use of these technologies.

Although the picture varies regionally and with technology, the general situation is one of relatively slow take-up. Currently around 13% of global primary energy is accounted for by renewable sources – but most of this is hydropower. In terms of ‘new’ technologies – eg solar, wind and wave – the figure is less than 0.5%. This is despite the strong evidence of wider environmental benefits from these technologies. One key reason cited for the relatively slight take-up of new technologies has been their low rates of return for individual users/investors – private returns do not reflect the positive externalities associated with renewable technologies (hence the rationale for the carbon market). However, in an era of higher oil prices, the immediate commercial attractiveness of energy technologies has changed significantly. In relation to producers and consumers of energy technologies, the key question ahead for agencies and governments is: what other actions are required to allow greater use of renewable and more energy-efficient technologies?

### The M4P perspective: beyond price, addressing other constraints to growth and access

The correction to relative prices in the energy market eases one central (incentive) constraint to growth. However, as in most markets, it is unlikely that this, by itself, will result in the degree of transformative change that may be possible and, it might be argued,

is required. For that to happen, other constraints preventing the development of the market system will need to be addressed. M4P allows a considered and comprehensive approach to the identification and prioritisation of these constraints. Depending on local context, a number of potential focal areas for intervention might emerge:

- The research and development/private sector divide: as in other markets (eg agriculture) a familiar challenge is how to take new and promising ideas developed in publicly funded research organisations and have these further developed and disseminated by private sector players in markets. This bridge between public and private good – and the processes and relationships which define it – is often weak.
- The innovation barrier: building on from the above, for the market to develop and change, private companies must invest in the development and distribution of new technologies. As with other product areas (eg financial services) where mainstream private providers have previously played little role but now see the commercial attractiveness of low-income and/or niche markets, the challenge is how to stimulate new (risk-taking) innovation. In the past (and currently) agencies’ interventions have tended to crowd out private sector interest by taking a direct role in the market as a supplier or by favouring one provider over another. Yet, there is no doubt that companies do tread warily into new ‘bottom of the pyramid’ markets. The opportunities here are for agencies to encourage change – by, for example, providing better information on market potential or selective and conditional support to a lead firm – throughout the market system towards more innovative business models that effectively enhance the access of low income groups to new technologies.
- The information gap: information constraints for both supply- and demand-sides are often acute – with market players not having enough information to make rational decisions.<sup>e</sup> Commonly, agencies have supported individual technologies and providers – sometimes through direct marketing support – but neglected the wider information constraint. Improving the information environment can be an important role for facilitators, for example through direct social marketing campaigns, supporting a public player (such as a business membership organisation [BMO]) to play this role or working with the media to encourage them to see the value in highlighting the potential benefits of new technologies.<sup>6</sup>
- Developing the services infrastructure: as with the carbon market and other product areas, knowledge and information are assuming more importance in the market for energy technologies. This often takes the form of improved services

<sup>e</sup> It is widely accepted that most market systems in developing countries are relatively information-poor.

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– offered by suppliers as an embedded part of their offer to consumers or from specialist consultants, brokers and advisers. Facilitating the development of these services and service providers is a central part of developing the energy technology market.

### How can consumer pressure become a positive force for change?

The power of consumers to influence corporate behaviour is evident in a number of product areas. In some cases pressure is manifested in formal systems of industry/legal standards – such as food and health – and in other cases less formally, for example through corporates' own codes of conduct in the garment sector. Consumer power is open to influence and can be ill-informed, especially in relation to the activities of producers in distant places but:

- it is increasingly important and, in a global economy, its importance seems likely to grow; and
- this growth will embrace climate change issues – indeed, this is already happening.

In this context, a variety of independent voluntary standards have arisen to 'encourage' consumers to check on the climate change credentials of products, in particular to gauge the appropriateness of offset projects. Some of these seek to follow the practice of the recognised carbon market, while others are tied closely to companies' own practice. As a consequence, there is little comparability between these standards. For corporate investors this is increasingly problematic, with many now complaining of a 'greenwash' phenomenon – "*vague qualitative disclosures*" that do not permit transparent examination of performance.<sup>7</sup>

Carbon labelling of products (especially food) is an attempt to replace this diversity and confusion with 'objective' measurement of carbon content. There are, however, formidable methodological issues associated with carbon labelling. The favoured approach of life cycle assessment is inherently complex and requires consistency in relation to key issues, for example whether electricity from renewable sources should be treated in the same way as that from other sources.<sup>8</sup> Moreover, there appears to be no simple way in which carbon labelling can be made consistent with the carbon market.

### The M4P perspective: developing services to promote access and inclusive market development

Consumer markets are likely to become a growing influence on climate change. The challenge for agencies is to shape this trend so that it allows:

- consumers to make rational, informed choices – standards have to be sufficiently rigorous;
- developing country producers to access markets – standards and processes have to be sufficiently inclusive.

The danger currently is that neither objective is being achieved. The multiplicity of standards being developed mirrors trends in other product areas<sup>f</sup> where standards are in danger of losing their authority and credibility. And for developing country producers, certification costs often constitute a relatively greater cost burden than that of their high-income country competitors.

In this context, M4P again offers a clearer picture of the market development challenge and sets out the areas where intervention is required. First, in response to the plethora of standards emerging, greater coordination is necessary to produce standard reporting and methodologies. This, in practice, is only likely to be done by governments and agencies. Second, developing standards that take inclusivity seriously means developing not just appropriate standards but functioning services and processes in low-income countries relating to both the imposition of standards and building capacity to meet standards. Without these steps, consumer markets are unlikely to be able to exert significantly positive pressures on climate change.

### Conclusions

This paper has set out three key issues that need to be confronted if action on climate change is to be effective and poor people in particular are not to be burdened by its consequences. The climate change challenge is obviously large and complicated. Yet, at its heart – as recognised by the Stern Report – it is about improving the functioning of market systems. For climate change to be addressed, three related markets need to operate more effectively: the carbon market, the market for energy-efficient technologies and the market for consumer products (especially food).

The climate change challenge can essentially be seen as a market development challenge. In this context, M4P is particularly relevant. As in other spheres, the value it adds is first by offering clarity in analysis – a transparent means through which governments and development agencies can examine the different market systems impinging on climate change and their own role in developing it. While some issues are specific to climate change, such as the *modus operandi* of carbon market operations, it has many issues in common with other markets such as how to develop standards, services, information and new business models that promote growth and access. Second, given this clarity, M4P potentially offers value by providing guidance for interventions – not only what these should focus on but how they are implemented.

<sup>f</sup> For example, 22 different national and international certification schemes are listed by international agencies in the aquaculture industry.

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