Overseas Development Institute

Opinion

February 2008

95

How to achieve growth: The million dollar question

Karen Ellis

'Growth is crucial for development and poverty reduction, and we have a good idea of the conditions that are generally conducive to achieving growth. Unfortunately, that does not make it easy to achieve'

There is now widespread recognition that achieving economic growth is essential for securing long-term development and poverty reduction. No country has succeeded in sustainably reducing poverty in the absence of growth. And evidence shows that growth usually benefits the poor, on aggregate (see Figure 1).[1]

For many developing countries, promoting growth has always been a priority. But with the backlash in the 1980s against the 'trickle down theory' (which argued that policies that led to higher incomes for the rich also benefited the poor), and then with the rise of the Washington consensus in the 1990s (which argued that if governments liberalised markets, growth would take care of itself), promoting growth as a focus for action has been out of favour amongst donors for some years now. Instead, donor policy and aid spending has often focused on interventions targeted more narrowly at benefiting the poor. In the last year, however, there has been a resurgence amongst donors of interest in growth policies.

In broad terms, we know the conditions that are conducive to growth, but that does not mean that achieving high and sustained rates of growth is easy – only a few countries have succeeded.

The conditions for growth

Sustained economic growth is the steady increase in the productive capacity of the economy – and hence in national income. The private sector drives growth. By investing, creating jobs, and producing goods and services which are then consumed, used as inputs for other businesses, or exported, private firms and farms are responsible for most of an economy's production. So long as they operate within well-functioning, competitive markets, they have incentives to produce goods as efficiently as they can, to innovate, and to fulfil market demand, which helps to increase the amount produced for a given level of resources, i.e. they increase a country's productivity. So in a market economy, it is private sector enterprises operating in a competitive environment that drive economic growth.

But a well-functioning, competitive market does not necessarily happen by default – the government has an important role to play in creating the right conditions for growth:

- It must provide an enabling environment for business, and a good investment climate, e.g. macroeconomic and political stability, good infrastructure, secure property rights, a well-regulated financial sector, a well-trained labour force etc. Those developing countries, such as China and Malaysia, which have enjoyed high and sustained rates of growth, have also had high levels of public investment. This is because improvements in things like education and infrastructure help to increase the return on private sector investment.
- Government also needs to stimulate competitive market conditions, e.g. by limiting state ownership of enterprises, and reducing state intervention in markets like the financial sector, opening up the economy to trade, removing regulatory barriers to entry, adopting a sound competition policy, and tackling corruption and cronyism etc.
- Government also needs to tackle market failures, for example by developing informational infrastructure such as asset registries and credit bureaux, and appropriately regulating industries with natural monopoly characteristics such as electricity and water.
- Successful integration into the global market is also key to growth. There are no examples of sustained high growth in the post-war period that do not involve integration into the global economy.[2] Access to international markets is important in providing: a major source of potential demand (which is particularly important for small economies); a source of investment capital; ways to facilitate the spread of new technologies and other innovations and know-how; and a way to stimulate competition, all of which contribute to productivity growth.

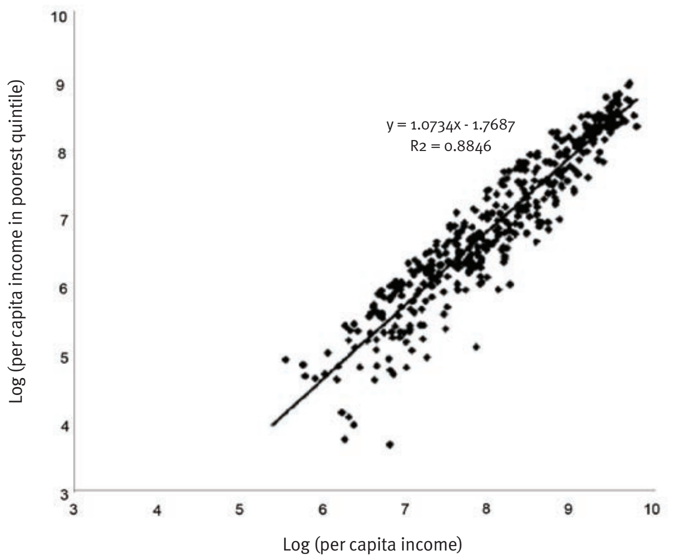
Overseas Development Institute

ODI is the UK's leading independent think-tank on international development and humanitarian issues.

ODI Opinions are signed pieces by ODI researchers on current development and humanitarian topics.

This and other ODI Opinions are available from www.odi.org.uk

Figure 1: The relationship between income of the poorest people and average income



Source: Dollar and Kraay (2001)

But achieving those conditions is not easy

Key constraints include:

Capacity constraints and prioritisation: Many developing countries are a long way from achieving the necessary conditions outlined above to underpin growth. Tackling such a long list of requirements is a huge challenge to most countries, which have limited capacity to undertake reform. In addition, it can be very difficult to identify which factors are the binding constraints to growth in a particular country, and hence need prioritising. Tackling the wrong problem will prove ineffective, if other factors are more constraining. Methodologies which attempt to diagnose the binding constraints to growth and identify priorities need further development.

The political economy of growth reforms: Growth can make it possible for everyone to be better off. But it usually benefits some people more than others, and income inequality sometimes increases with growth. In addition, transformational growth – which leads to the decline and closure of some industries alongside the rise of others – also inevitably creates some losers in the short to medium term. This can create serious opposition to growth-promoting reforms from workers in these sectors and other vested interests which have often succeeded in blocking or reversing reform, particularly in countries where there are strong links between government and business.

Thus governments need to address the political-economy obstacles to growth and support flexibility in the economy by introducing policies to help protect or compensate the losers from the economic transformation that often accompanies growth. Examples include social safety nets to protect the temporarily unemployed, re-training programmes, policies which ensure access to basic services like water and energy, or even compensation packages for incumbents losing out to increased competition. But this can be expensive.

Identifying likely sources of growth: Some of the most successful economies have benefited from a government-led strategy to develop particular industries where it is felt the country is likely to have a comparative advantage in the world economy. However, identifying them can be difficult and government attempts to 'pick winners' are often unsuccessful, with costly repercussions.

China and India, which are attractive prospects to investors because of their size, huge supplies of cheap labour, and relatively good standards of education, infrastructure, and institutional development, are making it more difficult for other countries to compete in labour-intensive manufacturing and services, which may otherwise have been an area of comparative advantage. In the longer term though, growth in India and China is likely to generate new markets for other developing countries' exports.

Some countries have particularly difficult circumstances to deal with, such as ongoing conflict or challenging geography (e.g. being landlocked, small, remote, prone to natural disasters or tropical diseases, or having mountainous or desert terrain), which will make it even more challenging to identify successful growth strategies.

Renewed donor support for growth policies is needed

Growth is crucial for development and poverty reduction, and we have a good idea of the conditions that are required to achieve it. But making significant pro-gress towards those conditions can be challenging.

The recent resurgence of interest in growth is thus to be welcomed, and should be maintained. Donor assistance for things like infrastructure development and education, capacity-building for macroeconomic management, market reform and regulation, and more work on how best to identify priorities and tackle political-economy problems, would make an invaluable contribution in supporting developing countries' efforts to achieve growth.

Written by Karen Ellis, ODI Research Fellow (k.ellis@odi.org.uk).

Endnotes

1 Dollar, D. and Kraay, A. (2001) 'Growth is Good for the Poor', Policy Research Working Paper 2587. Washington, DC: World Bank.
2 Spence, M. (2007), 'Why China Grows So Fast', *Wall Street Journal*, 23 January.

odi

Overseas Development Institute

111 Westminster Bridge Road, London SE1 7JD

Tel +44 (0)20 7922 0300

Fax +44 (0)20 7922 0399

Email publications@odi.org.uk

ISSN 1756-7629