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Integrated Economic Analysis for Pro-Poor Growth

A Methodological Approach

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PREFACE

An understanding of the many facets of poverty requires a multi-dimensional analytical approach. The need for such analysis is highlighted in *Perspectives on Poverty and Sida at Work*, while overall guidelines on how such analyses may be undertaken at the country level is provided in *Country Level Analysis for Poverty Reduction*. The present methodological guideline for *Integrated Economic Analysis (IEA)* forms part of this ongoing effort within Sida to strengthen the analytical basis for development cooperation and to enhance the poverty focus in country level analyses.

The approach underpinning the methodology rests on two basic premises. Firstly, pro-poor growth requires that poor women and men are able to participate fully and on an equal footing in economic development processes. Secondly, employment and income derived from employment (self-employment or wage employment) is the singularly most important link between economic development and reduction of income poverty.

The overall objective of the *IEA* methodological approach is to sharpen the poverty focus – and not least to focus on the role of poor women and men as actors – in the conduct of country level economic analysis and in the assessment of economic analyses and policies. More specifically, the objective of the methodological approach is to:

- Take the economic actors as the starting point, with special attention to poor women and men, and make sustainable poverty reduction the chief objective.
- Operationalise pro-poor growth by integrating employment analysis, business environment analysis and macroeconomic analysis.

This methodological guideline should be seen as an approach rather than a blueprint. A high degree of flexibility and a genuine embedding of the analysis in the country specific context are crucial for making the analytical work both manageable and relevant. It is our hope that the guideline will be useful not only as a support for comprehensive economic analysis, but also as a lens facilitating a sharp poverty focus in the assessment of other analyses.

The *IEA* methodological guidelines have been developed by Susanna Lundström and Per Ronnås as part of a collaborative effort between the Department for Infrastructure and Economic Cooperation (INEC) and the Department for Policy and Methodology (POM) at Sida, Stockholm. For further information please contact per.romnas@sida.se or susanna.lundstrom@sida.se.

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1 BACKGROUND: THE NECESSITY OF A SHARPER FOCUS ON THE POOR IN ECONOMIC ANALYSES

The purpose of this paper is to propose a methodology to achieve a stronger poverty focus within economic analysis in a way that highlights the economic role of the poor and the benefits they derive from growth. Despite the attention that the concept of pro-poor growth has attracted over the past few years, the analytical framework underpinning the concept has remained inadequate. Standard analysis of economic growth in developing countries has not focused sufficiently on elements that will maximise the participation of, and benefits to, the poor in the growth process itself. The standard ‘trickle down’ assumption (that overall growth will ultimately also benefit the poor), sometimes complemented by assumptions of redistribution policies, has *de facto* been the reigning paradigm. This paper, therefore, proposes an ‘Integrated Economic Analysis’ (IEA) to better understand the determinants of pro-poor growth at the country level, focussing on integrating employment analysis, macroeconomic analysis and business environment analysis.

Economic growth does not always bring about poverty reduction. There is no constant or invariant relationship between economic growth and poverty reduction. Similar rates of growth have been found to have different effects on poverty reduction in different countries. Similarly, the same economic policies have been found to have, at times vastly, differing outcomes in terms of both economic development and poverty reduction depending on the setting in which they are applied.¹ The concept of pro-poor growth – or more recently shared growth – has been developed in recognition of the fact that not only the rate of growth, but also the structure of growth, matters. The extensive and increasing literature on pro-poor growth is a testimony to the increased importance attached to the qualitative aspects of growth and to the causes behind the variation in the efficacy by which growth results in reduced poverty.

There is agreement on some general fundamentals that are necessary, but not sufficient, for pro-poor growth. Sustainable economic growth is an absolute precondition for long-term reduction of material poverty. Hence, the preconditions for growth apply equally to pro-poor growth; however they may not necessarily suffice. In order to achieve sustainable economic growth a number of basic attributes are required such as:

- An open, functioning market economy.
- Protection of property rights and contract enforcement.
- A high degree of predictability (including macroeconomic stability) and protection against vulnerability.
- A high rate of savings and a good business environment (including an efficient financial system).
- An adequate system for public resource mobilisation.
- Sustainable use of the environment and of natural resources.

Standard parameters need to be translated into specific policies, reforms and institutions depending on the country context. How these general functions presented

¹ See *The Growth Experience: What have We Learned from the 1990s?* (Washington D.C.: World Bank, 2005) and *Pro-Poor Growth in the 1990s: Lessons and Insights from 14 Countries* (Washington D.C.: World Bank, 2005).

above should be translated into specific policies, institutions and reforms, depends on the context. The form as well as the sequence is therefore country and time specific.²

Pro-poor growth requires that the poor are able to participate fully in the economy, and pro-poor growth analysis needs to capture how this can occur. For growth to become genuinely pro-poor the poor need to be able to participate fully and on an equal footing in the economy.³ Hence, in addition to the attributes above, issues of employability – access of the poor to resources enhancing their productivity such as education, skills, good health, but also capital and natural resources (land, water etc.) – and unhindered and equal access to employment opportunities and entrepreneurial activities become important.

Put the role of poor (and non-poor) people as creators of growth in focus. The traditional analytical approach focuses on economic growth per se, as growth is needed to reduce poverty. An alternative, and arguably more conducive, approach would be to view poor (and non-poor) people not primarily as the recipients of the benefits of growth, but as the creators of growth, i.e. to view them as economic actors (whether self-employed producers or employees) and not as more or less passive consumers. Thus, economic growth can, and should, be regarded as the aggregate result of the efforts of all individuals and groups to use the resources at hand productively with a view to increasing their welfare. It is not growth as such that reduces poverty, but individual people, including not least the poor, who create growth and improve their own well-being in the process.

This in turn requires a focus on employment, productivity and returns to labour. Employment and income derived from employment (self-employment or wage employment) is the singularly most important link between economic development and reduction of income poverty.⁴ Yet, employment analysis is seldom at the fore of economic analysis in a developing country context, if it is included at all. Moreover, the crucial importance of a business climate that is conducive for productive employment for self-employed producers, i.e. the majority of the poor, has not been sufficiently recognised in pro-poor growth analyses. The generation of productive employment opportunities is often regarded as a residual outcome of economic growth and economic policies, rather than as an objective. The scant regard paid to aspects of income generating employment in economic analysis also implies that the mechanisms translating economic growth into reduced poverty have remained poorly understood.

Employment, the business environment and the macroeconomic setting should be perceived as a whole. For various institutional and historical reasons, different types of economic analyses are often undertaken separately, thus the insights that may be gained from a more holistic approach are lost. Among international organisations, macroeconomic analysis falls within the realm of the IMF. The World Bank has

² See Rodrik 'Goodbye Washington Consensus, Hello Washington Confusion', *Journal of Economic Literature* (forthcoming).

³ See *Equity and Development*, World Development Report 2006 (Washington. D.C.: World Bank 2006).

⁴ See R. Islam (ed.), *Fighting Poverty: The Development – Employment Link* (London and Boulder: Rienner, 2006), A.R. Khan 'Employment Policies for Poverty Reduction' *Issues in Employment and Poverty* No. 1 (Geneva: ILO, 2001) and S.R. Osmani, *The Employment Nexus Between Growth and Poverty: An Asian Perspective*, Sida Studies no. 15 (Stockholm: Sida, 2005) for methodological discussions and country case studies exploring these linkages.

assumed the primary responsibility for analyses of the business environment as well as for development analyses more generally, while employment and labour market analyses have traditionally been a speciality of ILO. By integrating employment, business environment and macroeconomic analyses, the links between the aggregated outcomes and the structural constraints at the microeconomic level can be better understood.

The overall objective of the IEA methodological approach is to sharpen the poverty focus – and not least to focus on the role of poor people as actors – in the conduct of country-level economic analysis and in the assessment of economic analyses and policies. More specifically, the objective of this methodological approach is to:

- Take the economic actors as the starting point, with special attention paid to the poor, and make sustainable poverty reduction the chief objective.
- Operationalise pro-poor growth by integrating employment analysis, business environment analysis and macroeconomic analysis.

The remaining sections of the paper describe how the IEA approach to pro-poor growth augments traditional growth analysis (Section 2), outlines a methodology for undertaking an IEA (Section 3), and discusses the relevance and role of the IEA approach in a donor policy framework (Section 4).

2 POINTS OF DEPARTURE FOR THE *IEA* APPROACH

2.1 Viewing the Poor as Contributors to Growth through Productive and Income-Generating Employment

A focus on the poor as creators of growth calls for a focus on employment and labour productivity in economic analysis. This methodology takes the human resources and the need to create conditions conducive to unleashing the creative and productive forces inherent in this resource base, with particular emphasis on the poor, as the starting point of the analysis. Enhancing employment and returns to labour by (i) strengthening the productive *resources and capacity* of the poor and by (ii) opening up *opportunities* for everyone to make full use of the productive resources at hand, is considered the main avenue for reducing income poverty and achieving pro-poor growth. Thus, the focus of this methodological approach is not simply on employment creation, and hence not on fostering labour-intensive growth as a panacea for poverty reduction, but on employment and productivity in a manner that efficiently increases the income of the poor.

*By consistently focussing on both employment and productivity, the objective of the analysis becomes de facto also tantamount to enhancing growth while the focus on increasing employment opportunities and returns to labour for the poor enables a focus on pro-poor growth.*⁵ Hence, the value added from breaking down growth is that it opens up possibilities for a sharper poverty focus and a better understanding of the country-specific constraints on pro-poor growth. This ‘employment and productivity’ route to pro-poor growth helps sharpen the poverty focus in several ways:

1. Productive employment is arguably the most powerful vehicle for escaping income poverty. Moreover, it fosters personal empowerment and increases freedom of choice as well as freedom from want. It places the role of people as economic actors and creators of wealth at the centre, and *focuses on the creation of the preconditions for the poor to improve their own well-being.*
2. A *microeconomic perspective on the macroeconomic aspects of pro-poor growth* is achieved by placing the poor and other actors centre stage. An understanding of their specific strengths and weaknesses, potential and constraints permits a much sharper focus on the potential for, and constraints on, pro-poor growth than is commonly achieved in economic analysis. Similarly, by distinguishing between the employment and productivity components of growth, the analysis becomes more nuanced and the conclusions can be more finely tuned to the specific needs arising from the particularities of the employment situation and the labour force.⁶

⁵ It should be noted that the aggregate product of employment and labour productivity equals GDP and increases of this aggregate product amount to GDP growth.

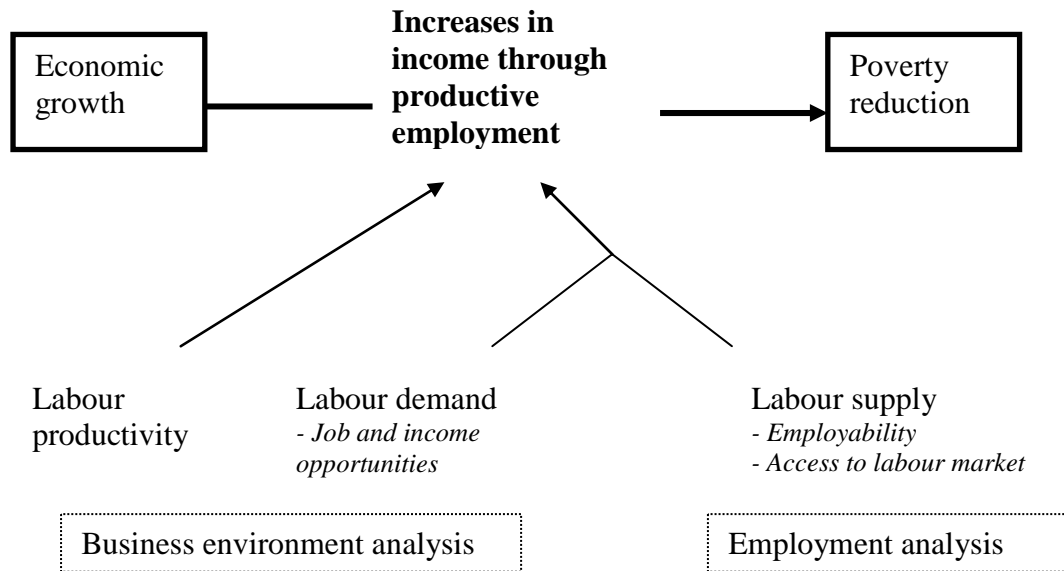
⁶ For instance, in a situation where most poor people work long hours, the emphasis would need to be on increasing productivity and returns to labour, rather than on increasing employment opportunities *per se*. A situation with low participation rates in the labour force may call for efforts to eliminate obstacles to labour market access, typically for women, while large open unemployment or under-employment in terms of time worked may highlight the need for employment creation and more labour-intensive growth. For a discussion on different growth and employment patterns, see A.R. Khan *Employment Policies for Poverty Reduction*, Issues in Employment and Poverty No. 1 (Geneva: ILO, 2001).

3. A focus on the economic actors also makes it possible, data permitting, to break down parts of the analysis into categories, such as by income, type of employment (occupation, sector and employment status), location (such as rural – urban), gender, age groups or ethnicity. This in turn makes it possible to highlight aspects of discrimination or unequal opportunities, i.e. *group specific constraints on pro-poor growth*.
4. *The focus on the human resources of a country rather than on the country as such makes it conceptually easier to incorporate overseas labour migration into the analysis.* Hence, the coverage of the analyses is defined by the economic actors rather than where they perform their activities. Labour migration abroad for shorter or longer periods is often a central component in household economic strategies, particularly in situations where employment and income opportunities at home are considered to be poor. At the individual and household level it can offer an escape from income poverty, although the costs and risks involved are often high. In situations where this phenomenon is widespread, it has a profound economic and social impact at the national level and obvious implications for policy-making. Yet labour migration abroad tends to be inadequately incorporated into most economic analyses at country level.

Thus, it is crucial to consider the poor not only as consumers who should receive a share of the country's growth, but also as active participants in the economy - which makes an employment analysis necessary - and as independent economic agents (it should be recalled that in most developing countries the vast majority of the labour force is self-employed) which makes a business climate analysis necessary. It is also important to analyse the macroeconomic environment that, to a large extent, determines the parameters for economic development and policies and also mirrors strengths and weaknesses in the economy. With this view on pro-poor growth, an integrated economic analysis becomes necessary in order to identify the bottlenecks to improving incomes and reducing material poverty.

Figure 1 describes how the business environment and the labour market affect economic growth as well as the poverty elasticity of growth through changes in employment, productivity and income. Employment and the remuneration derived from employment are determined by supply and demand for labour. An employment analysis casts light on the supply side of labour and the functioning of the labour market, while a business environment analysis gives insights into the level of, potentials for and constraints on economic activities and the resulting demand for and, through productivity, returns to labour.

Figure 1 Interaction Between the Business Environment Analysis and the Employment Analysis for Pro-Poor Growth.



2.2 Benefits of Integrating Employment, Business Environment and Macroeconomic Analyses

1. *Benefits to the employment analysis.* Employment analyses are traditionally based on an implicit understanding that different actors account for the supply and demand for labour, viz. there are employees and employers. This tends to make the analysis less meaningful in most developing countries where the majority of the labour force is self-employed. An integrated economic analysis partially solves this problem and makes the employment analysis more meaningful as:

- The business environment analysis is in practice, though often unwittingly, equivalent to an analysis of the demand side of employment (i.e. creation of jobs and income) – directly for the self-employed and indirectly for the wage employed. *The self-employed are in fact more or less identical to the economic actors in a business environment analysis.* In many developing countries the self-employed are the largest category of economic actors.
- More generally, by integrating business environment analysis and macroeconomic analysis with the employment analysis, the demand for labour is not only measured, but the *causes behind inadequate demand and low productivity/income opportunities are also identified.*

2. *Benefits to the business environment analysis.* The business environment analysis is greatly enriched by being linked to an employment analysis.

- The employment analysis provides *information on the characteristics of the economic actors* - with regard to endowment with human resources (education, skills), strengths and weaknesses etc. – as an essential complement to the analysis of the environment in which they function. Such knowledge is crucial to

assessing the particular needs of the economic actors – and of specific categories of economic actors, such as the poor and resource-weak - and the impact of deficiencies in the business environment as well as the potential gains from remedies.

- The business environment analysis attains a much *sharper poverty focus* as not only the general impediments and constraints on a more enabling environment are identified, but also how these affect smaller and weaker economic actors, i.e. the poor. To use a metaphor; the focus is not only on the general quality of the playing field, but also on how and how much it may be tilted against the poor.
- Integrating employment and business environment analysis makes it analytically *easier to incorporate the informal economy* into the analysis. Business environment analysis is not only connected to an employment analysis by studying the potential level of employment, but also by studying the potential quality of employment. Moreover, the business environment analysis can yield insights into the causes of the fragmentation of the economy into formal and informal parts.

3. *Benefits from integrating macroeconomic analysis.* Integrating macroeconomic analysis with employment and business environment analysis also brings considerable advantages.

- Linking the macroeconomic analysis to the microeconomic climate through the employment and business environment analysis is essential for *identifying structural causes* of macroeconomic vulnerability and causes of stability constraints on growth. It is also conducive for shifting the focus from short term remedies to acute macroeconomic problems to more long term prevention of macroeconomic instability by addressing the root causes of instability in the economy.
- By explicitly introducing growth and poverty objectives into the macroeconomic analysis and making *macroeconomic stability a necessary condition, and thus constraint, rather than chief objective of macroeconomic policies*, trade-offs and policy choices are brought into the spotlight.
- The knowledge about the characteristics of different economic actors obtained from the employment analysis and the opportunities and constraints they face derived from the business environment analysis makes it possible to analyse the *impact of macroeconomic changes and policies on different groups*. Such analysis can be employed to guide and ease reforms and give guidance on compensatory measures.

4. Integrating the analyses and taking poverty mapping and employment and income generation as starting points makes it analytically easier to *ensure a sharp poverty focus at all stages of the analysis*, as against making a general analysis from which conclusions relevant to poverty are drawn at the end.

5. The integrated approach facilitates the identification of *structural barriers to market access for the poor* (when it comes to both the labour market and markets in general), which is one of the main determinants of inequality. Moreover, this also *improves the understanding of how inequality in a particular country may limit opportunities for economic growth* and poverty reduction.

6. Through their links to employment analysis, which is gender specific, *gender is more easily mainstreamed* into the business environment and macroeconomic analysis.

7. The bottom-up approach of taking the strengths, weaknesses and needs of the poor as economic actors as the starting point, and a focusing on the interplay between the micro and the macro perspectives *facilitates the linking of IEA with other types of poverty analyses*, such as political and social analysis.

2.3 Mainstreaming Gender, Environment, Conflict Prevention and HIV/AIDS

By taking the starting point in the poor, and the not so poor, as economic actors, the IEA approach opens up for a much more gender sensitive process than is typically the case in economic analysis. The employment analysis, in particular, offers opportunities for gender disaggregated analysis which can and should inform the macroeconomic and business environment analyses. Gender differences in terms of resources, employability and labour market access are often considerable and need to be explored and fully taken into account in the analysis. Women often have more restricted access to the labour market than men and also face gender-determined obstacles as entrepreneurs. The fact that women bear the brunt of reproductive and household work also restricts their ability to participate in the labour force. It is therefore important that the opportunities offered by the IEA approach for mainstreaming gender equality into the analysis are made full use of.⁷

Poverty reduction, economic growth and environmental protection are closely linked. Most poor people depend, in one way or another, on natural resources for their livelihood and environmental degradation tends to hit the poor the hardest by undermining their resource base as well as presenting hazards to their health. Sound natural resource management and environmental protection are essential to ensure the sustainability of pro-poor growth. Hence, environmental aspects and concerns need to be incorporated as an integral part of the IEA. The analysis of development dynamics (including not least the poverty assessment), the employment analysis, the macroeconomic and the business environment analyses, all offer opportunities to bring key environmental aspects into the picture. In the final analysis, it is particularly important that a time dimension is fully taken into account in the identification of binding constraints. The often considerable lags in time between policy change and environmental impact imply that environmental preconditions for sustainable pro-poor growth need to be taken into account long before problems become acute.⁸

There are clear links in both directions between employment and income opportunities and susceptibility to violent conflict. Lack of adequate employment and income opportunities can contribute to the risk of violent conflict, at the same time as violent conflict aggravates poverty and undermines prospects for pro-poor growth. Enhancing opportunities for employment and income generation is therefore central to sustainable

⁷ For more detailed guidelines, see *Sida's Guidelines for Gender Mainstreaming*.

⁸ For more detailed analytical guidance on environment and poverty, see *The Country Strategies – Guidelines for Strategic Environmental and Sustainability Analysis* at [www.sida.se/Sida/articles/15300-15399/15361/CountryStrat02\[4\].pdf](http://www.sida.se/Sida/articles/15300-15399/15361/CountryStrat02[4].pdf) and *Sida's Policy for Environmentally Sustainable Development* at www.sida.se/jsp/polopoly.

reconstruction of post-conflict societies. In fragile states and post-conflict situations, promotion of peace and security becomes an important aspect of the IEA. The employment analysis provides a tool for adding a conflict perspective to the economic analysis, not least by identifying obstacles and discrimination with regard to labour market access and by focussing on youth employment. However, macroeconomic policies and the business environment can have a strong bearing on vulnerability to violent conflict and can also be used as instruments for promoting peace and security. In situations where vulnerability to conflict is perceived to be high, this aspect should be given prominence in the analysis.⁹

HIV/AIDS has a fundamental impact on poverty and on the ability of the households and individuals affected to escape poverty by means of their own labour. In countries with a high prevalence of HIV/AIDS the economy as a whole is affected in a multitude of ways and its impact is also strongly felt at the company level. In such countries, the impact of HIV/AIDS on demographic dynamics, labour force participation and the ability of the poor, and the not so poor, to participate as economic actors need to be in the focus, as the implications of HIV/AIDS for policies to enhance pro-poor growth are substantial and complex.¹⁰

2.4 Linking IEA to Social and Political Analyses

Economic development and pro-poor growth is conditioned by political and social as well as economic factors, and constraints on pro-poor growth may be of a political and social as well as and economic nature. Inequality has economic as well as political and social manifestations and roots, which often are interlinked. This also affects access to resources and opportunities. While an IEA can identify binding constraints on pro-poor growth, an understanding of power structures and the political and social setting is often needed to identify the best approach to removing these constraints. Hence, an understanding of power structures and the political and social setting is needed to inform the economic analysis, just as the IEA can feed into other types of analyses. A combination of economic, political and social analyses is also needed for an analysis of poverty in all its dimensions. The IEA opens up for such an integrated analytical approach by taking individual poor people as actors as the starting point of the analysis, although the methodology is confined to the economic aspects of the analysis.¹¹

⁹ See also Sida's policy *Promoting Peace and Security through Development Cooperation and Manual for Conflict Analysis* (Sida: January 2006).

¹⁰ See also *Investing in Future Generations*, Sweden's international response to HIV/AIDS (Stockholm: Ministry for Foreign Affairs and Sida)

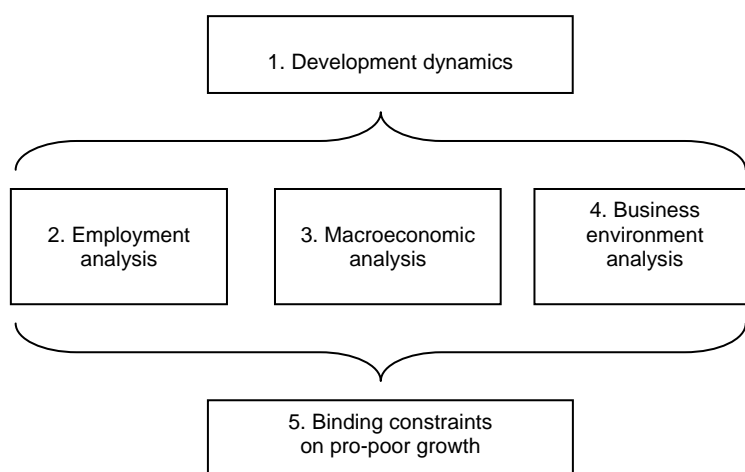
¹¹ For a methodological discussion on how different types of analyses can be integrated into a multidimensional analysis for poverty reduction, see *Country Level Analysis for Poverty Reduction* (Stockholm: Sida, 2005). A discussion on concepts and methods for power analysis, based on empirical experience is found in *Power Analysis – Experiences and Challenges* (Stockholm: Sida, 2006). DFID and the World Bank, among others, have produced useful handbooks for social analysis, see for instance *Social Analysis Sourcebook: Incorporating Social Dimensions into Bank-Supported Projects* (Washington D.C.: World Bank, 2003).

3 THE IEA METHODOLOGY

3.1 The Analysis: Step-by-Step

The IEA includes five main parts (see Figure 2) that are described in more detail later in this section. The sequence of these parts is not fixed, yet an argument is made for a certain model. As may become clear, the different parts may result in very complex analyses making a focus relatively early in the analytical process essential. The emphasis and the exact content of the different parts depend on the country-specific challenges and context. It should also be noted that all the parts of the analysis examine pro-poor growth possibilities and constraints, and may hence overlap, however from different perspectives.

Figure 2 The Five Parts of an Integrated Economic Analysis for Pro-Poor Growth.



Part 1, *Development dynamics*, identifies the major challenges and opportunities that the country in question faces. This in turn helps to focus the study. It identifies the external factors and forces that provide the parameters for a country's economic development and policy-making, and analyses how the country, and especially the poor, can profit from the opportunities and avoid the risks of these given factors. This part also provides the background and context for the subsequent analyses, i.e. it opens up for a country-specific as well as a time-specific analysis. Steps two to four make up the heart of the IEA and analyse strengths and weaknesses in the ability of the economy to meet the challenges or seize the opportunities identified in the development dynamics part from different angles. Part 2, the *Employment analysis*, should precede the other parts since it provides information on the economic actors which is necessary in order to view the macroeconomic environment and the business climate from the perspective of specific groups. Moreover, the employment analysis provides insights on the relative need to increase employment opportunities and the need to increase the productivity of employment. Part 3, the *Macroeconomic analysis*, will normally precede the business environment analysis since it provides the framework of economic activity and highlights the vulnerabilities of the current economic system. Part 4, the *Business environment analysis*, integrates to a great extent the previous analyses as parameters and maps out the constraints on business (and employment opportunities) from the

perspective of different economic actors and especially that of poor people. The final step, Part 5, the *Binding constraints on pro-poor growth*, presents the conclusions and the binding constraints that have arisen from the analyses.

3.2 Making the Analysis Manageable

Build on established economic theory. The IEA approach rests on established economic theory and, to a great extent, also on standard methods for economic analysis. The novelty lies in the approach of making enhanced employment and income opportunities for the poor the main objective of the analysis, and in the integration of employment analysis with macroeconomic analysis and business environment analysis. Hence, it is largely a question of applying the perspective of the poor as economic actors in the analyses of the macroeconomic framework and the business environment.

Draw as far as possible on existing data and analyses. In order to make the exercise manageable it is essential to draw, as far as possible, on existing studies, analyses and data. However, in practice it is realistic to expect that adequate existing analysis will not be available in all areas.

The employment analysis often presents the greatest problem with regard to existing analyses and data. Labour force surveys and/or living standard measurement surveys provide the main source of data. Where available, these should be complemented by time use surveys.¹² Agricultural surveys, population censuses and poverty assessments (including, not least, participatory poverty assessments) provide other important complementary sources of data. A breakdown of this analysis according to key categories, such as gender, type of employment, education etc. is necessary in order to obtain a picture that is sufficiently comprehensive to permit a high quality and proper focus within the subsequent analysis. Surveying the work of ILO in the country may be a good starting point for the employment analysis.

Macroeconomic data and statistics are usually readily available, not least from the websites of national statistical bureaus, governments, the UN and the IFIs. However, as the time perspective in most macroeconomic analyses tends to be short and the focus somewhat different to that of the IEA approach, additional analysis with a medium to long-term perspective, focussing on structural causes of instability and vulnerability with sustainable pro-poor growth as the objective, will often be required.

A great deal of methodological and empirical work in the field of business environment /investment climate analysis has been undertaken in recent years, not least by the World Bank. As a consequence, business environment analysis or investment climate information and analyses exists for most countries and can be used as an input into an IEA. Still, the analysis often needs to be recast from the perspective of the poor as economic actors and against the backdrop of the knowledge of the characteristics of these actors obtained from the employment analysis. A complicating factor can be that the existing analyses do not always have adequate breakdown into categories that would facilitate a poverty focus. Surveys covering constraints for SMEs and enterprises in the

¹² Labour force surveys and living standard measurement surveys (LSMS) can often be used to gain information on employment, income and other aspects of the informal sector that is typically not captured in enterprises surveys underpinning standard business environment analyses.

rural areas (farm and off-farm businesses) as well as urban areas outside the capital are valuable, as well as surveys covering the informal sector.

Another, arguably lesser, problem is that different types of economic analysis have different methodological traditions and terminologies. It is recommended that standard ILO definitions and terminology is used as far as possible in the employment analysis.¹³ The UN 1993 standard system of national accounts provide definitional and terminological basis for the macroeconomic analysis.¹⁴ The methodological approach and methodology for the business environment analysis is based essentially on Rodrik (2006) and work done by the World Bank in this field.

3.3 The Components of the Analysis

3.3.1 Development Dynamics

The first step of the IEA is an analysis of the contemporary patterns and dynamics of economic development and poverty reduction. The aim of this part of the analysis is to arrive at an understanding of the *country-specific development context and poverty situation* that is sufficiently comprehensive to permit a first broad identification of the strengths and weaknesses of the economy and challenges and opportunities to sustainable pro-poor growth. This in turn should make it possible to narrow down and achieve a sharper, yet relevant, focus in the subsequent analysis. In order to arrive at an identification of the major challenges and opportunities three main parts should be covered: An overview of (i) external or given factors, (ii) the growth, employment and productivity dynamics of sectors, and (iii) the functioning of market allocation mechanisms.

The first part of the development dynamics analysis reviews the main external forces that serve as parameters and pillars for the subsequent analysis. The *demographic structure and its dynamics* (including parameters such as the dependency ratio, internal and external migration, etc.) is a useful starting point for this analysis since the human resources and the necessity to create preconditions conducive to unleashing the creative and productive forces inherent in this resource base, with particular emphasis on the poor, is the starting point of the IEA methodology. A second important starting point is the *global context* since it provides the frame for economic opportunities and limitations in the medium to long term. Third, a *poverty mapping* provides information on who the poor are, where they are found and what their key characteristics are. Comparisons of poverty assessments made at different points in time, when possible, will provide valuable additional insights into the dynamics of poverty. This information is essential for the identification of what types of economic actors' perspectives are important for understanding constraints on pro-poor growth.

The second part is an analysis of the development of *the economic structure, reliance on natural resources, the dynamics of economic growth and the changes in employment and labour productivity* - broken down by economic sector, geographic area, gender etc.

¹³ For definitions as well as statistics, see <http://laborsta.ilo.org>.

¹⁴ See <http://unstats.un.org/unsd/sna1993>. See also *System of National Accounts 1993*, jointly published by the United Nations, the World Bank and IMF in 1993. For a glossary, see *System of National Accounts, 1993 -, Glossary*, published by OECD in 2000.

- and cast against the demographic dynamics, the global context and the poverty mapping(s). In countries with high rates of overseas labour migration this aspect should also be incorporated into the analysis. Thus, migrant labour and the associated remittances should be integral components of the analysis. This part provides the core of the development dynamics analysis. The understanding of these dynamics can help shed light on whether structural changes and trends are due to ‘pull’ or ‘push’ factors, i.e. demand-driven or a result of distress situations. The analysis needs to be linked to, and interpreted, in the context of other key economic variables such as savings and investments,¹⁵ trade and external relations and patterns of land and asset distribution as well as their institutional, political and social settings.

It is also important at an early stage of the study to get a first tentative grasp of the functioning of the economy, covering issues such as *robustness, market integration and a level playing field, flexibility* and antonyms such as vulnerability, fragmentation of the economy, inequality and exclusion. This third part of the development dynamics analysis is an attempt to narrow down the IEA. Robustness has to do with the breadth and depth of the economy - areas where small and poorly developed economies almost by definition are at a disadvantage – making market integration and flexibility all the more important. At this stage, the aim is not to pursue any in-depth analysis, but rather to obtain a sufficiently good understanding of the economy to make possible identification of key issues as a basis for sharpening the focus in the subsequent analysis.

Market integration has geographical as well as sectoral and structural aspects. Inadequate physical infrastructure, resulting in high transport costs and inefficient systems for disseminating market information are main causes of poor geographical integration of the economy and tend to result in a concentration of growth to the main cities and centrally located areas and to aggravate spatial inequality. Structural inequality has more to do with institutional factors and barriers to formalisation and growth of small-scale economic activities. The existence of a large informal economy alongside the formal economy and poor linkages between the two are hallmarks of a poorly integrated domestic economy.

Flexibility has to do with the ability of the economy to undergo structural changes with a minimum of friction and economic costs in response to changes in the external economic environment and new growth opportunities. Well-functioning capital and labour markets, as well as a high degree of domestic market integration, are essential to achieve such flexibility. A high degree of employability and labour market access for the poor is needed in order to turn structural change into opportunities to escape poverty. Hence, employability, occupational and geographical mobility and the role of returns to labour and wages as instruments for guiding labour to where their contribution to growth will be highest, become crucial for successful structural change and, by extension, for sustainable pro-poor growth.

In short, economic policies aimed at pro-poor growth need to contain a judicious blend of focussing on the sectors and areas where the poor are found and on enhancing the employability and labour market access of the poor, thus making it possible for them to

¹⁵ A complementary indicator - ‘adjusted net savings’ – has been developed by the World Bank. This indicator equals net savings plus educational expenditures minus energy depletion, mineral depletion, net forest depletion and particular and carbon dioxide damage.

escape poverty by moving to more dynamic sectors of the economy and to occupations promising higher returns to labour. Such flexibility determines the possibilities for combining structural changes with poverty reduction, or whether pro-poor growth policies need to focus on the sectors and areas where the poor are found.

3.3.2 Employment Analysis

The employment analysis focuses primarily, but not exclusively, on the supply side of labour given that expansion of demand and increasing labour productivity is very much in the focus of the business environment and macroeconomic analysis.

The analysis of the supply of labour can usefully be divided into three aspects: (i) a quantitative part, (ii) employability, which focuses on the qualitative aspects of labour, and (iii) labour market access. All aspects should, as far as possible, distinguish between different categories such as poor and non-poor, gender, rural and urban, wage-workers and self employed, etc.

3.3.2.1 *The quantitative aspects*

As described in Figure 3, the size of the population and its age structure which when combined give the working age population, set the outer limits for the size of the labour force. The participation rate tells us to which extent those in the economically active age groups actually engage in economic activities, i.e. are part of the labour force. The working-age population (typically comprising the 15-65 age brackets, although variations exist) can thus be divided into the economically active – the labour force – and the economically non-active. Knowledge about the size of the population by age groups and age specific participation rates makes it relatively easy to make forecasts concerning changes in the labour force during the next ten to fifteen years. This provides a first rough estimate of the need for additional employment generation.

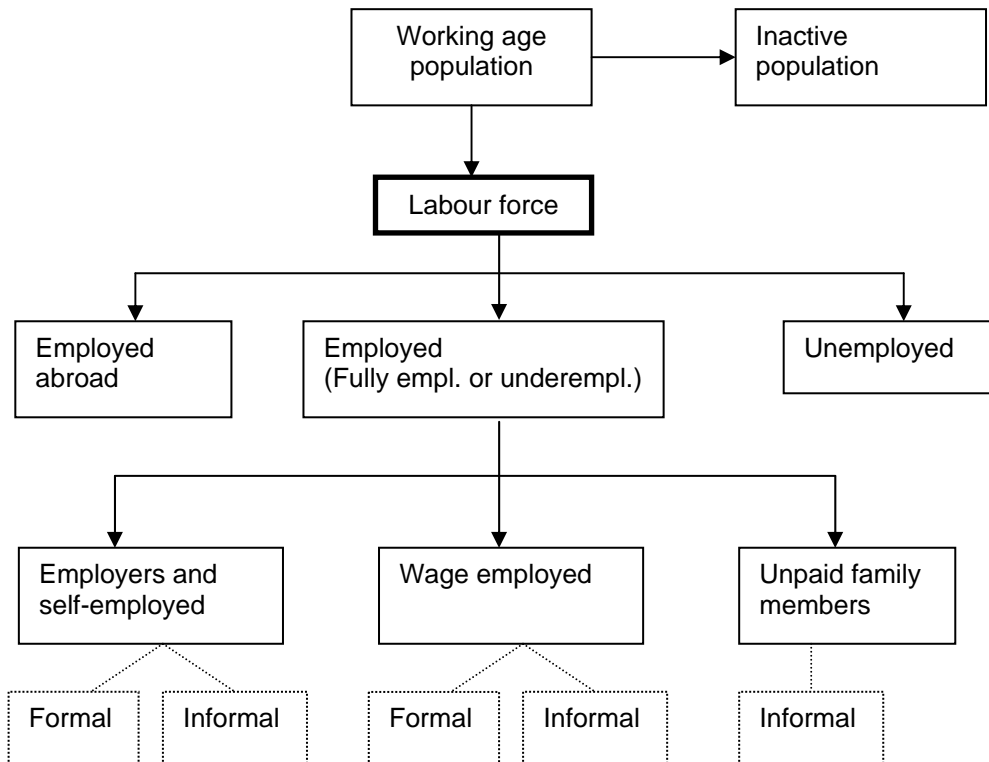
The labour force is subdivided into two categories: the employed and the unemployed, the latter consists of those who are without work but available for work and seeking work. Where relevant ‘employed abroad’ can be entered as a third category along with ‘employed’ and ‘unemployed’, in which case the categories ‘labour force’ and ‘working age population’ may need to be adjusted accordingly. Under-employed is often added as a subcategory of the employed category. Under-employed are those who lack sufficient work or, more commonly, are trapped in employment of such low productivity that it – despite long, hard hours – pays too little to enable them to escape poverty.

The employed category can be sub-divided into three types according to their employment status: employers (self-employed and owners of firms with employees), wage-workers (employees) and unpaid family helpers. It should be noted that while the income of wage-workers is a result of negotiations and at times legislation, the income of employers and self-employed is essentially determined by the profitability of their own businesses.¹⁶ The income of employers and those self-employed depends not only on the quantity and quality of the supply of their labour but also, crucially, on their

¹⁶ The only difference between the two categories is that foreign investors and domestic investors/entrepreneurs who do not derive any income from their own labour is included in the latter, but not the former.

ability to market the goods and services they produce, that is their ability to create a demand for their own labour. Hence, a business environment analysis becomes essential to understand the employment and income opportunities for this category of labour, as well as indirectly and more generally for all types of labour.

Figure 3 “The Employment Tree”.



The employed may also be sub-divided into a formal and an informal labour force. The former consisting of wage-workers in regular, contract-based employment and employers and self-employed in registered, formal sector enterprises. The latter consists of the rest of the labour force who are not, or only poorly, covered by any legislative or regulative framework. The division of the labour force into those with formal or informal employment is a direct reflection of the division of the economy into formal and non-formal parts, which in its turn is very much in the focus of a business environment analysis. Here again, a business environment analysis can provide valuable insights into constraints on formalising the informal economy and hence an analysis of the possibilities for the poor to gain, usually qualitatively superior, employment in the formal economy.

The participation rate depends on a variety of factors and can, in contrast to the demographically determined aspects of the labour force, be influenced by policies also in the medium, if not short, term. Among the reasons for not participating in the labour force can be mentioned school attendance, disabilities or illness as well as reproductive work and other household duties or pure discrimination. The participation rate in the labour force tends to be lower for women than for men as a result of the situation in most countries where women have to bear the brunt of the reproductive and household

work, leaving them less time for economic activities.¹⁷ Increased access to education tends to reduce the participation rate among the younger age groups as more years in school implies a later entrance into the labour force, at the same time as it is crucial for increasing employability. Investments in health care, on the other hand, will have a positive impact on the participation rate through improved health status. Another important reason for not being part of the labour force could also be sheer resignation: a perception that there is simply no work available.

3.3.2.2 Employability

Employability refers to the qualitative aspects of the labour force, more precisely to the endowments of the economically active with qualitative attributes that enhance their attractiveness on the labour market and their productivity, i.e. their income earning abilities.¹⁸ *Education and skills* are arguably the key attributes enhancing employability. The quality and relevance of education and skills is important. For instance, nine years of formal education can result in vast differences in actual learning depending on the quality of education. The issue of relevance is equally important, as the knowledge and skills acquired must be in tune with demand. A mismatch in skills, between the skills demanded by the expanding sectors of the economy and the skills possessed by the poor, will reduce the employability of the poor and thus their employment and income earning opportunities.

Health and nutrition are other important factors affecting employability. Poor nutrition, polluted water and air etc. lead to poor health, which impairs labour productivity and, thus employability. In extreme cases, not only poor health, but also poor nutrition will effectively prevent participation in the labour force.

Lack of economic margins makes the poor risk-adverse and place particular emphasis on the need for income predictability. In order to minimise economic risks, poor households often resort to a strategy of *employment diversification* even at the expense of income maximisation, according to the principle ‘not putting all your eggs in one basket’. Such an inability to specialise due to the risks involved is likely to reduce their returns to labour. More generally, the risks associated with mobility – geographic or vocational – also put the poor at a disadvantage.

In particular for the self-employed, *access to production factors other than labour*, such as land and capital, is also essential for employability both with regard to finding employment and, not least, to enhancing labour productivity and their return to labour.

3.3.2.3 Labour Market Access

However, employability alone will often not suffice to provide poor people with equal access to, and opportunities on, the labour market. Put differently, endowment with resources to engage in productive work needs to be matched with opportunities to make

¹⁷ Outright gender discrimination – women’s lives should focus on ‘kinder, kirche und küche’ – can also reduce the scope for women to participate in the labour force. Combating such gender-based discrimination and measures to reduce the time required for reproductive and household work, such as improved access to water and energy, can be vital to enhancing the scope of women to participate in the labour force, with direct positive consequences for economic growth, employment and income.

¹⁸ Hence, what constitutes employability differs depending on the type of employment. For the wage-employed it may be education and health, but for the self-employed factors such as capital and land may need to be added.

optimal use of these resources. Labour market access and inequalities in this regard are influenced by a number of factors.

One important function of the labour market is that of *intermediation*. Easy access to good quality information about employment and income opportunities is crucial for the ability of individuals to find employment and obtain good return to their labour, as well as for overall economic efficiency and growth. In situations where labour market information functions poorly in this regard, the poor are likely to suffer disproportionately.

Vocational, geographical and social mobility are important for labour market access, not least for the poor. As the most dynamic economic sectors and regions seldom coincide with those where the majority of the poor are to be found, mobility becomes crucial for accessing more or better jobs and for escaping income poverty. Even at high levels of employability, poor mobility may hinder the poor from accessing better jobs. The reasons behind poor mobility are often complex, but may perhaps be divided into three broad categories.

First - tradition. Social norms and outright labour market discrimination are often an important impediment to employment. Gender discrimination is perhaps the most blatant and frequent case in point, as women often are excluded from large, and often the most lucrative, segments of the labour market by tradition and social norms. However, discrimination can also be based on ethnicity, caste, disability etc. Social norms and traditions may also exert a more generally impairing impact on mobility.

Second - formal rules and labour market institutions. These can also provide an obstacle to mobility. "Certain types of labour laws and practices of collective bargaining may create an asymmetry of power between insiders (i.e. those already employed in the organised sector) and outsiders (i.e. those seeking entry into the organised sector) that the insiders may be able to effectively prevent the outsiders from gaining entry."¹⁹

Third - poor infrastructure. High cost of transport, lack of housing and a poorly functioning housing market may also provide obstacles to geographic mobility.

Another increasingly important aspect is access to labour markets abroad. This issue is dealt with in the business environment analysis as a decision to migrate abroad to work can be treated as an investment decision.

3.3.2.4 The Result of the Employment Analysis

The following should be achieved by the employment analysis:

First, a sufficient analysis of the supply side of labour, including (i) a forecast of changes in the supply of labour and an analysis of determinants of the participation rate and constraints on labour force participation, (ii) an analysis of the situation with regard to employability, broken down by gender and other relevant categories and with particular attention to the situation of the poor, and (iii) an analysis of labour market

¹⁹ S.R. Osmani, 'Exploring the Employment Nexus: The Analytics of Pro-Poor Growth' in R. Islam (ed.) *Fighting Poverty Through the Employment Route* (Lynne Reinner, 2006).

access, mobility and the functioning of the labour market, with particular emphasis on implications for the poor.

Second, conclusions regarding the need for employment and income generation as an input into the macroeconomic and business environment analysis. These conclusions should be as precise and detailed as possible and should distinguish between the need for (numeric) expansion of employment opportunities and the need and scope for increased labour productivity, as well as an appropriate balance of policies aimed at fostering mobility on the one hand and employment opportunities in sectors or areas experiencing widespread poverty on the other hand.

3.3.3 Macroeconomic Analysis

The macroeconomic analysis deals with *the structure of the economy* as a whole, the *external economy, the domestic economy and the public sector*. It deals with *overarching economic reforms*, such as external and internal liberalisation, deregulation etc. Moreover, it also explores the use of main *macroeconomic policy instruments*, notably monetary policies, fiscal policies and exchange rate policies.²⁰

As with the other components of the integrated economic analysis, poverty reduction and achieving sustainable pro-poor growth is the overall objective and should guide the macroeconomic analysis. This implies a focus on increasing employment opportunities and labour productivity in tune with conclusions regarding needs, opportunities and challenges resulting from the employment analysis, and on creating conditions permitting the poor to participate fully and on an equal footing in the economy. Other important aspects, such as maintaining overall macroeconomic stability, both on the external and on the domestic front, should thus be judged in terms of their role as preconditions for achieving this objective. This distinction between ends and means is important, not least because many policy choices involve trade-offs and costs as well as benefits.²¹

A macroeconomic analysis focussing on pro-poor growth needs to have a *medium to long term time perspective*. Only in situations of acute and severe macroeconomic imbalance should the short term take precedence over the more long term perspective. This implies a shift in focus from temporary imbalances to addressing macroeconomic vulnerability – not least to risk and impact management of external shocks – and to structural causes that make the economy susceptible to macroeconomic imbalances. Ensuring a high degree of predictability of the economic environment and minimising vulnerability to economic shocks is crucial not only for sustainable growth but also to safeguard the interests of the poor. Poor people typically lack the resources, opportunities and access to information needed to safeguard their economic interests at times of sudden change in the economic environment, which puts them at a distinct

²⁰ Note that many of the macroeconomic aspects are also part of the business environment analysis, but then as exogenous variables.

²¹ For instance, inflation may reduce the overall growth potential and tends to hurt the poor more than the rich, yet excessive use of monetary and fiscal policies to curb inflation can, in the short, term hamper growth and entail reduced space for pro-poor public expenditures as well as growth-enhancing public investments.

disadvantage. Experience also shows that the impact of economic shocks on poverty, as well as on inequality, is often severe and long lasting.

In essence, the macroeconomic analysis should first map macroeconomic outcomes through a number of indicators with a view to identifying strengths and weaknesses, areas of vulnerability and constraints on pro-poor growth.²² As a second step the causes of weaknesses and problems should be identified as either connected to macroeconomic policies or structural factors. When further discussing country-specific solutions to the problems identified it is obvious that a macroeconomic policy change is needed in cases where inappropriate policies are identified as the main cause. If the problem is linked to structural constraints, these constraints need to be addressed and the macroeconomic policy set-up must be re-considered, given the presence of the structural constraint.

3.3.3.1 *The External Economy*

The external economy tends to mirror the domestic economy reflecting, and often highlighting, its strengths and weaknesses. An analysis of the external economy and the trends and composition of the external account is therefore useful not only to identify comparative advantages, constraints and areas of vulnerability, but also because it yields insights into the structure and functioning of the economy as a whole. Hence, it is vital not to look at the external account in isolation, but to link it to the overall economic analysis.

The analysis of the external account by necessity requires attention to the *trade balance, the current account balance and the capital account balance*.²³ Such analyses are routinely produced, not least by IMF. The interpretation of the net results is not always straightforward. A positive balance need not necessarily be an indication that all is well.²⁴ Similarly, although large deficits in the current account cannot be maintained over extended periods of time and may indeed be an indication of acute problems, a current account deficit need not automatically be a cause for alarm. The source of the deficit and, in particular, how it is financed and if the financing of the deficit is debt-creating or not will determine if the deficit should be a major cause for concern, at least in the short term.²⁵

²² For the purpose of the IEA in countries with a high level of remittances, Gross National Income (GNI) is a better measurement of the economic production of the country's population than Gross National Product (GDP), as the former includes net receipts from abroad of compensation of employees (i.e. income remitted by nationals working overseas on a short term basis [less than 12 months]), but also net receipts of property income. Alternatively, Gross National Disposable Income (GNDI) may be used. GNDP equals GNI plus net current transfers from abroad. Main items under current transfers are remittances from migrants (i.e. people who have migrated for more than 12 months) and ODA intended for current use.

²³ The trade balance is the net result of exports minus imports. Net income from trade in services, net factor incomes and net public and official transfers (including private remittances and most ODA) make up the service balance. The current account balance is the combined result of the trade and services balances. The capital account can be regarded as a reflection of the mode of financing of the current account (deficit). It contains debt-generating flows such as net foreign lending, but also non-debt generating flows such as FDI and portfolio investments. The current account balance plus the capital account balance plus/minus errors and omissions make up the balance of payments.

²⁴ A case in point might be positive balance due to a large inflow of portfolio investments, which may prove to be of a short term nature and unrelated to the performance or perceived prospects of the real economy and which can be withdrawn at little or no notice.

²⁵ For instance, a trade deficit that is balanced by an inflow of FDI is often an indication of economic dynamism and need not be a cause of concern, even though it may result in a current account deficit.

The *structure of the account* is as important as the net results, especially when analysing longer term constraints on pro-poor growth. An analysis of the structure of the external account will cast light on vulnerability and external constraints on economic development and policies. For instance, a major share of investment goods in imports is a harbinger and natural consequence of economic growth and can, in an open economy, be expected to result in subsequent increased exports or import-replacing production. A large and increasing share of industrial inputs in imports, by contrast, may be an indication of a shallow or fragmented domestic economy, pointing to poor domestic multiplier effects and a risk that economic growth may run into balance of payment constraints. Thus, this may often be an indication of the need to address shortcomings in the business environment. A large and increasing share of consumer goods in imports may be an indication of poor international competitiveness, possibly resulting from an overvalued exchange rate, and/or a poor domestic supply response to demand. An analysis of the commodity composition of both imports and, not least, exports will cast light on the exposure of the economy to terms of trade fluctuations and, in the case of exports, to changes in external demand. A diversified export base reduces vulnerability, but is also contingent on a broad-based and diversified domestic economy. Similarly, a large share of raw material in exports raises the question of why more domestic processing does not take place.

The *exchange rate* plays a crucial role as it determines all domestic prices in relationship to those in the outside world and thus has a major impact on the international competitiveness of the economy. Simply put, a high or overvalued exchange rate implies a burden on exports and gives imports a competitive advantage, while a low or undervalued exchange rate has the opposite effect. Many developing countries are vulnerable to upward pressure of the exchange rate, which may undermine long term competitiveness and growth. This is due to large inflows of foreign exchange that are insensitive to the exchange rate. Primary sources of such flows are migrant remittances, earnings from export of raw materials and ODA.

The impact of (changes in) the exchange rate can vary greatly between different groups of people and between the short and the long term and is also highly context-specific. It also exerts differing impact on people, depending on their role as consumers and producers. While the scope for direct exchange rate policies may be limited, policies in a wide range of other areas also have long-term implications for the exchange rate. Moreover, complementary policies such as productivity-enhancing public investments might be appropriate, enabling the economy to remain competitive despite the higher exchange rate. Hence knowledge of the impact of the exchange rate on different groups of people, with a particular emphasis on the poor, and on the capacity of the economy to enhance employment and income opportunities for the poor, is essential for informing policy making in different areas.

With the move towards external liberalisation and the requirement to comply with WTO regulations the scope for *trade policies* has changed. While there is little doubt that outward orientation is beneficial for growth, at least in the long run, the manner in which external liberalisation is achieved matters greatly. Generally speaking, it is important that poor economic actors have the ability to adjust to changes in the economic environment resulting from external liberalisation. This calls for a focus on the need for flexibility and mobility, i.e. on well-functioning factor markets and high

employability, as well as on sequencing of reforms that take into account the ability of the poor to adjust and respond. External trade liberalisation need not imply a lack of active trade policies. It also highlights the need to address, e.g. through safety nets, the more short term consequences for those who may be negatively affected by structural changes.

3.3.3.2 *The Domestic Economy*

Inflation is a key indicator of domestic imbalance. A high and unpredictable rate of inflation has distorting effects on the economy; it tends to hurt the poor more than the rich and consequently increase economic inequality. It may also exert a growth-reducing impact since it affects price predictability and hence investment incentives. The causes of inflation may be manifold and are often complex. Inflation may be externally induced, for instance through increased world market prices of key imports, or produced internally. Internal causes of inflation may be structural in nature, the result of market rigidities and malfunctions, or caused by lax or inappropriate monetary and fiscal policies. As the causes of inflation vary greatly, there can be no standard prescriptions for curing it. Analysing the causes of inflation is essential in order to identify remedies. Some causes of inflation, such as lax monetary or fiscal policies, can be addressed in the short term. Other causes pertaining to the functioning of the economy require a more long term perspective in order to be effectively addressed. As addressing inflation by means of monetary and fiscal policies typically involves trade-offs in terms of an overall cooling effect on the economy and cutbacks in public expenditures, such actions need to be based on an assessment of the costs and benefits, with particular attention paid to the employment and income opportunities of poor people, and on a thorough analysis of the causes of inflation.

The *interest rate* expresses the price of capital and is, as such, a main market instrument for influencing savings and investments. In most developing countries there is a large spread between deposit and lending rates as well as considerable differences in the rate of interest charged for different types of loans and to different types of borrowers, reflecting both poorly functioning financial sectors and high perceived risks associated with lending. In situations where only a few financial institutions dominate the market it may also reflect monopolistic or oligopolistic pricing. Substantial differences in interest rates depending on the category of borrower are common and almost invariably discriminate against weak, small-scale economic actors. These differences may often have more to do with perceived rather than actual risks, reflecting poor and asymmetric information and poorly functional legal systems. Reducing the spread between deposit and lending rates is important for fostering sustainable, high rates of pro-poor growth. This typically requires not only reform of the financial system, but also long term institution building.

3.3.3.3 *The Public Sector*

The analysis of the public sector focuses primarily on the consolidated government budget²⁶ from two key perspectives: (i) sustainability and vulnerability, and (ii) distributional aspects and consequences for pro-poor growth. The issue of *sustainability and vulnerability* pertains both to the revenue and the expenditure side and, in

²⁶ The consolidated government budget includes not only the budget of the central government, but also those of lower government levels (provincial and local), although the practice may vary from country to country.

particular, to the relation between the two. On the revenue side, a distinction needs to be made between (i) current incomes in the form of taxes and levies, (ii) discretionary incomes, i.e. proceeds from privatisation, (iii) external support in the form of grants, and (iv) external and (v) domestic borrowing. Such a breakdown will yield a picture of the predictability and sustainability of public revenues. To this should be linked a breakdown of the expenditure side into (i) current expenditure that are fixed in the short to medium term, (ii) investment or capital expenditure that have a more discretionary nature, and (iii) an analysis of the public debt. The combined picture of the analysis of these three aspects will yield a rough and ready assessment of the sustainability of the budget and vulnerability in terms of exposure to factors beyond the direct control of the government.

Among the more important aspects are:

- The magnitude and trend of budget deficits and their source of funding.
- The share of current expenditures covered by continuous and predictable sources of income, e.g. regular tax collection.
- Dependence on external funding (ODA), totally and for current and capital expenditures and with a distinction made between grants and loans
- The terms and conditions of external borrowing, which should be set against the expected return to investments financed by loans.
- The extent of domestic borrowing. Domestic borrowing is often expensive and can crowd out private investments as the government is treated as a preferential borrower.
- Discrepancies between planned budget and outcome and the causes behind such discrepancies.

In most situations this exercise can be based on existing analyses and assessments undertaken by the World Bank, IMF and others.

Public sector analysis from the *distributional and growth perspective* essentially implies an assessment of government policies as expressed in plan documents and, not least, in the budget. This assessment should be made against the backdrop of the conclusions drawn from the earlier parts on the development dynamics and the employment analysis. A key question should be to what extent and in what manner the public sector, as expressed both in plans and budgets, addresses the identified constraints, challenges and opportunities with regard to enhancing employment and labour productivity and promoting full and equal participation of the poor in the growth process. The allocation of public current expenditure and investments needs to take into account the poverty situation as well as the scope for pro-poor structural reforms, the mobility of the labour force and the overall flexibility of the economy. Another distributional aspect has to do with social protection and the need to provide, by fiscal means, an economic safety net against destitution and for those who, for one reason or other, do not have the resources or ability to earn their own income.

3.3.3.4 A Note on Macroeconomic Policies in Developing Countries

Monetary, exchange rate and fiscal policies are the main, traditional macro-economic policy instruments. They have the advantage that they can be pursued at short notice and often also have an impact with relatively short time lags. However, they also have limitations. Monetary policies aimed at influencing the interest rate and monetary

expansion tends to be a blunter instrument in most developing countries than in industrial countries as the financial sectors are often poorly developed. Investments are, to a greater degree, based on own capital and savings rather than loans making them comparatively insensitive to changes in the exchange rate. Similarly, much of the savings are often channelled outside the financial sector. The wide spread between deposit and lending rates also implies a very high real cost of borrowing, reducing the relative impact of changes in the interest rate. The scope for pursuing an active exchange rate policy can also to be limited, except for smoothing short term fluctuations, as the size of the flows involved are simply too large to permit any decisive domestic control over the exchange rate.²⁷ Fiscal policies are important, but require a well-functioning public financial system and a high degree of domestic control over, and predictability of, public revenues in particular. The impact of macro-economic policies on growth and poverty reduction is far from straightforward and does not really lend itself to generalisations but must be assessed on a case-by-case basis. In such assessments it is important to look at more long term dynamics as well as short term static effects. Without playing down the role of these traditional policy instruments, their use must not divert attention from the need to address important structural causes of macroeconomic vulnerability that can be identified by a business environment analysis.

3.3.3.5 The Results of the Macroeconomic Analysis

Against the backdrop of the employment analysis, the macroeconomic analysis should result in an identification of macroeconomic constraints on enhancing employment and income generation, with a particular focus on the poor. Moreover, the linkages between the macroeconomic situation and the scope for increased employment and productivity at the microeconomic level should be indicated. It should also assess the current macroeconomic policies in this light and point to the policies needed to reduce the constraints identified and to ensure that the macroeconomic setting is as amenable as possible to pro-poor growth. As part of this, the need for reducing macroeconomic vulnerability and susceptibility to instability through structural changes in the economy should be identified.

The macroeconomic analysis should also provide the overall economic framework for the business environment analysis where, for instance, conclusions regarding structural causes of macroeconomic vulnerability and instability are carried over into the business environment analysis as inputs.

3.3.4 Business Environment Analysis

The private sector is the primary engine not only of growth, but also of pro-poor growth. The benefits from business development do not only increase the income of the economic actors but also contribute to government revenues and hence public expenditure. It should be noted that the definition of business includes small and large

²⁷ Exchange rate policies may also entail a trade-off between short and long term objectives. In the short term, an appreciation of the exchange rate can have a positive impact on poverty by reducing the cost of external public debt servicing – thus releasing more resources for domestic pro-poor public expenditures – and by reducing the cost of imported basic needs, such as energy. However, in a slightly longer term perspective, the negative consequences in terms of reduced growth and employment and income opportunities are likely to outweigh the short term gains.

businesses, businesses in the fields of agriculture, manufacturing and services, businesses in rural as well as urban areas, and formal as well as informal businesses. Hence, the business environment fundamentally affects opportunities for all economic actors, not least the poor.

3.3.4.1 *Links to the Quantity and Quality of Employment*

As argued above, the business environment and the level and type of employment are closely linked. An investor wanting to start a business may soon find that the investment environment is quite hostile – it costs a lot just to start a business as well as to run or expand a business. For a large foreign investor it may be possible to negotiate a special deal with the relevant authorities, offering privileges and a better investment climate and hence a possibility to escape some of the distortions in the regular formal sector. An investment following from such a deal will create some employment opportunities, but also distort domestic competition. A potential domestic investor has three options. First, to refrain from starting any business and hence create no employment opportunities, second to start a business without informing the authorities in order to escape some parts of the poor investment climate, but at the expense of losing the benefits of being part of the formal structure. This will create some informal employment opportunities but those employed will not be protected by formal labour or wage regulations. Or third to start a formal business, but be forced to operate below its potential due to the inimical business environment and consequently at a disadvantage vis-à-vis other competing firms (firms abroad or FDIs). This will generate some employment opportunities, but less than there could have been. Hence, a bad business environment not only lowers the level of employment, but the type of employment created will also be of lower quality – both of these mechanisms mainly affecting the poor.

A business environment analysis will therefore be essential in order to understand the existence, as well as the dynamics, of the informal sector. A formal economy is a precondition for a modern economy²⁸ however it may be hindered by factors such as high financial and time costs for doing business, corruption and resulting efforts to stay invisible etc. Hence, when available, information on the perceptions of SMEs and informal enterprises with regard to their business constraints may form an important complement to general business environment assessments.

3.3.4.2 *Returns and Costs for Business*

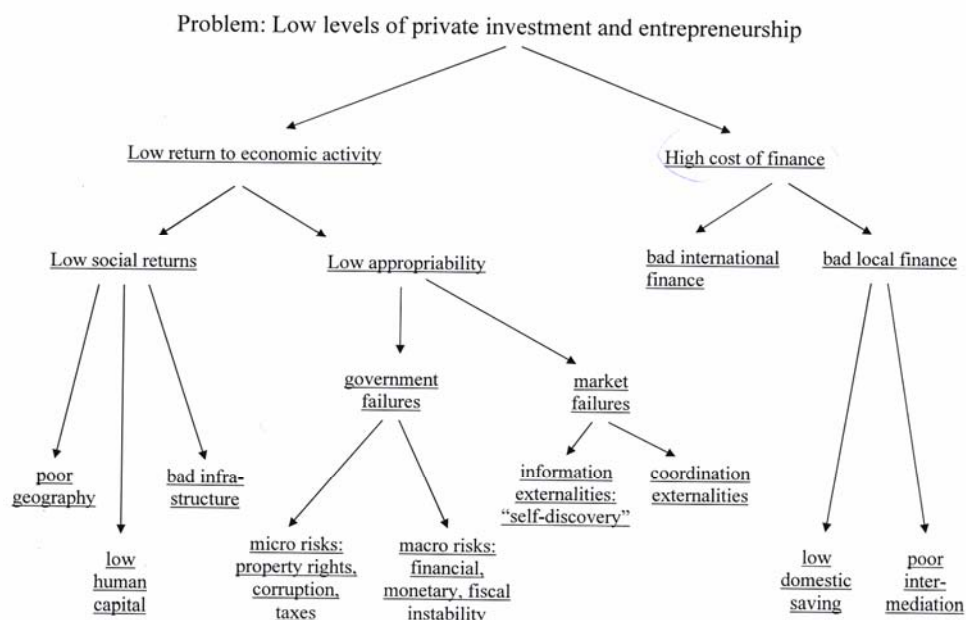
The business environment analysis is based on methodology developed by Hausmann, Rodrik and Velasco called ‘Growth Diagnostics’.²⁹ Investments and entrepreneurial activities are determined by the relationship between the *private return* to economic activities and the *costs of finance* (Figure 4). The private returns are a result of the social returns and the private appropriability of these returns. *Social returns* are interpreted in a broad sense as the return to accumulation of physical capital, human capital,

²⁸ When a business becomes formal it becomes visible and can hence market itself. Moreover, it gains access to risk-reducing legal protection. It is also crucial for the public sector in a modern economy since the formal private sector is a main source of domestic public revenues.

²⁹ Hausmann, Rodrik and Velasco (2005). *Growth Diagnostics*, John F. Kennedy School of Government, Harvard University, March 2005. For an overview see Rodrik ‘Goodbye Washington Consensus, Hello Washington Confusion’, *Journal of Economic Literature* (forthcoming).

entrepreneurship, technology, etc.³⁰ The *private appropriability* refers to the extent to which the investor will actually be able to reap these returns.

Figure 4 Growth Diagnostics.



Source: Hausmann, Rodrik, and Velasco (2005).

Social returns are determined by factors such as geography, technology, infrastructure and human capital. Research and development and entrepreneurial profits can increase social returns through new technologies or organisational structures. However, in the case of a developing country in the process of catching up with other more developed countries, it is usually a matter of diffusion of technology and organisational structure rather than innovation. The diffusion of technology can be hindered by shortage of scientists, engineers and research institutions, limited availability of risk capital for financing of new ideas, etc. A main channel for technological transfer is through foreign direct investments (FDI). However, for inter-firm spill-over of technology to take place, the FDI must become embedded in a dynamic domestic enterprise environment. Hence, apart from increased human capital, there is a need for reasonably diversified production and a high degree of market integration with strong backward and forward linkages for new technology to spread throughout the economy. Another important determinant of social returns is lack of investment in infrastructure (roads, electricity, telecommunications, water etc), which is often a binding constraint since releasing other constraints may have no effect, or even a negative effect, if there is no access to markets.³¹ Finally, low levels of human capital are primarily due to inadequate education and a lack of skills. However, the existing human capital may also be underutilised due to poor labour market access.³²

³⁰ Social returns can be seen as the potential gross return to an investment. Hence, it should not be interpreted as the return to society at large.

³¹ Other types of improvements that increase production without increasing demand can affect the price of the product negatively and hence profits and potential poverty reduction.

³² See also the discussion on the employment analysis in 3.3.2.

Private appropriability reflects the extent to which the social returns are translated into private returns and is negatively affected by government failures or market failures. *Government failures*, or bad policy and poor institutional environment, include macroeconomic risks such as financial, monetary and fiscal instability, and microeconomic risks, such as insecure property rights, corruption, poor governance, inefficient systems for tax collection and cumbersome regulations and business registration procedures. Macroeconomic risks can be caused by macroeconomic instability such as inflation and exchange rate uncertainty, but are more often due to policy instability in general and lack of predictability of reforms. Property rights are fundamental for pro-poor growth, yet they are often not clear or inadequately enforced (especially for the poor). Corruption has an impact on growth not only by increasing the level and unpredictability of transaction costs, but also by preventing small enterprises from growing at all. When small businesses grow to a certain level, the owner may choose to start another small business, rather than expand the current one, in order to stay less visible. Hence, corruption contributes to preserving a large informal sector to the impediment of the development of a modern economy.

The other explanation of low private appropriability is *market failures* or poorly developed market functions, which could be in the form of limited information and coordination externalities (fragmented markets).³³ There may be a geographical fragmentation of the economy with lack of connections between local markets that puts a lid on enterprise development and growth. Market fragmentation implies that local markets can serve as incubators at an early phase of development by shielding infant industries from outside competition, creating opportunities for monopoly profits and rapid capital accumulation which can be used for investment. However, it also constrains the growth of local firms due to the difficulties of tapping demand beyond the local market. It prevents specialisation and is an obstacle to increases in total factor productivity and increased competitiveness. Hence, market integration resulting in gradual increase in competitive pressure is an indispensable aspect of economic development and sustainable growth. Fragmentation may be partly due to the level and quality of infrastructure and the shortage of business development services, but also to lack of business associations and middlemen as a consequence of the limited amount of trade compared to the associated costs (including informal fees). There may also be a vertical fragmentation of markets where inputs needed in the production are either not available at all domestically or available only in limited quantity and quality and therefore need to be procured from outside the country. This type of fragmentation has severe negative implications on the country's economic growth since the multiplier effect from expansion in one sector becomes very weak in the rest of the economy. It is important to identify the reason behind the fragmentation of markets. It might be a natural consequence of a small and still poorly developed economy, and hence a limited demand for market information. A key question that must be addressed to determine if this should be a policy issue or not is if these markets will develop by themselves as potential returns increase, or if there are inherent market failures such as when the services needed have the characteristics of a public good. In the latter case, some sort of government intervention becomes necessary.

³³ Market failures in this context are those that affect the investors and not society at large.

The cost of accumulation is determined by access to, and price of, capital (international as well as domestic) and is affected by low savings as well as poor intermediation. The cost of local finance will be a binding constraint if there is a demand for business expansion but the price of, or access to, capital is too high. However, it might be the case that the environment for doing business is so difficult that the willingness to invest, i.e. the demand for finance, is low almost irrespective of the cost of finance. Moreover, a disadvantageous investment climate increases the probability of unsuccessful investments, which pushes up the interest rate demanded by banks as they need to compensate for increased risk exposure. Since the opportunities for successful investments are limited this will also affect the quantitative supply of financial services as well as their diversity. This lack of competition might be another reason for the price of capital. However, once the enabling environment for business improves, the acceptable level of interest rate will increase for investors and decrease for the banking sector, given that the larger market will lead to increased competition. As discussed in the section on macroeconomic analysis, efforts should be made to reduce the spread of the interest rate as much as possible; however how this could or should be done depends on the underlying causes. One important question is how much of the interest spread is due to a natural response to the investment climate, and how much is due to a poorly functioning banking sector (lack of competition, lack of information, lack of general trust in the sector etc.), which would warrant some sort of intervention.

3.3.4.3 Specific Business Environments for Specific Groups

The business environment analysis aims at mapping the main problems when it comes to all the above dimensions of returns and costs of investments. It is important to have the analytical set-up shown in Figure 4 in mind in order to identify the specific characteristics of the country in question, identify the binding constraints (as described in the next section), and target the right challenges and opportunities identified in the previous analyses. Moreover, given the aim to focus on the poor, it is important to look at constraints for different groups such as large versus small businesses, urban versus rural, agricultural versus manufacturing, formal versus informal, etc. A bad business environment often affects the business situation of the poor in a disproportional manner when it comes to social returns and the private appropriability of these returns, as well as the cost of finance. For example, public investment such as in roads and electricity are often directed toward the urban areas, education may not be fairly distributed or accessible among different groups, many constraints imply fixed costs (such as informal fees to corrupt official, a private electricity generator, etc) that will hurt a small enterprise more than a large. One main asset of the poor – land – is often connected with titling problems, and information asymmetries create fixed costs of gathering information or a high risk, thus affecting the willingness of financial institutions to provide small loans.

3.3.4.4 Business Environment Analysis for Agriculture

Agriculture is an integral part of the economy and in most developing countries a key sector for providing employment and income opportunities, not least for poor people, as well as being a contributor to overall economic output. Hence, the business environment analysis must cover the whole economy and cannot be confined to only the non-farm sectors. Indeed, this requirement follows logically from, and is enforced by, undertaking the analysis from the perspective of the poor as economic actors. The general aspects of the business environment analysis outlined above are not sector-specific, but applicable

to agriculture as well as the other economic sectors. However, agriculture has a number of specific features that require particular attention, such as:

- Land is a key production factor in agriculture. Thus, land distribution and access to land is of crucial importance, all the more so as land is a finite resource.
- Agriculture is by definition a spatially dispersed economic activity, in contrast to non-farm economic activities which tend to be concentrated in space to specific localities and benefit from economies of agglomeration. Hence, the spatial aspect of economic development, and not least access to markets, becomes particularly important.
- Agricultural producers produce both for their own consumption and for the market and can opt out of the market yet continue to produce for their own consumption if the business environment is hostile. While producing for the market is a precondition for sustainable agricultural development and for increasing employment and income opportunities in agriculture, an inimical business environment often makes increased market-orientation of agriculture difficult.
- Agriculture is heavily dependent on natural conditions such as the properties of soil, weather, rainfall etc. Furthermore, agriculture is also affected by human induced factors such as polluted water, soils and climate change, which add to existing risks for producers.
- Production in agriculture is seasonal. Large seasonal variations in revenue as well as in costs imply specific needs for access to seasonal credits. It also results in large seasonal variations in the demand for labour that can result in periods of labour shortage in the peak season followed by underemployment in the slack season.

This calls in most instances for a specific focus on, and analysis of, the business environment for agriculture. In this context, the interplay between dynamics of agriculture and the non-agricultural sectors deserve particular attention.³⁴

3.3.4.5 Investing in Overseas Migration

A decision to migrate to work abroad can be regarded as an investment decision. For the individual or household concerned, overseas migration to work implies costs and risks, which must be weighted against the prospects of improved incomes, much like a decision to invest in an enterprise. The costs and risks involved can vary greatly depending on access to legal migration channels, access to information and formal costs such as for transport, visa fees etc. The expected return on the investment will obviously depend on differences in wage levels between the source and the destination country (adjusted for cost of living), but also on the position of and legal protection of migrant labour in the destination country. The lower the costs and risks involved, the higher the return to the individual as well as the net economic contribution to the source country (in the form of remittances and secondary effects on the domestic economy). Yet, the costs, e.g. in the form of fees for visa and other permits, and high rents extracted from migrants, in particular in the absence of well-developed channels for legal migration and effective protection of migrant workers' rights, as well as the risks, are often very

³⁴ For a more detailed discussion on rural pro-poor growth see *Improving Income among Rural Poor*, Strategic Guidelines for Sida Support to Market-Based Rural Poverty Reduction (Stockholm: Sida, 2004).

high. A ‘Business Environment Analysis’ for overseas migration should particularly focus on the scope for reducing the costs and risks of migration.

3.3.4.6 Most Important Results of the Business Environment Analysis

Against the backdrop of the previous analyses, the business environment analysis should identify the constraints on and opportunities for increasing employment opportunities and productivity in the economy. Apart from a general analysis, a differentiated analysis from the perspective of the poor as economic actors and in the light of the knowledge of the characteristics of this group (obtained from the employment analysis) should be made. Similarly, a gender disaggregation of the analysis and the conclusions should be carried out as far as possible and where relevant, drawing on the gender specific characteristics highlighted in the employment analysis. Expressed in other terms, the business environment analysis should identify demand constraints for employment and obstacles to increased labour productivity and suggest ways of improving the business environment in these regards with a special emphasis on safeguarding the interests of poor and weak economic actors.

The business environment analysis should also further explore the structural causes to macroeconomic vulnerability and susceptibility to imbalances identified in the macroeconomic analysis.

3.3.5 Binding Constraints on Pro-Poor Growth

In the final stage of the IEA analysis the findings and conclusions from the employment, macroeconomic and business environment analyses are brought together with a view to identifying the binding constraints on enhancing employment, labour productivity and return to labour, and to ensuring the full and equal participation of the poor in the economy. The three analytical and policy arenas – employment, the macro economy and the business environment – are combined into an articulated unity where causal interrelationships between the three are highlighted.

A modified version of a ‘Growth Diagnostics’ approach, built on the principles of binding constraints, is used to inform the analysis. A binding constraint is defined as the constraint that, if relaxed, will boost growth in a given situation.³⁵ This approach has several advantages over the ‘laundry list’ of reform requirements resulting from the augmented Washington Consensus.

- It requires a situation-specific analysis and results in country-specific conclusions. This is not only essential to, but also facilitated by, the IEA approach.
- It is an effective tool for prioritising and sequencing of policies and reforms.
- It translates into a humble, step-by-step approach combining a consciousness of the causal links and major bottlenecks in a specific country with continuous calibration of policies.

³⁵ See Hausmann, Rodrik and Velasco (2005). *Growth Diagnostics*, John F. Kennedy School of Government, Harvard University, March 2005. See also Rodrik ‘Goodbye Washington Consensus, Hello Washington Confusion’, *Journal of Economic Literature* (forthcoming).

However, some modifications of the original approach as laid down by Hausmann, Rodrik and Velasco need to be made in order to fit it with the IEA approach.

First of all, the analysis will focus on the binding constraints on pro-poor growth rather than economic growth in general. Hence, the binding constraints on increased employment, labour productivity and return to labour for the poor should be the focus.

Second, Hausmann, Rodrik and Velasco essentially confine their analysis to the business environment and draw conclusions on binding constraints from that. In the IEA analysis for pro-poor growth, the binding constraints are identified by bringing together employment, the macro economy and the business environment in the final analysis.

Third, the ‘Growth Diagnostics’ approach captures growth constraints due to low productivity (technology, institutions, risk, etc) or low levels of input of production factors (land, labour, capital). However, growth can also be a result of *structural changes* where labour is moving to a sector of higher productivity (for example from agriculture to industry, or from low productivity manufacturing to high productivity manufacturing), or from deploying previously unutilised productive resources. Such sources of growth also need to be brought into the picture.

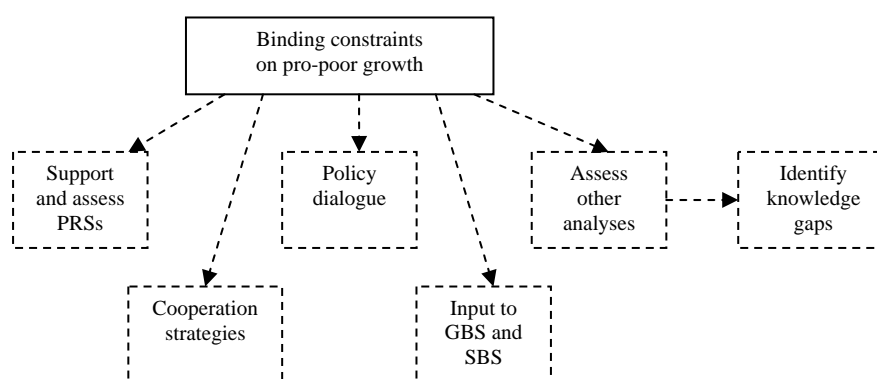
Fourth, in its most stylised form the ‘Growth Diagnostics’ approach sets as its objective to identify a single binding constraint. However, it is important to look at *the bundle of constraints* that can realistically be addressed within a specific period of time, such as the period covered by a PRS. Focusing on only one constraint at a time may be sub-optimal. There may be inter-linkages between different constraints making it necessary to address several constraints jointly (which does not diminish the importance of sequencing). Furthermore, over a slightly longer period of time the optimal direction of reforms may differ from that of a very short term perspective and the identification of the single, most acute, binding constraint would suggest. Extending the analysis to include more than one binding constraint also reduces the risk of missing important constraints, which is especially serious when donors harmonise around a single development strategy.

There may also be *time lags* from policy change to a changed economic environment, for example in the case of human capital formation or in addressing environmental concerns. This means that some future binding constraint must be addressed today, even though it is not binding at present.

4 USING IEA

The purpose of conducting an IEA is to obtain a clear picture of the country-specific challenges and opportunities for pro-poor growth, and how to meet these challenges and opportunities in order to efficiently achieve pro-poor growth. These insights can be used in several processes (see Figure 5).

Figure 5 Using Integrated Economic Analysis.



The undertaking of an IEA should be regarded as an integral part of country analytical work. The level of ambition and scope of the IEA will clearly depend on the coverage and quality of existing analysis. The IEA approach can, however, also usefully be applied in the assessment of existing economic analysis and as a tool to identify knowledge gaps. In this context, the IEA will typically be undertaken in tandem with other analyses, such as political or social analyses.

The results of the IEA may serve as an input into a joint or bilateral cooperation strategy, however in the latter case there are many other factors to take into account. The donor community as a whole should aim at relaxing the binding constraints on pro-poor growth (hopefully clearly prioritised in the PRS), but the division of sectors among donors depends on the donors' comparative advantage in the partner country.

Given the central role of poverty reduction strategies (PRS), a key purpose of an IEA is to inform the discussions and analytical work leading up to the formulation of a PRS. Its broad integrated approach to economic analysis, its strong focus on the poor as economic actors and on aspects (employment, productivity and returns to labour) that have a direct impact on poverty, and the identification of binding constraints makes it well suited to this purpose. It can thus contribute to a strong poverty focus in areas of the PRS pertaining to economic policies and growth promotion, while at the same time facilitating prioritisation and sequencing. It can similarly be used as a tool in the development of National Employment Strategies. The strong recognition of the country-specific context and the use of a binding constraint approach gives it affinity to the methodological World Bank-led work on growth diagnostics, although it differs with regard to its broad integrated approach and focus on employment and productivity. However, it should be noted that the step-by-step procedure inherent in the binding constraint approach implies a need for flexibility in strategies and plans since secondary

effects of reforms and policies are complex and there must be a continuous mechanism for evaluation and monitoring and for making adjustments according to results achieved. Awareness about the country-specific links will facilitate a potential revision of the strategy. This requirement of flexibility points to a role for an IEA in the middle of a planning period as well.

Since general budget support (GBS) is support to a country's national strategy for development and poverty reduction, the IEA can be useful in the assessment of the preconditions for GBS such as macroeconomic development and policies and the potential effects of the PRS in terms of enhancing pro-poor growth and achieving sustainable poverty reduction etc.³⁶ It can also be helpful in the identification of result indicators. Since these should be restricted in number, the binding constraint approach in the IEA can be particularly useful as a means of prioritisation.

Similarly, the results of the IEA can of course also be used in the assessment of sector budget support. The IEA seeks to identify the most urgent constraints on pro-poor growth, which indirectly indicate the role of, and challenges to, different sectors. The IEA can also inform the sequence of reforms and the complementarity between the reforms, highlighting the importance of synchronised sector strategies.

Finally, the IEA approach need not always be used as a tool to conduct extensive analyses, but may also be used as a 'lens' through which different problems are approached. The IEA lens can be useful to, and provide new perspectives on, the general and continuous dialogue among partner governments and donors as well as to the assessment and discussion of other analyses of the country in question. This type of dialogue is essential in the new aid agenda where, for example, budget support requires extensive donor-government dialogue and harmonisation efforts call for intensified donor-donor discussions on country level developments and strategies.

³⁶ However, the IEA for Pro-Poor Growth will not cover analyses of the political context, the public financial system etc. that are also necessary for evaluating GBS possibilities.