

Shanghai Conference: Scaling Up Poverty Reduction: Lessons and Challenges from China, Indonesia, Korea and Malaysia

The “Scaling Up Poverty Reduction Conference” in Shanghai on May 25-27, 2004 will bring 600 participants together to analyze 70 case studies on successful approaches to reducing poverty on a large scale within various economic, social, and institutional contexts.¹ The World Bank is promoting this global dialogue to identify promising and effective avenues to accelerate the fight against poverty.

China, Indonesia, Korea and Malaysia have improved indicators of well being--life expectancy, infant mortality, school enrolments, incidence of poverty-- at a faster rate than virtually any other developing country. In three decades, these four East Asian countries lifted more people out of poverty than all other developing countries combined. Four case studies on these countries have been prepared by local researchers for the Shanghai Conference to understand the reasons for these accomplishments, and to draw lessons. This note builds on these and other sources to put these country experiences in a broader perspective which highlights three features of their success: growth that has been not only rapid but, more importantly, sustained over time; prosperity that has been shared; and institutions that strike a balance between stability and adaptation to the changing needs of increasingly sophisticated, urbanizing and globalizing societies.

I. Sustained Growth: An Exceptional Achievement

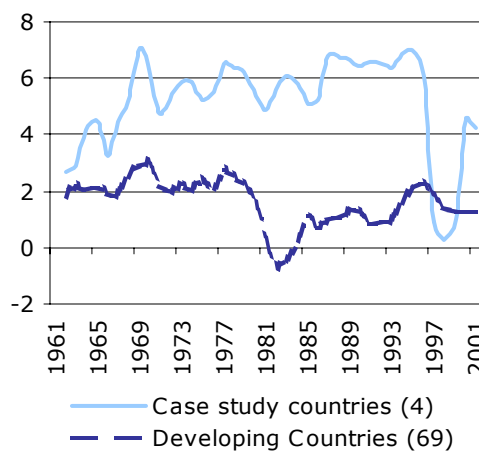
Growth rates: high and sustained. While industrial countries grow at remarkably steady rates with limited fluctuations over time, developing countries’ growth is seldom sustained. Booms, busts, and periods of stagnation often follow each other. Low average growth in developing countries typically results from volatile growth rates, rather than from absence of episodes of rapid growth. What sets China, Indonesia, Korea and Malaysia apart is less the fact that they achieved high levels of growth in some years—which many other developing countries have

also been able to do periodically—than the fact that they have systematically avoided episodes of slow growth. Table 1 shows evidence from 79 countries for the four decades since 1961. By and large developing countries experienced a year of negative per capita growth roughly once every three years. For the four East Asian countries, the average is only about quarter that rate, that is negative growth happened only once every twelve years. In fact, Korea has only had one year of negative per capita growth since 1961 – during the crisis in 1998. Over the long haul it is in large part the ability to avoid downturns that helps explain East Asia’s “miracle” growth relative to other developing countries (Figure 1), and in turn this performance largely explains the equally dramatic reductions in poverty in these countries (Figure 2 on China).

Table 1: Per Capital Growth Rates – 1961-2002

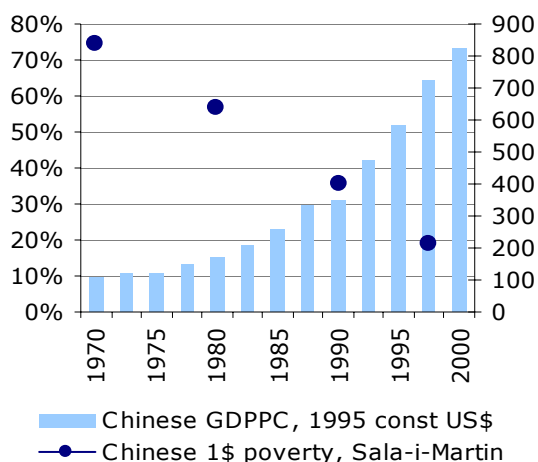
Means	Number of years in which the rate was:			
	Negative	Below 1	Below 2	Above 2
79 Countries	9.9	14.0	19.96	20.9
High Income OECD	3.6	7.6	14.4	26.4
Developing Countries	12.2	16.4	21.6	18.9
Middle Income Countries	10.2	14.4	19.9	20.8
EAP	3.5	5.3	6.8	34.3
China	3.0	4.0	6.0	35.0
Korea	1.0	4.0	5.0	36.0
Indonesia	7.0	7.0	9.0	32.0
Malaysia	3.0	6.0	7.0	34.0
LAC	11.8	17.1	23.0	17.8
SSA	17.8	21.9	26.9	13.8
MNA	10.1	13.7	18.1	21.0

Figure 1. Per capita GDP growth 1961-2002



¹ For details of the Conference please go to <http://www.worldbank.org/wbi/reducingpoverty/Conference.html>

Figure 2: Poverty Reduction--China



Avoiding volatility and sustaining growth over several decades is not an easy task. The more developed countries manage it quite well, and Table 1 shows that high income OECD countries average only one year in ten of negative per capita growth rates. But only 17 developing countries out of a sample of 116 have managed to exceed the US long term per capita growth rate of 2 percent per year for the last two decades.

Common strategies. The reasons for success are complex and quite varied across countries. While there are certain shared features of rapid growth that have been emphasized – including export orientation, macroeconomic stability, employment creation, education, and a favorable environment for private investment – the precise growth strategies followed by each country are quite varied. However, underlying these strategies were a focused determination to pragmatically adjust policies whenever growth started to falter, a commitment to shared, broad-based growth that maintained social stability and order, and an ability to implement new policy directives effectively. Key in this process were unambiguous indicators of performance (e.g. exports), accountable institutions for implementation that prevented capture by narrow interests, and exit strategies when results were below expectations.

Importantly, the pursuit of growth as a central objective of policy has perhaps meant that downturns have been perceived as creating opportunities for reforms that strengthened economic foundations rather than as excuses for inaction. The oil shock of the 1970s, for example, was an opportunity for Korea to open its economy, and expand exports, a sustainable

longer term strategy, whereas in Brazil tariffs were raised and a second phase of import substitution policies was introduced, an approach with negative growth consequences in the long run. Korea's response to the 1998 financial crisis was to relax restrictions on foreign direct investment. Each of the external shocks Indonesia faced, in response to commodity prices or to other external developments, provided stimulus to strengthen the policy regime. With the fading of the second oil boom in the early 1980s, Indonesia introduced two devaluations and micro-economic reforms that helped diversify exports and strengthen productivity growth. In multi-ethnic Malaysia, the response to the racial riots of 1969 – which could have destabilized the country for decades and reduced growth far below its potential, as has happened in Sri Lanka—was a New Economic Policy aimed at sharing wealth equitably for all Malaysians through growth. When growth began to falter in China in the late-1990s, the government response was to expand public investment and rationalize the export regime.

More recently, the 1997 financial crisis provided the opportunity to introduce much needed institutional reforms in banking and corporate governance in Korea, Malaysia and Indonesia. In each of these countries, economic reforms have also been accompanied by political change fostering democracy and accountability at the highest levels of government.

II. The centrality of shared growth

Increasing opportunities through growth. None of the four countries has had debates of the kind: “grow first, distribute later” frequent in Latin America in the 1970s or 1980s. Ensuring that the benefits of growth reached all segments of the population directly, without the need for “distributions” by government or other agencies, was part of the growth strategy. Soeharto's Indonesia developed the concept of “economic democracy” which advocated reliance on the free market for growth, even though corruption and cronyism are now acknowledged to have been serious problems. In Malaysia, the New Economic Policy formally articulated a consensus strategy to eliminate the identification of race with economic function. What sets apart Indonesia and Malaysia is that the natural resource rents did not give rise to a small privileged elite which designed policies for its own benefit—as has been the case of Nigeria or Venezuela and other developing countries suffering from institutional weaknesses induced by a “resource

curse”—but that the rents were invested in growth and service delivery.

What stands out in the East Asian case study countries is that the growth rate of the incomes of the bottom 40 percent of the population has generally been higher than the average growth rate for the economy as a whole (Figure 3) and has been quite rapid over the last twenty years. Korea is the East Asian country with the highest growth rate of incomes of the bottom 40 percent, despite the fact that its average aggregate growth was slower than China’s. And even though China has seen more rapid growth in the richest 20 percent of the population (the urban middle and upper class), the growth rate of its poorest citizens was still increasing at a very rapid rate of over 6 percent per year. By contrast, countries in other regions, as represented by Mexico and Nigeria in Figure 3, have mostly seen below-average growth rates of the bottom 40 percent. Brazil is an exception, but aggregate growth in this period has been very slow.

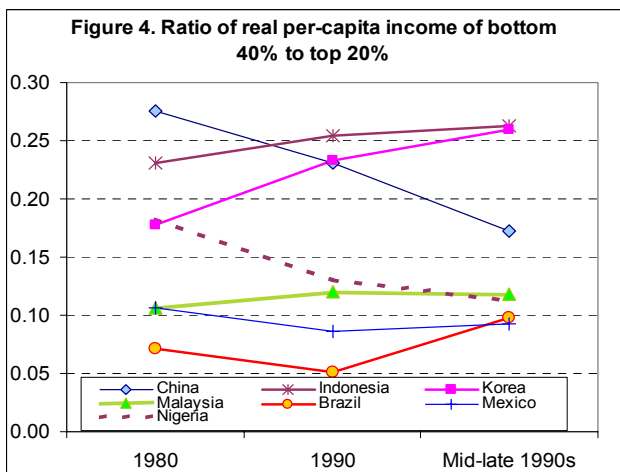
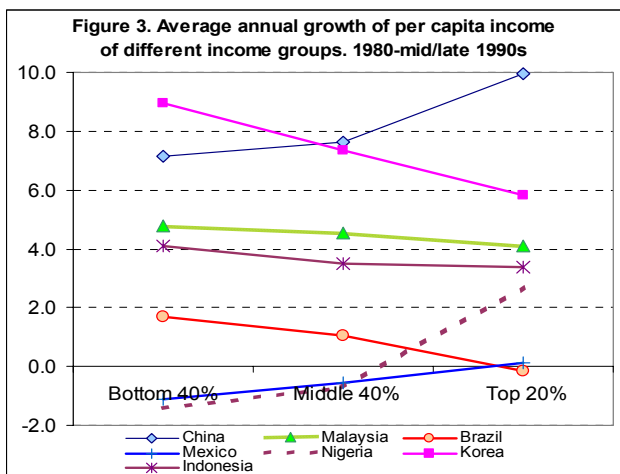


Figure 4 shows that this result does not just reflect the initial distribution of income. In 1980, Korea and

Nigeria had roughly similar income distribution as measured by the share of the bottom 40 percent of the population in total income. Yet the relative growth rates of income of the bottom and top strata differed substantially between the two countries. Similarly, Malaysia and Mexico had similar initial income distributions but a different sharing of growth. It appears that the growth strategies themselves produced the different distributional outcomes, and that more equitable outcomes have been more sustainable over time.

Distribution through growth. The emphasis on growth has had an influence on the type of initiatives the four East Asian governments have taken to ensure more equitable distribution: they have all given priority to augmenting productive capacity, rather than augmenting consumption of groups that might otherwise be left behind. Instead of granting direct income transfers or subsidizing specific commodities, as has been common elsewhere, the four countries have favored mechanisms that facilitate upward mobility: universal education, equitable distribution of land, expansion of small and medium scale enterprises in some countries, privileged access to lending and other resources, emphasis on rural growth through agricultural research and extension, infrastructure investment and access to loans. Governments played important roles in each of these programs. Agricultural and rural development was particularly important. All four East Asian countries had a substantial agricultural sector, whose rapid development contributed significantly to their overall growth and poverty alleviation. Korea, Malaysia, Indonesia and China were able to complete their transition from agriculture to industry faster than other developing countries to a large degree because agricultural growth and productivity rose fast.

Growth oriented strategies to reducing poverty and generating opportunities required access to public services, and all the four countries have also been successful at creating an efficient system of internal accountability for delivering public services that reached the majority of the population. Even in Soeharto’s Indonesia, with corruption eroding the effectiveness of some of the country’s key institutions, infrastructure and social services were considerably expanded to reach significant segments of the population and played an important role in the creation of opportunities and the sharing of growth.

Last but not least, particularly in Indonesia and Malaysia, the flexibility of labor markets enabled

growth to generate employment, instead of rents as has been the case in other developing countries, and thus ensure that all groups of the population benefited. Labor market flexibility helps explain the gains in income across income groups and particularly in the bottom 40 percent. Women benefited in particular from the opportunity to make the transition from low productivity self-employed work to wage labor. The growing number of wage earners per household (and per dependent) has been a major factor behind the faster growth of per capita incomes in the bottom 40 percent of the distribution shown in Figure 3.

In short, the four countries have been able to base high growth on the principles of an inclusive society and the sharing of the benefits of growth, which in turn leads to greater social cohesion, further institutional upgrading and development, better public policies and service delivery, again feeding into higher growth. This helped them avoid the problems faced by other developing countries where inequality retards development because the privileged few with access to resources have less incentives to finance systems whose benefits will largely accrue outside the group.

Specific interventions. In the case of **China**, poverty reduction always received special attention. In the Seventh Five Year Development Plan, the State Council's Leading Group for Poverty Reduction, established in 1986 to rationalize poverty reduction initiatives, focused on bringing infrastructure and public services to the poorest areas of the country. China decided to promote profit-oriented incentives, which required striking a balance between freeing individual incentives, and government initiatives to increase access to opportunities.

Targeted programs such as the 8-7 Plan avoided handouts or income transfers. They sought to raise the income generating capacity of poor rural households through investments in rural infrastructure, agriculture and rural enterprises, and rising support to human capital development in rural areas. They included loans to increase agricultural productivity (including subsidized loans to farmers and food for work programs), to develop infrastructure (road access, electricity, drinking water) and to achieve universal primary education and basic preventive and curative health care. The 8-7 Plan emphasis on physical facilities improved productive conditions, such as basic farmland and irrigation, and living conditions, including drinking water and electricity, for the poor communities

Agricultural growth, rural infrastructure, health and education were central to these four countries' growth strategies. And in some cases, so was the distribution of assets. The case of **Korea** is important in this respect. In the early years following the Second World War, the rural areas in Korea suffered from acute poverty. A survey by the Ministry of Internal Affairs in 1957 found that over 15 percent of the country's farmers were short of food. Another survey revealed that in the period just before the harvest, numerous farmers had to rely on roots and bark in order to survive. The budgets of many farm households were continually in deficit, leading to severe problems of rural indebtedness at high rates of interest. Korea was able to undertake a thorough-going land redistribution between 1945 and 1950. The resulting improvements in rural incomes were impressive. Park (1998) reports that farm household income increased from \$400 in 1965 to \$15,000 in 1990, rising further to \$25,000 in 1994.

A similar approach was pursued by **Malaysia**. Contrary to other countries with ethnic fragmentation, or with natural resources, it managed to drastically reduce the incidence of poverty and lessen income inequality whilst achieving rapid economic growth and maintaining racial harmony. Malaysia's development process was guided by two core national policies: the New Economic Policy, 1970-1990 and National Development Policy, 1991-2000. Both were based on a philosophy of growth with equitable distribution of opportunities.

In the case of **Indonesia**, the expansion of education and health services during the 1970s, as well as the agricultural development policies in the 1960s and 70s were both important in reducing poverty. The Village grant program (Inpres Desa), started in the 1970s, is a good example, as well as a case of innovation and adaptation. The program, which started as a top-down grant for centrally prescribed expenditures at the village level evolved into the village improvement program (VIP) which in turn was the inspiration of the Kecamatan Development Program, the largest successful community development program in the world. Little recognized, but perhaps as important for rural development as targeted programs, was the maintenance of a competitive exchange rate. Regular devaluations gave a boost to tradable sector incomes, and farmers on Indonesia's outer islands that relied to a much larger extent than Java on resources rather than manufacturing, benefited from the move.

As a result, both income inequality and poverty declined in pre-crisis Indonesia and Malaysia. The only country where inequality increased substantially was China. However, China's inequality was extremely low at the beginning of its high growth period, reflecting its early revolutionary history, and increasing inequality of outcomes was viewed by the political leadership as a necessary by-product of the creation of the incentives and opportunities needed for growth and a transition to a socialist market economy—and there is little question that China's poor have benefitted tremendously from this approach, which has been complemented with some of the largest anti-poverty programs in the world.

III. Institutional Learning and Adaptation

In low income economies, positive growth shocks can easily become growth episodes. Examples include: adoption of new agricultural technologies, investments in infrastructure, or subsidizing private sector risk taking. The challenge of development is to transform these growth episodes into sustained growth—a challenge that requires not only effective macro- and micro-policies, but also institutions capable of supporting and adapting to increasingly complex social and production systems. East Asian countries have met this challenge more successfully than most other developing economies. Institutions changed as needed to respond to demands posed by more urbanized societies, and increasingly sophisticated and global economies. Equally important, notwithstanding inevitable periods of stress and uncertainty, such as Indonesia's current democratic transition, all four East Asian economies were able to strike a balance between institutional stability and standardization to reduce costs and adaptation to emerging needs. At the same time, new institutional issues have emerged—in the areas of corporate governance, legal systems, and social protection. Below are a few observations on these four countries institutional strengths, and on the challenges they face.

Accountable bureaucracies. The best policies need to be implemented effectively. All four countries have had accountable bureaucracies. President Park's reforms in the 1960s to root out corruption from the civil service, succeeded in establishing a fiercely competitive, meritocratic civil service. In Indonesia, the country's economic policies were managed by a group of technocrats, isolated from politics, alert to opportunities to drive structural reforms.

Notwithstanding problems with corruption, Indonesia has been able to establish a system of delivery taking public services to virtually all areas of this large and fragmented country, including the most remote ones—explaining Indonesia's broad-based improvements in school enrollments and health indicators.

Institutional Innovation, Learning, Experimentation and Crises as Opportunities

There is no such thing as *development first, institutions later*; development is the development of institutions. East Asian countries have long realized the importance of institutional change and innovation, and the recent crisis makes this realization all the more acute. Without the rule of law, an increasingly complex economy is hard to manage. Without an independent supervisor, the financial sector needed for a modern economy cannot emerge. Without transparent information and popular participation in decision-making, the increasingly difficult economic choices a government must make may lack the legitimacy needed to make these decisions effective. And without a clean, efficient civil service, implementation of those policies, and their effects may diverge strongly from what policymakers intended. But, just as there has been no strict commonality in the policy choices behind different country growth strategies, there has also been a great divergence in institutional approaches. Successful institutional development has been based on a common experience with innovation, empirically-based assessments, and learning and adaptation as conditions change.

Indonesia's difficult transition. Indonesia is the one East Asian country where the 1997 financial turmoil has had the longest lasting effects. It experienced a 12 percent per-capita GDP contraction in 1998 and it is only in 2004 that incomes are expected to exceed their pre-crisis levels. Much of Indonesia's slow recovery is attributable to the weaknesses of its institutions. Under Soeharto, the country's financial, legal and political institutions did not keep pace with Indonesia's increasingly complex and open economy, and made the country vulnerable to shocks. Lack of appropriate controls and oversight weakened the financial sector. Following the 1997 crisis, absence of strong institutions made recovery more difficult and more costly. Institutions to manage the crisis—banking supervision, commercial courts—could not be isolated from the weak institutional environment, and were only partially effective.

The crisis has stimulated a number of positive institutional changes, however. The constitution has been amended to limit presidential powers, and strengthen checks and balances. For 2004, direct presidential elections are planned for the first time in the country's history. The military will no longer have reserved seats in the Parliament that will be elected this year, and the police are no longer part of the military. An anti-corruption commission has just taken office, and all state officials are now required to report their wealth. New laws on the judiciary will make it independent from government, and judges are to be selected by a judiciary commission rather than being appointed by the President. New laws on state finances provide for more transparency and accountability, and a new central bank law grants independence to this key institution. A free press and media are thriving, and a wide range of civil society organizations and NGOs has sprung to life. This partial listing illustrates the central point: institutional innovation and adaptation is happening rapidly across East Asia, including in countries such as Indonesia which may, on other economic indicators, be perceived as a laggard relative to its neighbors.

Institutional Challenges

East Asian countries have proven themselves to be adept at meeting institutional challenges which require short to medium term adaptations which can be introduced from best practices elsewhere in the world. The response to **corporate governance** is a good example where progress has been made, based largely on OECD experiences.

Recent developments in the US illustrate the difficulties associated to strike an effective balance between protection of shareholders from predation by managers, including protection of minority shareholders, creditors' rights, and incentives for risk taking by managers. Absent an effective framework to deal with these issues, it is difficult to develop capital markets, particularly stock markets. In East Asia, these issues are rendered all the more complex by three factors. The first is concentrated ownership of industrial firms and banks. The second is weaknesses in the operation of bankruptcy laws. Insufficient clarity of the law, lack of transparency in the interpretation of the law and inconsistency in its application, alongside with weak commercial courts have been problems in Korea, China and Indonesia—although it has been improving in all cases. Malaysia is an exception in that bankruptcy laws have been quite effective, and well implemented. Recent

surveys suggest, however, that progress is being made in strengthening corporate governance, but a true market for corporate control has yet to emerge. Such a market requires governments' willingness to withdraw from ownership, and relinquish a tendency to manage markets. This evolution may take some time to complete.

A more challenging institutional issue is how to sustain the demand for reforms over a longer term. Economic shocks or crises rarely last for long enough to provide sufficient impetus in this area, and impacts are felt after a generation not a couple of years. There is broad recognition across the region that **legal systems** are in need of reform, yet the institutional ability to move aggressively on this front seems to be limited and progress has been very slow. Relatively weak legal systems did not impede rapid economic growth in the past because governments intervened frequently, and controlled market forces. In the next phase of their institutional evolution, particularly Korea, China and Indonesia will need to strengthen their legal framework and impersonal enforcement of the law. The challenge of building a stronger market economy includes the difficult task of strengthening the courts and regulators relative to the executive and legislative parts of government.

In *Korea*, there have been strict limits on the number of law school graduates. By 2000, the whole legal profession, including judges and prosecutors, numbered fewer than 7,000, only slightly more than in Hong Kong, China, with one-eighth of Korea's population. *Indonesia* faces the problem of laws that are good on the books, but where implementation is perceived to be subject to influence. *China* started to reform its legal system in the early 1980s and the judiciary has been increasingly active in settling economic disputes, particularly in the most advanced parts of the country, and this has facilitated formalization of contracts. China's entry in the WTO further reinforces the role of formal legal proceedings, but Chinese laws still need to be made compatible with WTO requirements. In addition, at present, the job of the courts is made much more difficult from the start because they adjudicate, but do not interpret the laws. Enforcement is another problem because the courts do not have primacy over the executive, and many court rulings are simply ignored.

Poverty reduction on a national scale requires a "scaling up" of project experiences to a nation-wide program and of growth episodes to sustained economic progress over several decades. Such scaling

up has been elusive for most countries, but a few in East Asia have achieved significant success, and much can be learned from their experiences. Government commitment and attention to growth and to managing or avoiding economic downturns, strategies and incentives for shared growth in which the lowest quintiles directly participate, and institutional innovation and effectiveness are common features of successful scaling up.

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