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**INSTITUTIONS AND POVERTY REDUCTION.**

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## 1. Introduction

For more than a decade now, economists have argued and shown that institutions are critical to spurring and sustaining investment and economic growth. Douglas North (1990) has defined institutions very broadly as “the rules of the game” that govern the protection (or lack thereof) of property rights and underpin the rule of law. This encompasses a wide range of phenomena, from informal arrangements to formal laws and regulations or from simple norms to complex set of rules, e.g., an importation rule for sugar vs. the Constitution. Formal rules are written and enforced by the State; informal rules are typically unwritten and enforced by groups within society.

There are many kinds of institutions in society: one important set consists of rules that align the incentives of so-called “agents” with the interests of so-called “principals” in a chain that runs from voters (as principals) to elected leaders (as agents) and elected leaders (as principals) to government officials (as agents).<sup>1</sup> In the context of pro-poor growth, the ultimate principals are the poor and the agents are politicians and bureaucrats: good institutions are thus those that align the incentives of public officials with the interests of the poor.

Institutions of this type have in fact come to characterize the state and quality of governance in a country. Many definitions of governance have been offered (each donor agency for instance has its own) but at the core of each is that governance refers to the manner in which the State exercises and acquires the authority to provide and manage public goods and services. The manner in which this authority is acquired and exercised is anchored in many different sets of rules called governance institutions, all of which interact to shape the quality of governance – the extent to and quality with which public goods and services are provided to the citizenry and the business community.

In medieval Europe, it was the king, his court advisers, his army, and the feudal nobility that combined to form the State and wielded the authority to provide public goods and services, although their authority did not emanate from the people but through historical antecedent and tradition. In modern democracies, it is the Executive (including local governments), the Legislature, the Judiciary, and a host of (relatively) independent bodies, e.g., constitutional courts in some countries, that form the State and in combination produce the public goods and services needed by the citizenry and the business community. Their authority, however, is a delegated one: the citizenry voluntarily cedes authority to them. Today there are many different systems, including many variations of so-called democracies. Indeed, this is reflected by the variety of systems found in the fourteen country case studies included in this volume.

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<sup>1</sup> In fact, the principal-agent relationship between citizens and leaders can exist even in non-democracies. For instance, it has been convincingly argued that, because of the credible threat of a communist takeover, then President Suharto of Indonesia paid close attention to the welfare of the poor since communist forces worked through the plight and dissatisfaction of the poor (Campos and Root, 1996). The threat in this case was “dismissal by rebellion” rather than by defeat at the polls.

Research on the causes and impact of bad institutions i.e., poor governance, dates back several decades.<sup>2</sup> But it was not till the mid-1990s, with improvements in data and econometric techniques, that large, cross-country analyses of the impact of governance institutions on investment and growth emerged. Since then, many empirical studies have shown that bad institutions retard both investment and growth (see for instance, Keefer and Knack, 1996; World Bank, 1997; Kaufman et al, 2000 and 2002). More importantly, recent research suggests that governance institutions are perhaps even more significant than good policies or other explanatory variables in explaining cross-country variations in investment and growth (Rodrik and Subramanian, 2003): governance institutions are at the core of growth.

Perhaps the most popular measures of the quality of governance institutions are the perception or experience based survey indices on corruption (ICRG, Transparency International, KKZ).<sup>3</sup> Using one or more of such indices, several empirical cross-country studies have shown that corruption has a deleterious effect on investment and growth (see for instance Mauro, 1996; Wei, 1996, World Bank, 1997). Moreover, similar studies have indicated that corruption distorts the allocation of public investment and more broadly public expenditures (Mauro, 1998; Tanzi and Davoodi, 1998), constrains and distorts the collection of tax revenues (Ghura, 2002), and, most significantly, increases income inequality and fosters poverty (Gupta, Davoodi, Alonso-Terme, 2002). These latter studies have underscored the role of governance institutions in poverty reduction.

Interest in the impact of governance institutions on poverty reduction evolved from the research on investment and growth. Many studies have shown that economic growth is necessary to combat poverty. As the World Bank (2001) reports, “growth in the 1990s and the 1980s was a powerful force for reducing income poverty. On average, growth in the consumption of the poorest fifth of the population tracked economic growth one for one over this period. . . . The pattern is similar for the share of people living on less than \$1 a day. On average, every additional percentage point of growth in average household consumption reduces that share by about 2 percent. . . . Although the deviations from this average relationship show that in some countries growth is associated with much more poverty reduction than others, the relationship highlights the importance of economic growth for improving the incomes of poor people and for moving people out of poverty.” Given this research and that on the impact of institutions on growth, donors and policy makers could thus conclude that good institutions are likewise critical for poverty reduction.

Indeed, the simplest statistical analysis correlating institutional quality with the incomes of the poorest quintiles shows that 70% of the variation across countries of the living standards of the poorest fifth can be explained by the quality of institutions. This

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<sup>2</sup> See for instance Susan Rose Ackerman (2004) and Robert Klitgaard (1988) among others. Much of the work on rent-seeking that punctuated the literature from the mid 70s to the 80s, e.g. Krueger (1976), Bhagwati (1978), essentially tackled conceptual issues.

<sup>3</sup> Kaufmann et al (2003) have assembled what is perhaps the most extensive and robust data base on governance indicators which effectively reflect various dimensions of governance – control of corruption, voice and accountability, rule of law, government effectiveness, regulatory quality, and political stability. Not surprisingly, these measures are highly correlated.

relationship holds whether institutional quality is measured by using indices of “property rights and the rule of law”, “control of corruption” or “government effectiveness”. Indeed there is **no** country in the top quartile of the governance ratings that has a poverty rate of above 2% as measured by the now famous “dollar a day” metric. Compare this to the global average of the prevalence of poverty, which is 20% on the same “dollar a day” metric. The global average of \$2/day poverty is above 50%, but the highest prevalence of \$2/day poverty in the top quartile of the governance distribution is only 8%. The average poverty rate on this measure in the countries in the top quartile of the governance measures is close to 0 for both \$1/day and \$2/day.

The plan of this paper is as follows:

This paper explores the role of institutions in implementing pro-poor growth policies.

(1) It starts by reviewing the literature to define what is meant by institutions and what we know about their importance for growth and poverty reduction. It then reviews the case studies identifying examples where institutional capacity affected the implementation of policies related to pro-poor growth outcomes (labor market policies, agricultural policies, pro-poor spending, quality of service delivery, growth policies, etc.).

(2) Building on the issues identified in the case studies (in the previous section), the third section draws on examples as to how institutional capacity can be strengthened at the local level to improve the implementation of policies related to pro-poor growth, focusing on the government capacity to implement distributional policies, the development of transparent and accountable institutions at the local level, the role of improving information flows.

(3) The last section will summarize the main lessons learned from the review and recommendations for improving institutional capacity as well as the quality of our analysis of these issues in our analytical and operational work.

## **2. Measuring Institutions**

“Good institutions” can refer to laws that align the incentives of private sector agents (e.g., debtors) with the interests of principals (e.g., creditors). Both legal institutions (commercial laws) and private institutions (group lending in microfinance) can do this. Another set of important institutions are regulatory institutions that can raise the cost of doing business. In this case “good institutions” refers to regulatory systems which only demand that firms comply with socially efficient regulations rather than the Byzantine regulations imposed on firms in many countries.

Data on institutions exists in many forms, but one important way to make a distinction is between data on specific institutions and data on institutional quality. Cross-country data is now available on a number of specific institutions—for instance, on whether or not a country is democratic, whether it has a presidential or parliamentary system, whether it is a federation, the number of steps to start a business, the number of steps to collect on a bounced check, and whether the commercial law requires that secured creditors get paid first.

Data are also available on institutional quality. The World Bank produces indices of six dimensions of governance: Voice and Accountability, Property Rights and the Rule of Law, Government Effectiveness, Regulatory Quality, Control of Corruption, and Political Stability and Violence (Kaufmann, Kraay and Mastruzzi 2003). These indices are developed by aggregating governance indices produced by other organizations. One disadvantage of this data is that it is only available from 1996 onwards. For some statistical tests it is important to have data from an earlier period. In these instances we use the ICRG data, which is available for many countries from 1982 onwards (Knack and Keefer 1995).

It is difficult to distinguish empirically between institutions defined as rules and their enforcement and the quality of government capacity. Government Effectiveness, Property Rights and Rule of Law, and Control of Corruption are in fact highly correlated with each other, and empirically are nearly indistinguishable, with correlation coefficients of around 0.95. If one interprets “Government Effectiveness” as a measure of organizational capacity and “Property Rights and Rule of Law” as a measure of rules and enforcement that provide security to citizens, then it is impossible to distinguish the effects of one from the other in using cross-country comparisons.

There are several possible reasons for this close relationship between organizational capacity and rule enforcement. The most plausible of these is that it takes organizational capacity to enforce rules. The governments that are capable of delivering other services are also more capable of delivering law enforcement services. Another is that the governments that are more willing to provide other services are also more willing to provide law enforcement services. In fact the three governance measures are also correlated with Voice and Accountability, with “Stable Democracy”, and with settler mortality.<sup>4</sup>

Ignoring enforcement and focusing on rules themselves gives an incomplete and misleading picture. In many instances enforcement appears much more important than rules in affecting outcomes. Capital market development, for instance, appears to be affected by rules like commercial laws, but much more strongly affected by law enforcement (Azfar and Matheson 2003). Human trafficking outcomes also appear to be more strongly affected by law enforcement than laws that aim to prevent trafficking (Azfar and Lee 2003).

In Table 1 we present data on various institutional quality measures for the case study countries. The four institutional quality measures from the World Bank on Voice and Accountability, Government Effectiveness, Rule of Law and Control of Corruption, are normalized measures with a mean of 0 and a standard deviation of 1. It is notable that almost all case study countries are below the global mean on all these measures except Voice and Accountability. But because these measures are on a comparative scale they cannot easily communicate the depth of misgovernance in the case study countries.

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<sup>4</sup> Mortality rates for European settlers differed widely across geographic zones and may have affected the character of colonization and hence the nature of present day governance Acemoglu et al. 2000.

To understand the depth of misgovernance in the case study countries we have to turn to measures in “natural scales”. Here we find that it can take over a year to get a simple contract enforced in Bolivia, and 88 days to start a business. In addition 48% of households state that teachers are frequently absent, and 30% of poor Bolivians report that they have been asked for a bribe by a government official in the last year<sup>5</sup>. These manifestations of misgovernance may be no accident: 93% of Bolivians believe their government is run for the benefits of a few big interests. It would be hard to understand how such a depth of misgovernance would not affect the growth in the incomes of the poor, and indeed as we shall soon see, it does.

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<sup>5</sup> The actual number is probably higher as people may be reticent in their responses to survey questions on corruption. New techniques being developed at IRIS may allow researchers to assess the extent of such biases.

**Table 1. Institutional quality in 14 case study countries**

Like most other kinds of data, all variables listed below are imprecise measures.

- VA2002 Voice and accountability from Kaufmann, Kray and Mastruzzi (KKM). Normalized score with global mean=0, std. dev. = 1
- GE2002 Government effectiveness from KKM Normalized score with global m=0, s.d.=1
- RL2002 Property rights and rule of law from KKM Normalized score with global m=0, s.d.= 1
- CC2002 Control of corruption from KKM Normalized score with global m=0, s.d. = 1
- Durtot check Number of days to collect on a bounced check (Djankov et al. )
- Steps start bus Number of steps to start a business (Djankov et al.)
- Time start bus Time to start a business in days (Djankov et al.)
- Teacher absent Percentage of respondents saying teachers are frequently absent (Knack)
- Corr Poor Reported incidence of corruption related to law enforcement agencies for poorest third in last year (International crime victimization survey)

Country	Code	VA 2002	GE 2002	RL 2002	CC 2002	Durtot check	Steps Start bus	Time start bus	Teacher Absent	Corr poor
BANGLADESH	BGD	-0.57	-0.53	-0.78	-1.12	270				
BOLIVIA	BOL	0.01	-0.53	-0.60	-0.82	464	20	88	48%	30%
BRAZIL	BRA	0.28	-0.22	-0.30	-0.05	180	11	63		10%
BURKINA FASO	BFA	-0.27	-0.69	-0.55	-0.04		14	33		
EL SALVADOR	SLV	0.06	-0.53	-0.46	-0.54	60				
GHANA	GHA	0.01	0.01	-0.15	-0.40	90	10	45		
INDIA	IND	0.38	-0.13	0.07	-0.25	106	10	77	33%	6%
INDONESIA	IDN	-0.49	-0.56	-0.80	-1.16	225	11	128	14%	21%
ROMANIA	ROM	0.38	-0.33	-0.12	-0.34	225	13	97		14%
SENEGAL	SEN	0.15	-0.18	-0.20	-0.17	335	16	69		
TUNISIA	TUN	-0.83	0.65	0.27	0.35	7	4	41		
UGANDA	UGA	-0.77	-0.41	-0.84	-0.92	99	11	29	39%	28%
VIETNAM	VNM	-1.36	-0.27	-0.39	-0.68	120	16	112		
ZAMBIA	ZMB	-0.40	-0.93	-0.52	-0.97	188	5	29		11%
<i>Average</i>		<i>-0.24</i>	<i>-0.33</i>	<i>-0.38</i>	<i>-0.51</i>	<i>182.23</i>	<i>11.75</i>	<i>67.58</i>	<i>34%</i>	<i>17%</i>

### 3. Cross-Country evidence on Institutions and Pro-poor Growth

The cross country evidence shows a clear link between institutional quality and poverty reduction. Knack (2001) shows that institutional quality is associated with rapid growth of the poorest quintile, and with a reduction in inequality. Our results from the larger Dollar and Kraay data set (Dollar and Kraay 2001) also show that countries with better governance have faster growth in the incomes of the poorest quintile than poorly governed countries.

Data on both governance and incomes of the poor is noisy. In addition incomes of the poor in any one year can be affected by idiosyncratic shocks caused by crop failures, changes in commodity prices and business cycles. To minimize these problems we constructed a data base with one observation per country of the annual rate of growth from the first to the last period with available data. We then dropped all observations that had less than 10 years difference from the first to the last year.

The results of the regression are shown in Table 2. Institutional quality has a large and significant effect on growth rates of the poorest quintile. If the ICRG index were 3 points higher then the annual growth of incomes of the poorest quintile would be 2.4 percentage points faster. This is a large number. If the incomes of the poor had grown 2.4% faster per year in India since independence there would be almost no one in India living on less than a dollar a day, and very few living on less than 2 dollars a day. We also find that openness, and low levels of inflation lead to growth in the incomes of the poor.

**Table 2**  
**Dependent variable: Growth of poorest quintile.**

		OLS	OLS	OLS	OLS
Growthl	GDP/Cap growth			1.147	0.994
				(7.95)**	(5.46)**
lypl	Lagged Log(GDP/cap)	-1.939	-1.683	-1.096	-1.053
		(4.94)**	(3.67)**	(3.70)**	(2.73)**
icrg82	ICRG 1982 or earliest year	0.76	0.399	0.346	0.242
		(5.01)**	(2.27)*	(2.91)**	(1.68)+
openc	(Exp+Imp)/GDP	0.013	0.011	0.001	0.002
		(2.16)*	(1.91)+	(0.28)	(0.35)
linf	Log(1+inflation rate)	-0.82	-0.66	-0.026	-0.018
		(2.22)*	(1.91)+	(0.09)	(0.06)
lsc	Secondary schooling		0.098		0.045
			(2.49)*		(1.36)
Con		8.385	8.067	3.292	3.483
		(3.66)**	(3.53)**	(1.90)+	(1.73)+
Obsns		66	58	66	58
R-sq		0.44	0.38	0.73	0.61

Absolute value of t statistics in parentheses

+ significant at 10%; \* significant at 5%; \*\* significant at 1%

One observation per country: Annual growth of per capita income of poorest quintile from the first period with data on income of the poorest quintile to the last period with data on income of the poorest quintile. At least 10 year differences between first and last year.

The results become weaker but remain significant if we control for education. In fact, education levels themselves depend on institutional quality, as we will soon discuss. Thus, one way to interpret the difference in the coefficients in the regressions with and without education is that the coefficient in the regression without education shows the total effect of institutional quality on the growth of the poorest quintile, i.e., it shows the sum of the direct effect and the effect through improvements in the quality of education.

The regression has a number of outliers so we ran robust regressions which downweight outliers to check whether the results were being driven by outliers. In fact the results become stronger when we run robust regressions (results omitted to save space and are available from the author).

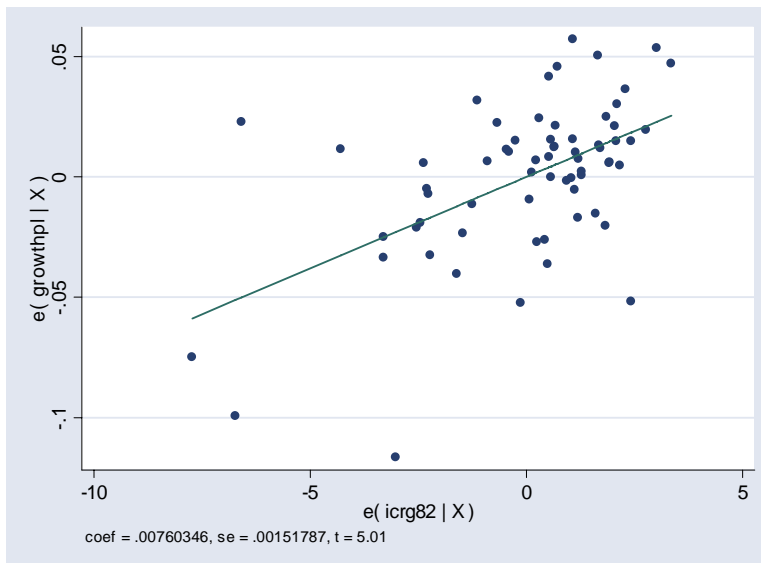
Indeed it appears that better institutional quality leads to faster growth for the poorest quintile than for the whole economy (Table 2). While introducing growth on the right hand side of the regression knocks out all other determinants of growth, institutional quality remains significant in the regression that doesn't include education, and marginally significant in the regression that includes education. These results contrast with the results of Dollar and Kraay (2001), who find that growth is no faster for the poorest quintile. One difference in our results is our insistence on at least a 10 year period between the first and last year, which we think is necessary to have an even approximately accurate measure of growth of the poorest quintile. Another difference is that we have do not have identical control variables. Our results resonate with the results of Knack (2001) who finds that institutional quality is associated with reductions in inequality.

It is important to distinguish what the different columns of Table 2 indicate. Columns 1 and 2 indicate that there is a strong relationship between institutions and poverty reduction. Columns 3 and 4 indicate that the relationship between institutions and poverty reduction is stronger for the poorest quintile than for the average person. These relationships do not imply that institutions are a binding constraint in the narrow sense of "binding constraint" that growth is impossible in the presence of poor institutional quality. There are instances of growth with poor institutional quality, much as there are instances of growth in countries with hyperinflations, autarkic trade regimes, and low human capital. Rather the results indicate that on average, growth rates are likely to be higher if institutional quality is better.

Figure 1 shows the partial relationship between ICRG82 and the growth of the poorest quintile after controlling for initial income, openness and inflation. In fact the measures of both institutional quality (ICRG82) and the growth in incomes of the poor are imprecise measures of the quality of institutions and actual growth in the incomes of the poor. The actual relationship may well be much closer than the graph shows because in cases where the true relationship between variables is close, but the variables are badly measured, the observed pattern appears to have a less close fit than the actual relationship.

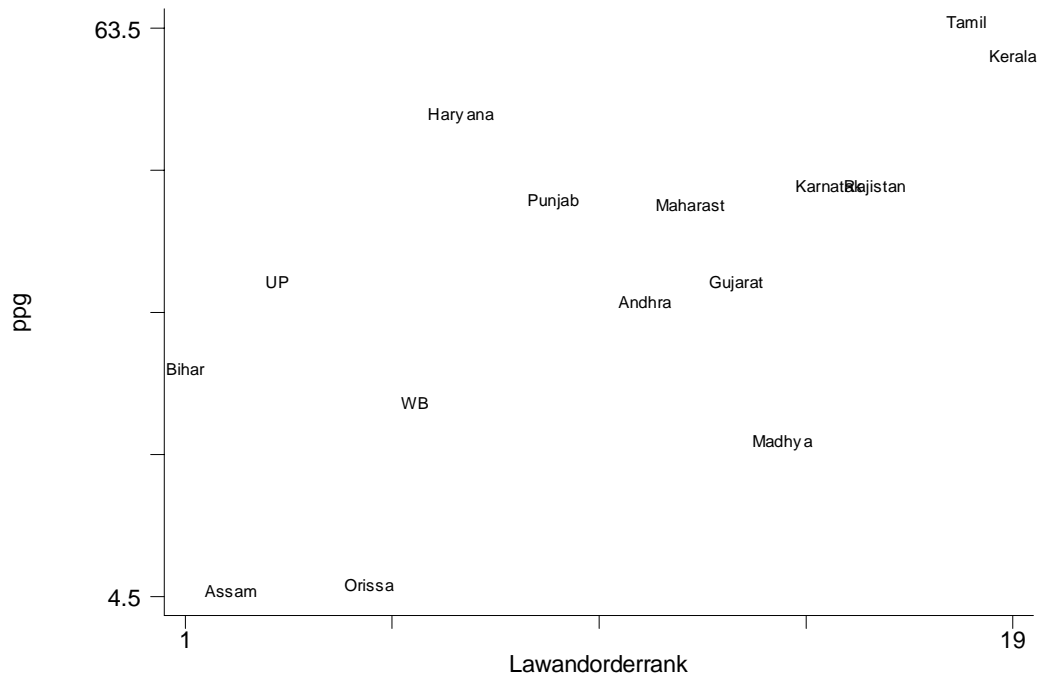
A similar statistical analysis has been carried out by Kathryn Sadler and Nuning Akhmadi (2004) across Indonesian regions. They find that regions with better institutions experiences faster rates of poverty reduction. In one analysis relating the rate of poverty reduction to “how conducive was the business environment” across 87 municipalities they found that poverty reduction rates were more than twice as high in districts where the business environment was “conductive” or “very conducive” (the mean poverty reduction rate increased from 3.4 to 8.4). While neither analysis had clearly significant results, the combination of the two sets of results does suggest that better governance leads to improvements in pro-poor outcomes. Similarly another analysis using business permit fees as the governance variable found that the mean poverty reduction rate was 4.33 in the districts with worse performance on business fees but 10.11 in the districts with better performance on business fees. Such analyses are increasingly possible in other countries as decentralization spreads and more data becomes available at the local level. We strongly recommend that such studies be designed and implemented.

**Figure 1**  
**Partial plot Annual Growth of the Poorest Quintile. Regression controls for initial income of poorest quintile, inflation and trade openness.**



Across Indian states too, the patterns in Figure 1a indicates that poverty reduction has been most successful in the better governed states. The data on institutional quality are measures of law and order constructed by “India Today” (August 2004), and the pro-poor growth data are from the India case study (Besley et al. 2004). The relationship is statistically significant (t-stat=3.19, P-value=0.01). For instance the top performing states of Kerala and Tamil Nadu also have the best governance, and the troubled state of Assam both the worst governance and the worst rate of pro-poor growth. The data also shows some interesting surprises, for instance the traditionally poor performing “BIMARU” state of Rajasthan is doing rather well in terms of both governance and pro-poor growth.

**Figure 1a. Institutional quality and pro-poor growth across Indian States. (Kerala has best institutions and second highest pro-poor growth etc.)**



Cross country and cross province regressions cannot easily resolve problems of causality. One way to deal with the problem is to use instrumental variables. The fashionable way to do this is to use settler mortality as an instrument for institutional quality. Acemoglu et al. (2000) eloquently argue that in places with high levels of settler mortality, colonial institutions were set up to be extractive, and not to nurture growth. Hence, institutions were focused on predation, not production. Thus settler mortality would have affected governance. Acemoglu et al. show that settler mortality affected the probability of democratic rule in the early 20<sup>th</sup> century and both settler mortality and lagged democracy predict the quality of present day governance. However, settler mortality is only defined for former colonies and therefore we lose around half the sample when we try instrumental variable regressions. The coefficients on the institutional variable rise considerably but are statistically insignificant. In any case, settler mortality may not be a valid instrument in this instance as it is strongly correlated with modern day disease prevalence—malaria, the most important cause of settler mortality, tragically persists to the present day—, and disease could independently affect the growth in the incomes of the poor. For these reasons we do not present the instrumental variable results. We will discuss other implications of the settler mortality results on the persistence of institutions later in the paper.

Another way to convince the reader that institutional quality affects the welfare of the poor is to present other forms of statistical evidence and examine case studies that allow

us to describe mechanisms which demonstrate that the statistical relationship we have found could plausibly reflect a causal relationship. We take the latter approach in this paper. We use a combination of case study and statistical evidence to describe how institutional quality affects the effectiveness of redistributive policies, the quantity and quality of education provided to the population, and the poor's access to justice.

#### **4. Institutions and the mechanics of pro-poor growth:**

##### *4.1. The mechanics of pro-poor growth in rural and urban areas*

In the following sections we use a combination of case study and cross-country evidence to understand the mechanisms by which institutions lead to pro-poor growth. The likely mechanics of pro-poor growth are the following: Agricultural workers either move to cities or increase their productivity—defined as revenue product, not physical product. Their productivity depends on their education levels, access to inputs such as seeds, fertilizer and irrigation, and access to markets via roads and better communication about prices. The urban poor, and recent rural migrants, are generally either unemployed or work in services and manufacturing, sometimes for themselves and sometimes in firms. Their productivity too depends on their education levels and the regulatory and law enforcement environment they work in. Finally, pro-poor growth could be achieved by improving redistribution to the poor.

Institutions affect the mechanics of pro-poor growth in many ways. The relatively effective Indonesian government was able to provide infrastructure and schooling for farmers and a rice policy that led to a large increase in the production of rice over 35 years. The Zambian government by contrast was unable or unwilling to provide badly needed infrastructure or schooling. One possible explanation for the poor schooling outcomes in Zambia is the extensive leakage of educational finances. Nor is this leakage rate unusual, Uganda's pre reform rate is similar. In addition, many countries suffer from endemic teacher absenteeism. Cross-country evidence also shows significant relationships between institutional quality and both the quantity and quality of schooling. Institutions also affect the ability to do business in many countries: governments interfere with business formation, and take months to resolve the simplest of disputes. In India over-regulation is associated with both lower growth and a lower poverty elasticity of growth. Poorly governed countries also have high rates of crime victimization for the poor, which can both directly impoverish them and make them reluctant to save and undertake market transactions, which compounds their poverty and vulnerability. Finally, poor institutions also make governments unwilling or unable to use redistribution to reduce poverty.

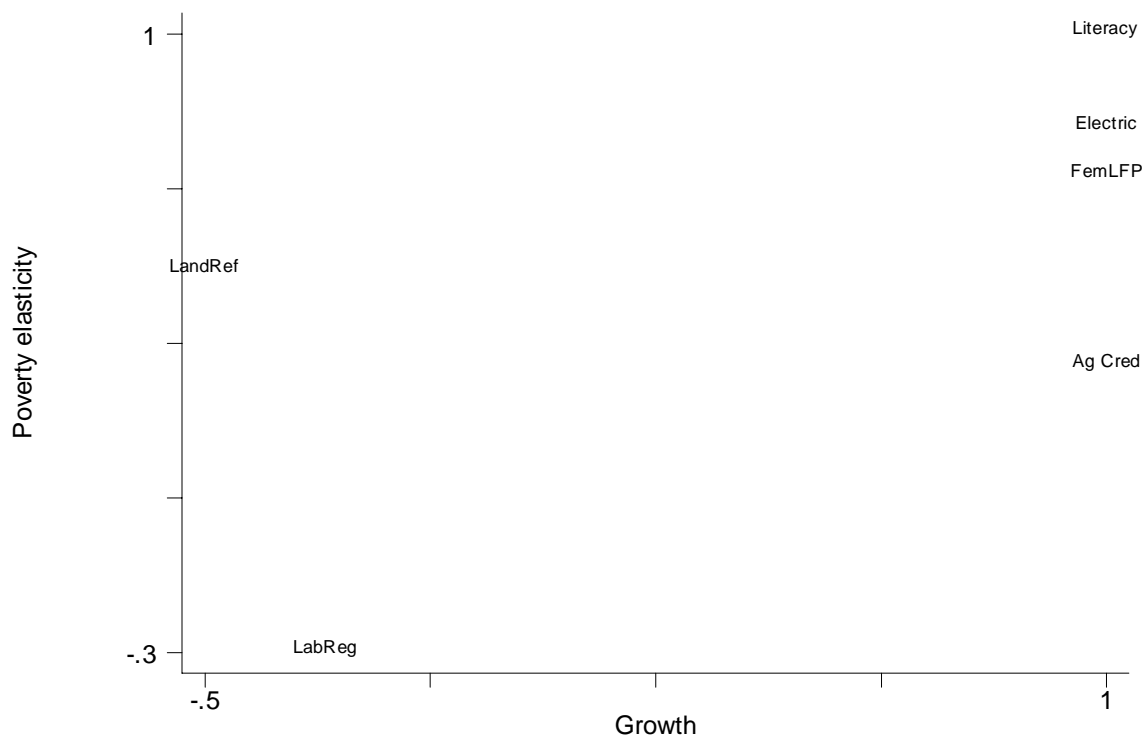
The India case study examines patterns between both growth rates and the poverty elasticity of growth for various policies.<sup>6</sup> These are summarized in Figure 2. Each point

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<sup>6</sup> The poverty elasticity is the change in pro-poor growth for a unit change in actual growth. This is a useful concept but becomes less meaningful if growth rates are close to 0, in which case a small measurement error in the growth rate can cause a large change in the magnitude of the measured poverty elasticity by changing its sign.

on the graph combines information from two graphs in the Besley et al. paper: the graph showing the relationship between the variable (e.g. literacy) and growth across Indian states; and the graph showing the relationship between the variable and poverty elasticity across Indian states. Thus the point “Literacy” on the graph below represents a strong positive relationship between literacy and growth, and a strong positive relationship between literacy and poverty elasticity. Land reform by contrast is associated with positive poverty elasticity, but negatively with growth. The provision of literacy, electricity and agricultural credit increase both the growth rate and the poverty elasticity of growth. Increased labor regulation reduces both the growth rate and weakens the relationship between growth and pro-poor growth.

**Figure 2. The effect of policies on growth and poverty elasticity in India (Besley et al.)**



#### 4.2. Agricultural and Natural Resource Policy

The Indonesian case study mentions that the majority of Indonesia’s poor live in rural areas, and agricultural policies of infrastructure provision, and price support were important for the welfare of the poor. In fact, it appears that many of the “price support” policies have not been as good for the poor as they might have been. A recent study (Sadler and Akhmadi) has found that corruption and political capture in the formulation of regulations and monopolies in agriculture, and inefficiency in the purchase and marketing of agricultural products, may have led to significantly lower farm gate prices for producers with no benefit for consumers. Subsequent deregulation of the process of agricultural marketing in the late 1990s led to an average 6.7% reduction in the profit margins of intermediaries, and an average increase in the buying price of 9%. This

represents an increase in pro-poor growth of the poor farmers by more than 9% (revenues rise by 9% and this implies profits [incomes] rise by more than 9%).

Indonesia's agricultural policy also had some important successes. The rice policy stabilized the price of rice for both consumers and producers, which may have had a significant impact on poverty reduction. However over time inefficiency in the management of BULOG, the rice marketing agency, may have created a wider wedge between the purchase and selling price of rice, which in turn may have reduced the rate of pro-poor growth in the 1990's.

Indonesia also managed increases in the prices of other commodities like oil in ways that supported rather than undermined agriculture. In times of increased oil revenues, Indonesia invested in rural infrastructure such as roads and irrigation, and increased farmers' access to markets. In contrast to Indonesia, increases in the price of copper in Zambia were not allocated to improvements in rural infrastructure or education. In fact proximity to infrastructure is an important determinant of farm production in Zambia (Kahkonen and Leathers), which underscores the importance of the foregone rural infrastructure investments.

At least some of this difference in policies seems attributable to differences in the capacity to manage economic policy. Indonesia had a cadre of capable economists, known as "the Berkeley mafia" who generally got things right, and when they got things wrong had the savvy to fix the problem (Timmer et al. Indonesia case study). Zambia's economic policy on the other hand seems chaotic, with several disorganized policy reversals over the same thirty-five-year period. Zambia lacked both a cadre of influential and capable economists, and had a government more beholden to specific interests in the copper belt. Both capacity, and political economy problems seem to have contributed to Zambia's chaotic policy regimes and the significant decline(!) in living standards over the thirty five year period from 1965 to 2000 (Zambia case study, Bigsten and Kayizzi-Mugerwa). Nor are Indonesia and Zambia isolated incidents, Rodrik (1999) shows that one the important benefits of good institutions is the ability to manage crises caused by terms of trade shifts or other external shocks.

#### *4.3. Financial Sector Policy*

The experience of the Indonesian financial crisis shows how poor institutional quality can affect the rate of pro-poor growth and the incomes of the poor. Over time Indonesia went into "economic overhang" with the economy and especially financial sector expanding faster than its institutional quality could support. This led to the financial crisis in 1997 (Hoffman et al. 2004). The crisis itself was at least partly rooted in poor institutions: both fiduciary standards and corporate governance were weak, and the government had adopted policies of financial liberalization when the quality of supporting institutions did not warrant it (Hoffman et al., Lanyi and Lee 2003). The crisis led to the closure of a large number of firms that went bankrupt. This led to a large number of poor Indonesians losing their jobs and becoming poorer. The poor suffered badly in the crisis and the incidence of poverty more than doubled from 11.3% in 1996 to 24.2% in 1998.

Across countries, financial development is an important determinant of economic growth, and financial development in turn is driven by the quality of institutions. Both the general quality of institutions, and institutions specific to financial development, like laws that insist secured lenders are paid first, are important for financial development (Azfar and Matheson 2003). The Indian case study shows that access to finance had a significant impact on poverty reduction in rural India (India case study, Burgess and Pande 2004). Indeed, the impact on access to finance on development appears to be very strong: the regression coefficients of the Burgess and Pande (2004) study imply that half the variance in rural poverty reduction across Indian states can be explained by access to finance. Taken together with evidence that the landless have equal access to rural finance as land owners, the Burgess and Pande results suggest that access to finance has an important effect on poverty reduction in rural India.

The experience with micro finance in developing countries also suggests that finance is an important determinant of poverty reduction. In this case the main institutional innovations are in the private and non-profit sector, where group lending and other institutional innovations have improved the efficiency of small scale finance. Bangladesh and Bolivia both have large micro-finance sectors that may have had a large impact on poverty reduction. Pitt and Khandker (1998) find using a quasi experimental approach that microfinance loans of 100 taka increase incomes of female borrowers by 18 Taka and that of male borrowers by 11 taka. Hulme and Mosley find that a BancoSol program in Bolivia led to income growth for borrowers. Weiss and Montgomery (2004) survey a number of statistical studies, the majority—but not all—of which find that microfinance does improve the incomes of the poor. Some of these financial institutions like Bancosol in Bolivia and BRI in Indonesia may even have begun to cover both borrowing and administrative costs and have achieved financial sustainability (Robinson 2001).

Governments can provide appropriate prudential regulation, and credit bureaus for better functioning of microfinance institutions. For instance, insisting on the same prudential regulations as financial institutions that take deposits for microfinance institutions that only lend, may be counterproductive. More details on guidelines for what governments and donors can do to support microfinance are given in a CGAP (Consultative Group to Assist the Poorest) document [http://www.cgap.org/docs/Guideline\\_RegSup.pdf](http://www.cgap.org/docs/Guideline_RegSup.pdf).

In many parts of Bolivia the contraction of the formal banking sector has reportedly made credit inaccessible to all but the largest producers (Bolivia case study). Klasen et al. ascribe the reduction in non-MFI finance to the spread of micro-finance, but the spread of micro-finance is unlikely to have had a negative impact on total access to finance (A positive supply shift [increased microfinance] may reduce the quantity supplied by others [formal finance] but is unlikely to decrease equilibrium market quantities [microfinance+formal finance]). A more likely culprit is Bolivia's poor institutions. Institutional quality is particularly bad in Bolivia for institutions that support financial transactions: Djankov et al. (2001b) report that it takes 464 days (!) to resolve a simple dispute involving a bounced check in Bolivia. The case study's report on difficulty in access to finance for the poor in Bolivia, a relatively small country with a large and well-run microfinance program, is telling. While microfinance can provide targeted relief to

many—perhaps even Millions of—poor households, sustainable improvements in financial access to the Billions of poor people in the world must come from reforming the institutions that underpin financial transactions.

These institutions are very weak in many poor countries. The “routine” matter of collecting on a bounced check can take many months in several case study countries (Djankov et al. 2001b report it takes 225 days in Romania, 188 in Zambia, 180 in Brazil, 106 in India, 99 in Uganda and 90 in Ghana. By contrast it takes only 7 days in Tunisia.). The quality of judicial systems in Indian states also appear to be an important determinant of growth in India. Besley and Burgess (2004) report that the length of judicial delays has an impact on both urban and rural growth across Indian states (footnote 24).

In fact problems with corruption and the rule of law are important constraints that businesses face in Bolivia (Bolivia case study pg. 41) and many other countries (BEEPS, WB Anti-corruption in transition 2000). More generally variations in institutional quality have a large effect on productivity, with productivity being 44% lower in the worse governed Indian states (Dollar et al.).

#### *4.4. Regulatory policies*

Besides access to finance, entrepreneurs also need institutional environments where they are not prevented from doing business by excessive regulation. Djankov et al. (2001a) have documented the incredible amount of interference that entrepreneurs suffer from across the world. They find that starting a small business, with no serious environmental or other concerns, can take 128 days in Indonesia, 112 in Vietnam, 97 in Romania, 88 in Bolivia and 77 in India (Table 1 has data on more case study countries). This can have serious effects on both the extent and the formalization of economic activity (Figure 1.9 Doing Business in 2004 shows a significant relationship between informal activity and regulation controlling for income per capita). The combination of administrative difficulties in entering the formal sector and ineffective law enforcement services like helping a creditor collect on a bounced check, lead to many firms in developing countries remaining in the informal sector, and many entrepreneurs from not starting businesses at all. The costs of informality can be especially significant for the poor: informality reduces the tax base with the consequence that the government cannot fund education and infrastructure; or it creates deficits that lead to inflation, which affects the incomes of the poor; or it leads the government to raise taxes to distortionary levels on imports and exports, which are relatively easy to tax. In other words, the financial consequences for the government of increased informality can affect three important determinants of the growth of the poor: education, inflation and trade openness (Table 1). Informality also indicates that the poor, whose microenterprises remain in the informal sector, cannot use the benefits of contract enforcement.

The India case study reports that some Indian states adopted “pro-worker” regulations that turned out to be anti-worker, as they adversely affected employment opportunities and kept firms informal (Besley et al. 2004, Figure 2). The implied impact of these employment laws is large, leading to a significant reduction in the incomes of the urban

poor. A one-point change in the labor regulation score is associated with a 2 point increase in the urban poverty headcount. Thus a change from the worst scoring state to the best scoring state (-2 to 4) can lead to a 12-percentage point change in the urban poverty headcount.

#### *4.5. Education*

A number of the case studies show that education is one of the most important correlates of poverty. For instance, moving from the first education category to the second in Brazil reduces the likelihood of being poor from 70% to 30%, and to almost 0 in the top educational category (Brazil case study, Menezes Filho and Vasconcellos 2004). In Uganda a household where the household head has completed secondary education is likely to have living standards that are 250% higher than a household where the head has no education (Okidi et al.). In Bolivia the poverty gap for a household in which the head has less than 5 years of education is 60 but the poverty gap is only 10 for households where the head has more than 13 years of education. On average, the rate of return to education is between 6 and 10% in developing countries (Besley and Burgess 2004).

There is some concern that these measured rates of return may reflect differences in ability, but recent evidence from natural experiments (Angrist and Krueger, 1991, for example), suggests that estimates of returns to education that do not control for ability are not upward biased. Furthermore, Krueger and Lindahl (2001) find that the IV estimation in these cases produces estimated returns that are greater than or not significantly different from OLS estimates. Hence it seems reasonable to interpret the measured rates of returns to schooling as unbiased estimates of the true rates of return.

The relationship between education and poverty reduction is also apparent at the aggregate level. We saw in the previous section that secondary schooling was associated with faster growth of the poorest quintile. In the India case study, Besley et al. show that Indian states that had better education outcomes had faster pro-poor growth both because growth rates are faster and because the poverty elasticity is higher. In Brazil too, Menezes Filho and Vasconcellos find that the poverty elasticity of growth is higher in states with higher levels of human capital.

The Ugandan experience shows how capacity constraints can reduce the effectiveness of reform programs, and how capacity constraints themselves may be the consequences of poor institutions like the lack of rules on accounting standards, or the lack of enforcement of rules on accounting standards. In Uganda, the abolition of school fees under the Universal Primary Education program dramatically increased educational enrolments. While this has probably had net positive results on pro-poor growth, it also had the unfortunate consequence of creating a reduction in the quality of education as fewer resources had to be spread over more students. One of the causes of the small resource student ratio was the extensive leakage in educational funds documented by Reinikka and Svensson (2002a). The rates of leakage are high: for three case study countries we found

leakage rates of 49% (Ghana), 76% (Zambia) and 78% (Uganda).<sup>7</sup> Leakage rates of this magnitude are likely to undermine the delivery of education. Subsequent reforms using Public Expenditure Tracking Surveys (PETS) may have reduced this leakage. We will return to this experience later in the paper.

Capacity constraints also appear to be important for the provision of education in the Indian state of Uttar Pradesh. The India case study states that “...poor public services are rooted in the state’s low commitment to development and social equity, and the failure of its civil society to promote social needs.” (P 19) and that “...endemic teacher absenteeism and shirking is linked to poor schooling outcomes” (p 28). In contrast, in Kerala there is less absenteeism and shirking among teachers, and indeed there is a cadre of volunteers—generally retired civil servants—who advise and help local governments implement programs (Shubham Chaudhary 2003).

Several studies—notably Gupta et al.—have shown negative effects of corruption on education outcomes in cross-sectional analyses. Additionally, Mauro (1998) and Knack and Sanyal (2000) have shown that corruption reduces the share of public expenditures on education. These results can be interpreted as the impact of a governance variable on the dependent variable. Corruption and government effectiveness are too highly correlated to be able to disentangle the effects of one from the other (The correlation coefficient between the World Bank’s measure of government effectiveness and control of corruption is 0.95!). Perhaps the best way to view the existing evidence is that it establishes the importance of good governance as a whole, one aspect of which is reducing the level of corruption.

Gupta et al. conduct a multivariate analysis of dropout rates, controlling for average female education among adults, public education spending, the dependency ratio and urbanization. They use the ICRG score as the governance variable. They find a persistently significant effect of corruption on dropout rates with a coefficient of 0.13. This implies that a two-point improvement in the integrity of government would reduce dropout rates by around 22%. Gupta et al. also test for causality in the relationship and present instrumental variable estimates of the effect of corruption on education outcomes, which also show that corruption undermines education delivery. Cross country evidence cannot yet distinguish between the effects of governance on the education outcomes of the rich and the poor, as data on “educational outcomes of the poor” is not widely available. Azfar and Gurgur (2004a), are able to distinguish between the rich and poor and show that corruption adversely affects the poor’s access to health and education services in the Philippines.

The Bolivia case study mentions the problems caused by low quality of education and lower test scores for Bolivian students than other Latin American countries (Klasen et al. p24). We were also able to examine the relationship between math and science scores and institutional quality, using the World Bank’s measure of “Government effectiveness”

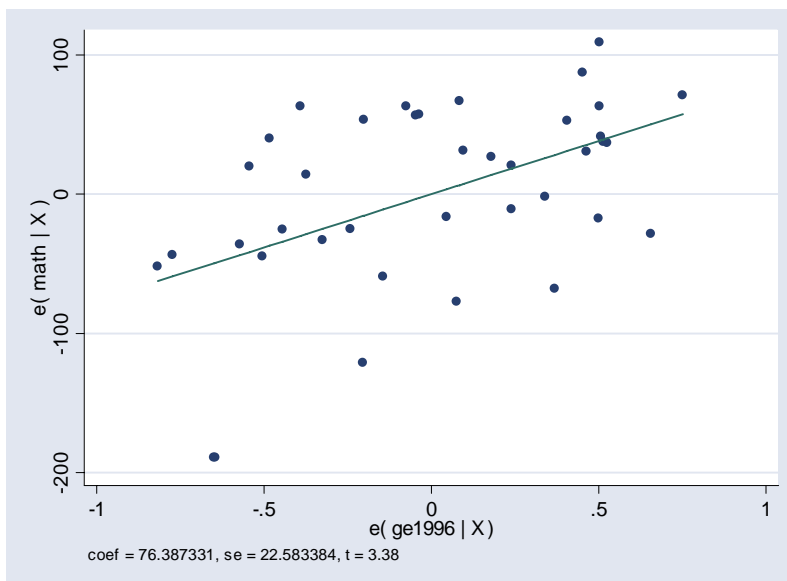
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<sup>7</sup> Summarized from Reinikka and Svensson 2002a (Original sources Reinikka and Svensson 2002b, Price-Waterhouse Coopers 1999 and Ye and Canagarajah 2001)

as institutional quality. We found a strong relationship between institutional quality and math and science scores, and it remains significant after controlling for secondary school enrolments, income and education expenditure (Figure 3).

Some reports indicate that development programs can improve educational outcomes of the poor. Poorer households in Vietnam are less likely to send their children to school, a dynamic which can lead to the persistence of poverty levels. The reasons for not sending children to school are at least partially financial. Schools demand fees and even if they did not, many households cannot afford to forego the wages the children can earn. This is especially true for secondary education. Decentralized poverty targeting programs like program 135 have been shown to be at least partially successful in improving school enrolments. The program is supposed to involve communities in planning and implementation, and in some provinces actually does so. A majority of funds (55%) are in fact targeted to the poor, and appear to have a significant impact on school enrolment (OPPG Vietnam). Expanding programs like Program 135 using inter-regional transfer, if combined with proper oversight, may have a significant impact on reducing the persistence of intergenerational poverty in Vietnam.

**Figure 3**  
**Partial plot of Math Scores and Government Effectiveness in 1996.<sup>8</sup>**  
**Regression controls for income, secondary enrolment and education expenditures.**



#### 4.6. Infrastructure

The Uganda case study also mentions the growing importance of electricity supply as education levels rise and electricity supply becomes the binding constraint for many firms. Keefer (2000) reports that poor institutions may have prevented the development

<sup>8</sup> Math Score data from Third International Math and Science Study, Gonzales et al. (2004).

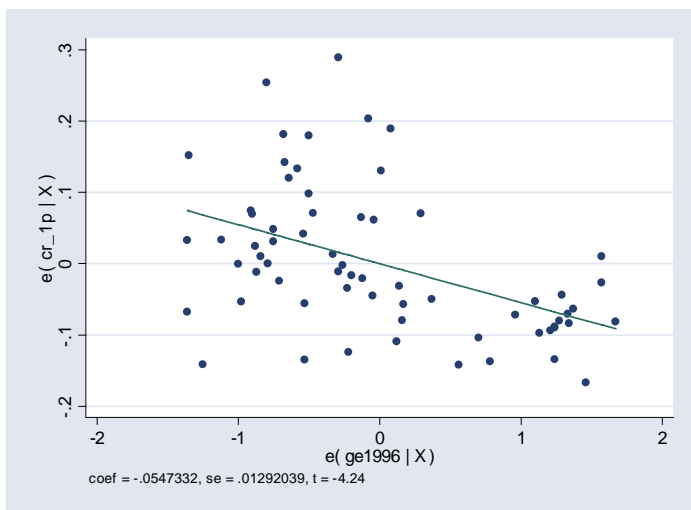
of a better power infrastructure in Uganda. Cross-country evidence also shows a strong correlation between institutional quality and infrastructure (correlation for electricity supply =0.68, P-value=0.00 and for telephone faults=.33, P-value=0.00).

#### 4.7. Crime.

The direct effects of crimes, such as robbery, on the poor, can be disastrous. If a poor farmer were to lose the revenue from the sale of a crop, his family could fall into destitution. This insecurity also affects the ability of the poor to undertake economic activities other than subsistence. Crime also affects the poor in other ways: for example, some local governments in Indonesia tolerate the presence of “Organized thugs” who demand protection fees from trucks which raises transport costs and probably lowers farm gate prices for poor farmers.

Institutional quality also affects the personal safety of the poor and their access to justice. Figure 4 shows the cross country variation in crimes that affect the poorest third of the population in various countries (The crime data is from the International Crime Victimization Survey which has data on theft, burglary and robbery. The survey asks respondents to self-identify themselves in the poorest, middle and richest tercile). In many, but not all, poorly governed countries crime rates are very high. The impact of poor governance on crime rates is sizeable, with a one standard deviation change on governance leading to an increase in the likelihood of victimization of the poor by 5% over a five-year period (See Azfar and Gurgur 2004b for a detailed analysis of the relationship between crime and government effectiveness).

**Figure 4.**  
**Government effectiveness and crime victimization rates of the poor**



The ICVS also asks respondents other questions that allow us to examine whether ineffective governance is in fact the cause of higher crime rates. Respondents are asked about whether they reported crimes. The crime reporting rate is much lower in poorly governed countries. Respondents are also asked why they did not report crimes. Poor

respondents in misgoverned countries often report that “they did not believe the police could or would do anything”, or that they “feared or disliked the police”. These results on crime reporting suggest that poor governance is at least partly responsible for the higher crime rates the poor suffer from in countries with low institutional quality.

Corruption in law enforcement is also a problem in other developing countries and can directly affect the poor: 28% of poor Ugandans and 21% of poor Indonesians reported paying a bribe to a law enforcement officer in the last year. In all likelihood these reports seriously underestimate the actual prevalence of corruption in these countries as respondents may be reticent in answering such sensitive questions.

#### *4.8 Redistribution*

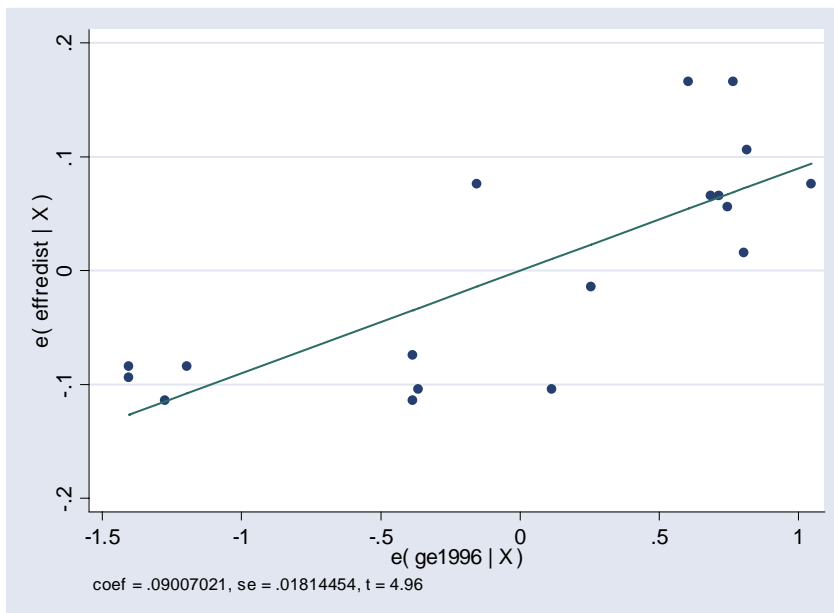
The Indonesia case study reports that Indonesian transfer programs are inefficient. In IRIS work in Indonesia we found that one transfer program that was supposed to provide loans to poor farmers was providing loans to people who were neither poor nor farmers (Azfar 2001). There was no clear evidence on whether the nature of institutional failure was deliberate (fraud and corruption) or incidental (ineffectiveness and neglect). In either case, poor institutional quality led to weakness in this transfer program. This case was actually successfully prosecuted as neglect and mismanagement at least could be proved and the protagonists were convicted on a civil charge of mismanagement. In another more prominent case \$4.5 million which were meant to feed the poor were allegedly misappropriated for the Golkar party (Suharto’s party) in February 1999 (Center for Public Integrity 2004).

There are also reports about other case study countries that indicate ineffectiveness in redistribution. In Burkina Faso, the analysis of benefit incidence suggests that public funds are more likely to benefit the rich than the poor (Burkina Faso case study). In El Salvador the post tax Gini is higher than the pre-tax Gini, indicating that transfer policies are ineffective.

#### **Figure 5.**

**Transfer policies are much more effective in countries with better institutions.**

**Simple plot: Government effectiveness and Effectiveness of redistribution (difference between pre tax and transfer and post tax and transfer Gini). Univariate regression.**



There is in fact a clear statistical relationship between institutional quality and the efficiency of transfer policies across countries. We compiled data on the differences between “pre-tax and transfer” and “post-tax and transfer” Gini coefficients.<sup>9</sup> The reduction in Gini by tax and transfer policies can be interpreted as a measure of the inefficiency of redistribution.

We found that the World Bank’s measure of government effectiveness (KKM 2003) is strongly correlated with the effectiveness of transfer policies. In fact the regression on which Figure 2 is based shows that almost all the countries below the global average on the governance rankings are **completely ineffective** at redistributing to the poor. Well-governed countries, on the other hand, apparently manage to reduce inequality by significant amounts. The average reduction is around 0.15 Gini points which from an average base of around 0.4 represents a reduction in inequality of more than 1/3! The ineffectiveness of transfer policies in poorly governed countries may be one mechanism by which poor institutions affect the living standards of the poor.

Some cynicism about whether the governments in the poorly governed countries even want to redistribute is probably appropriate. Acemoglu et al. (2001) argue that that modern-day governance is a consequence of the creation of extractive institutions in colonial times. If this is correct, then it strongly suggests that the reason for enduringly bad governance in many developing countries is elite capture. If elite capture had disappeared since colonial times, it seems likely that modern-day governments would fix the problem of bureaucratic inefficiency and petty corruption (We know they can: see Klitgaard, Maclean-Abarrora and Parris (2000) for a discussion of reforming the municipal government of La Paz, Bolivia). It is likely that many poorly governed

<sup>9</sup> Personal correspondence with Louise Cord.

countries are deliberately governed in ways that impoverish the poor —and possibly also many of the rich— for the benefits of some of the rich. Indeed most people in developing believe that their governments are run for the benefits of a few big interests: According to a recent set of results from the World Values Survey and the Knack-Gallup data set on elite capture, 93% of Bolivians, 75% of Brazilians, 74% of Salvadorians, 89% of Romanians, 66% of Indians and 60% of Indonesians say they believe that their governments are run for the benefits of a few big interests.<sup>10</sup>

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<sup>10</sup> Personal correspondence wit Steve Knack.

## **Section 5. Decentralization.**

### *5.1 The impact of decentralization on pro-poor outcomes*

In recent years there has been a significant decentralization of political, fiscal and administrative authority in many developing countries, and in many of the 14 case study countries we are studying. While many of the movements have been internally driven by political and economic imperative, the process has also in part been driven by donors frustrated by working with central governments. The hope appears to be that decentralization can somehow compensate for weak institutions. This section makes the point that expectations of the effects of decentralization need to be more nuanced: it can improve institutional quality and other outcomes, but is more likely to lead to improvements if certain preconditions exist. Furthermore, there are some concerns specifically about the “pro-poorness of decentralization”: in certain conditions decentralization might lead to average improvements but deteriorations in the welfare of the poorer regions, as may have been the case in Vietnam (Vietnam case study).

The extent of decentralization has at least three important dimensions: political, fiscal and administrative (Schneider 2001). Political decentralization refers to the extent to which the governors of the regions are accountable to local populations as opposed to the central government. The most important distinction here is between systems where the local government is elected or appointed. Fiscal decentralization refers to the extent to which the local government has revenue and expenditure authority. Administrative decentralization refers to the extent to which the local government can make administrative decisions like choosing the staff on its payrolls.

Whether decentralization has led to improvements in pro-poor growth is an extremely important but also extremely difficult question. There are several problems with addressing this question in scientifically satisfactory manner. Two of these are the following.

First, the question is not precise enough. Decentralization takes many forms—at the simplest level it can be it can be administrative, fiscal or political, but, of course, there are important variations within each of these three categories—and the impact of different kinds of decentralization can be very different.<sup>11</sup> Second, different kinds of decentralization may work in different ways in countries with different geographies, different political systems, different levels of development, and different social structures.

Hence the question must be posed as “Did the kind of decentralization implemented in country X lead to improvements in pro-poor growth?” This leads us to the second set of problems: that of scientific inference. Decentralization is often implemented as a part of

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<sup>11</sup> In fact different researchers using different variables find different results: for instance, Fisman and Gatti (2000) use a measure of fiscal decentralization and show that decentralization is associated with better governance; Treisman (2000) uses a measure of constitutional federalism and shows that decentralization is associated with worse governance.

a package of reforms, and because there are some inevitable coordination problems in administrative changes of this complexity, there are good theoretical reasons to believe that the immediate impact is different from the medium-term impact. A scientific answer to the question would need to address a situation where a reform (decentralization) is implemented as a part of a package of other reforms, and there is a likely but unknown lag structure to outcomes. Disentangling the effects of decentralization from the effect of other reforms, and other internal and external shocks is a formidable econometric task.

While, to the best of our knowledge, no scientifically rigorous studies are available, a number of authors have provided their evaluations of how well decentralization has worked in the various case study countries. Often these evaluations are provided with the appropriate caveats that they are not the result of scientific studies. For some of the countries reports are mixed: some studies report that there may have been improvements, but other studies report that decentralization may have undermined pro-poor outcomes. In other countries the reports are generally negative.

In some cases decentralization may not have been implemented as planned. In Ghana, Areyeety and McKay (OPPG) report that while the actual transfer formula seems sensible, the actual transfers did not appear to match the transfer formulas. Killick (2004) reports that “the expenditure side of the budgetary process is so weak as to be essentially ritualistic, with limited bearing upon reality”.

In other cases, decentralization gets generally negative reports, perhaps because the complementary institutions are weak. In Bangladesh, Crook and Manor (1998) report that decentralization increased corruption and inefficiency in public works spending. In Romania, Topinska et al. (OPPG) report that decentralization may have created new inequalities. In Uganda, Azfar et al. (2001) find that the presumptive reasons that make decentralization improve outcomes are missing. Local officials have only imperfect knowledge of citizen’s preferences; people don’t vote more often in local elections, or for reasons more closely related to pro-poor outcomes; and people rely disproportionately often on local leaders—rather than formal channels—for news on local matters, and appear to be getting less information on sensitive matters through these informal channels. An ODI study of Uganda (Piron and Norton 2004) reports that the decentralization was conducted without adequate capacity building; that interregional grants are not an effective tool for tackling regional disparities seriously; that there is not sufficient fiscal flexibility for the decentralization to be real; and that the local electoral system is not working well with vote buying and patronage being common. The evidence on the allocation of local source revenue—for which there is sufficient fiscal flexibility—is mixed with some of these funds being properly invested but other funds being wasted.

For several case study countries reports are mixed: decentralization is credited with some successes in some areas, but there appear to be problems in others. In Bolivia, Klasen (OPPG) reports that decentralization may have been counterproductive but Faguet (2005) is more optimistic, at least with respect to some municipalities. In Burkina Faso, Grimm and Gunther (OPPG) report that decentralization may have been more harmful than

beneficial, but Ye et al. (1999) report that in some areas with “high quality local institutions” the expectations may be more optimistic. Crook and Manor report that decentralization improved government performance in Karnataka but not Tamil Nadu. In Karnataka the media, political system and effective voluntary organizations led to the improvement. In contrast in Tamil Nadu caste divisions and other social problems, when combined with decentralization, reportedly led to problems. In Vietnam, van der Walle (2004) reports that decentralization was done to the wrong level (i.e., provinces) and the administrative, fiscal and political dimensions were not well coordinated. Reports suggest that decentralization may have led to a worsening of inequality as poorer regions had more serious resource constraints. Again, there are reports of a successful experience in places where participation and local capacity building are encouraged. For instance, Bonshcab and Klump (OPPG) report that the UNCDFP introduced a system of participatory planning in Son La province which may have reduced the cost of development projects like building rural roads. In Indonesia, Alm et al (2001) report that decentralization was carried out without adequate capacity building, and Azfar (2002) reports that there were serious problems with the political system introduced after decentralization. Consequently local corruption may have increased after decentralization (Timmer et al. OPPG). However, there are reports of improvements associated with the Kecamatan Development Program, which introduced local control over World Bank provided funds (Olken 2004). There are also reports of decentralization leading to some successes in some localities in other countries like Porto Alegre and Belo Horizonte in Brazil, Kerala in India.

One thread that seems common among the successful experiences is that decentralization is combined with participatory decision making and capacity building (see section 5.4 for more discussion on participatory budgeting). There is some evidence on whether participation or capacity building lead to improvements in pro-poor outcomes. Chaudhary, Heller and Harllal (2005) for instance find that the vast majority of informed respondents believe that the participatory system introduced with the Panchayati Raj in Kerala improved allocations of funds to more pro-poor expenditures.

The question of whether participation, oversight, capacity building or other complements of decentralization improve outcomes is also amenable to more rigorous scientific inquiry. While analyzing the impact of decentralization on outcomes is difficult, decentralization creates the opportunity to conduct scientific analyses. Systems to improve participation like participatory budgeting, auditing or improvements in physical and human capacity of municipalities can be introduced in randomized or quasi-randomized ways across sub-national units. The impact of institutions complementary to decentralization can then be evaluated by comparing the control and treatment groups.

One example of such a study is a recent study on Indonesia by Olken (2004), which finds that improved auditing systems reduced corruption, and improved participation reduced corruption in wage flows, but may have increased corruption in the purchase of materials (perhaps because those determined to steal government funds chose to steal funds that community members cared less about). The results with respect to audits are important, and suggest that higher levels of government have an important oversight role to play in

decentralized systems. It is important to note that the “performance variable” in this study, financial leakage, is not the performance variable most likely to be positively affected by participation (Rose-Ackerman 2004). Participation is more likely to lead to a prioritization of pro-poor needs, but less likely to reduce leakage because the details of the finances may not be understood by community members. Also, because many of the employees were local citizens, citizens may care about the leakage of wage payments than the leakage of non-wage funds. In terms of whether participation led to improved pro-poor outcomes, the likely answer appears to be yes: The theft of wages fell, and wages are likely to have been paid to the poor; hence, the likely immediate impact of participation on pro-poor outcomes is likely to have been positive.

More generally, if packages of reforms complementary to decentralization were implemented in a randomized way and combined with careful collection of data on pro-poor outcomes before and after the reforms, such experiments could answer questions about whether participation and capacity building improve outcomes. Across the developing world, billions of dollars are being transferred from central to local governments. An improved understanding of the complementary institutions that improve the effectiveness of such transfers, would provide valuable advice to policy makers around the developing world.

### *5.2 When would decentralization work? How can we make it work better? And, how can it be made pro-poor?.*

The aim of this subsection is to list the various arguments for why decentralization may improve service delivery, and discuss the complementary institutions that have to be in place for these arguments to hold.

*Expenditures need to match preferences.* One important argument in favor of decentralization is that local governments are better able to match services to the population’s preferences. However, public officials are often not closely aware of the preferences of local populations. The extent of this knowledge can be evaluated by collecting data on preferences and public official’s knowledge of preferences. This was done in the IRIS study on devolution in the Philippines and Uganda, Azfar et al. 2001, which found evidence of only weak matching between citizens’ preferences and public official’s knowledge of citizens’ preferences, and even weaker evidence of a match between citizens’ preferences and allocation of public resources to preferred expenditures. Surveys can also be used to improve public officials’ knowledge of preferences, but other more interactive methods like participatory budgeting—discussed in section 5.4—may be more effective. One evaluation, by Chaudhary, Heller and Harllal (2005) suggests that participation did improve responsiveness to the needs of the poor in Kerala, India.

*Experimental federalism.* Another argument for decentralization is that local governments can learn from successful policy experiments in other jurisdictions. But for this process to work well, there needs to be an infrastructure to conduct evaluations on the impact of policy, and the capacity to disseminate these lessons. This capacity is often

lacking in developing countries, but this is an issue that international assistance can address. For instance, an IRIS project in Romania, created mechanisms for communicating information on the success of local deregulation programs, and participatory decision making to other localities and the central government. As a consequence these reforms spread across other localities. Eventually even the central government was inspired by these reforms and adopted reforms related to both deregulation and participatory decision making at the national level.

*Competition between jurisdictions.* Another argument often made in favor of decentralization is that it encourages competitions between jurisdictions as different municipalities compete for firms and residents. This process works best when people and firms are mobile, and are aware of the quality of government in other municipalities. Both mobility and knowledge are often lacking. One helpful complementary reform would be to disseminate information about the quality of government in different localities. This is already done by the private media in some developing countries like India where India Today publishes a ranking of states. Another complementary reform would be to make it easier for firms and households to move to other jurisdictions by reforming laws related to selling and renting property.

*Better political disciplines.* Local governments would work best if there was greater political participation at the local level. The level of existing political accountability may help determine the optimal extent of decentralization, and improving the extent of accountability in local government may improve the effectiveness of local governments. An obvious way to increase accountability is to have elections, and perhaps even to have separate elections for the executive and the legislature. IRIS research in Indonesia has found that most people thought the system of indirect elections was corrupt, and that the quality and honesty of local government would improve if a system of direct elections was introduced (Azfar 2001). In fact a system of direct elections is now being introduced. Another way to improve accountability is to involve people more directly in decision making by participatory budgeting, participatory oversight, report cards and the like. Some case study countries like Bolivia also have oversight committees consisting of members of civil society, which can block financial flows to local governments.

*Capacity constraints.* Local governments often have less capacity than central government to provide services. This can also translate into lower accountability as the mechanisms of accountability themselves require adequate capacity (Campos and Hellman 2004). Committed leaders can help overcome these capacity constraints. In Kerala the provincial government was able to mobilize support of a large number of educated people to help the process of decentralization. This capacity building was an important part of the successful decentralization experience in Kerala (Chaudhary, Heller and Harllal 2005).

*Pro-poor decentralization.* In many instances while decentralization can be efficiency improving, it may still not be “pro-poor”. The reason is that the richer localities may do better in certain decentralized arrangements. For instance, revenue decentralization is thought to be a critical part of decentralization by some scholars, because it provides

local government with “the fiscal incentive to provide better governance”. According to some scholars this is the main reason that localities compete for people and firms to move to their region. However, revenue decentralization also accentuates differences in publicly provided resources and may lead to worse provision of health and education in the poorer localities.

A measure of pro-poor decentralization would probably focus on expenditure decentralization combined with means of improving the accountability of service providers to the poor. Revenue decentralization by contrast would probably not be regarded as pro-poor. Pro-poor decentralization would probably also include mechanisms to increase the voices of the poor in policy making by participatory budgeting etc. The notion of “pro-poor decentralization” is new, and a lot more thought has to be given to it before the details are worked out.

We now turn to the examination of a couple of reforms that improved institutional quality at the local level in some case study countries in ways that benefited the poor. Both improved expenditure tracking and increased community participation in decision making appear to have improved the willingness or ability to deliver education services. In addition some programs appear to have improved the delivery of rural infrastructure.

### *5.3 Public Expenditure Tracking Surveys (PETS)*

A recent effort being undertaken by the World Bank is on public expenditure tracking surveys (PETS). These were pioneered by Ritva Reinikka and Jakob Svensson in Uganda and are now being implemented in several countries. Public Expenditure Tracking Surveys track public expenditures down the chain from the central government, to the provincial government, to the district government, to the subdistrict governments all the way to delivery points (i.e., schools and clinics—though there is no fundamental reason why the surveys should be restricted to health and education services). If one level of government reports distributing more funds than the level below receives, it may be possible to pinpoint the leakage (by theft or diversion) of public funds.

Reinikka and Svensson found that 87% of non-wage expenditures allocated to education in Uganda were leaked in the transfer from districts to schools over the period 1991-1995 (though the leakage steadily declined over the period). In Ghana 50% of non-wage expenditures in education were similarly lost. While reported leakage was lower in wage expenditures (20% in both Uganda and Ghana), this may simply be an artifact of accounting. Leakage in “wage” expenditures may consist of people getting paid but not working, which would not necessarily show up in a purely expenditure tracking survey. Reinikka and Smith report there are significant absences for both health workers and teachers in Uganda and Zambia. Adding these figures to the observed leakage of around 20% in wage expenditures brings the total leakage closer to that in non-wage expenditures. While we did not have data on absenteeism in Ghana, there are reports of a large number of ghost workers in Ghana (Center for Public Integrity 2004). This may explain why increased spending on education in Ghana has led to only disappointing improvements in performance (Ghana case study)

**Table 3: Results from Public Expenditure Tracking Surveys.  
Percentage leakage of public funds.**

Country	Year	Education Wage	Education non wage	Teacher absence rate
Uganda	1993	20	85	26
Ghana	2000	20	50	
Zambia	2001		76	17

Summarized from Reinikka and Svensson

One interesting question for reformers is whether PETS can reduce the leakage of public funds. As with accounting systems, if the flow of money is better tracked, it may make it more difficult for agents to steal from principals. Nevertheless, in our conversations about public expenditure tracking with Indian civil servants, we have been reminded that accounting systems can be rigged to hide theft from a mechanical PETS type investigation—it just takes some effort to do so. As a rule of thumb, one should expect the agent to be craftier than the principal. In the immediate aftermath of implementing a public expenditure tracking survey, theft may well decline. Business might, however, return to usual if bureaucrats observe that sanctions are not applied when discrepancies are found—or only applied selectively. Over time, it is also likely that corrupt officials will find other ways of siphoning off money, like paying more for procurement and getting kickbacks. Money that was once stolen easily will now be stolen in cleverer and subtler ways.

For a PETS to be effective, it must be followed by a tracking of procurement practices and other dimensions of public administration to cover other avenues for corruption that become more lucrative when expenditure tracking is introduced. Ultimately, it is unclear whether all such avenues can be identified and blocked. The most effective reform of the system may require a measurement of ultimate outcomes—literacy rates and exam scores directly measured by external evaluators, etc. Incentives based on such measures, which are difficult to manipulate, may be more effective at improving service delivery than measures that seek to reduce specific instances of leakage and corruption.

*5.4 Participatory Government: Porto Alegre, Brazil; Kerala, India; and Charangua, Bolivia; and Participatory Bank projects: The Kecamatan Development Program in Indonesia.*

Improving the quality of information flows is most likely to be effective if the poor are empowered to respond to the information and provide clear incentives to public officials to improve their performance. A number of reforms in fact have improved the participation of the poor in policy making, especially at the local level.

In this section we examine three examples of local governments which share common elements: In each case a “New left” party came to power and implemented a program that both elicited information from the poor about their priorities, and was able to mobilize significant human capacity to help in the design and implementations of these policies.

We conclude the section with an example of how the World Bank can introduce participation in its own projects.

Many Brazilian municipalities have implemented a process of participatory budgeting whereby they both consult with the citizenry in making budgetary allocations and are monitored by the citizenry. In Kerala, India, the state government devolved significant responsibilities to local government and required them to use a participatory process of prioritization and design of reforms. In Bolivia, the decentralization law requires the creation of an oversight committee that oversees the performance of the local government and has the power to block the flow of funds if it suspects there are serious improprieties. In all cases there is evidence for improved policy making following the adoption of participatory processes.

In Porto Alegre, Brazil, the Partido de Trabalhadores introduced the process of participatory budgeting. Currently, the process involves the participation of community members in both budget prioritization and in monitoring progress over the year. The process helped in the implementation of politically thorny legislation like the introduction of land taxes and in improving outcomes, including access to clean water and doubling the number of children in primary school (Baiocchi 2003).

Participatory budgeting has also been adopted in a number of other cities, including Belem, Santos, Angra dos Reis, Belo Horizonte, and Campinas and has reportedly led to positive redistributive outcomes and improved government efficiency. In addition, the experience may have led to positive externalities for the central government, as several ex-mayors of Porto Alegre have become ministers in the Central Government, which may improve an appreciation of both the importance and the mechanics of learning about the people's needs at the highest levels of power.

In Kerala, when the Left Democratic Front came to power in 1996, it implemented the "People's Campaign for Decentralized Planning". All local governments in Kerala at the district, block and village level were given new powers, asked to come up with their own development plans, and required to do so using a specific participatory process. All local governments were asked to hold one assembly at the beginning of the budgetary cycle to identify priorities and specify a process by which a detailed plan would be designed, which a second assembly would approve (Chaudhary 2003).

The Keralan government both leveraged existing human capital effectively and invested in a massive accumulation of human capital. The decentralization process used the immense human capacity in the Keralan People's Science Movement, which has over 50,000 members who are generally retired civil servants or teachers. These people served as "key resource people" who facilitated the budget assemblies and in the design of specific programs. In addition, the Keralan government invested in a massive educational campaign for elected representatives, public officials and volunteers, training more than 100,000 people.

Kerala's performance over the period has been impressive. Headcount poverty has fallen by half since the early 1990s, rural per capita expenditure has risen by 20%, and the school attendance rate has risen from an already impressive 85% to 96%. Chaudhary, Heller and Harllal (2005) conducted an evaluation of the program. They surveyed a number of different kinds of informed respondents, members of the ruling coalition, members of the opposition, civil servants and members of civil society groups. They found that the vast majority of these respondents believed that the poor are more likely to be selected into programs, and that a vast majority of each category of respondents (including opposition members) believed that the situation had improved for the poor in terms of housing and support.

Results from India suggest that increasingly the representation of traditionally disadvantages people—women, and members of scheduled castes—affects the allocation of publicly provided goods in ways that benefit these groups (Pande 2002, and Chattopadhyay and Duflo 2001).

Porto Alegre and Kerala are both relatively developed localities in their respective countries, but our third example of successful government comes from a relatively backward locality: Charangua, Bolivia.

When the Asemblea del Pueblo Guarani came to power in Charangua it undertook policies that actively solicited input from the population. This led both to better prioritization and helped the government effectively demand contributions in both labor and materials from the citizens. Chanagua's government as a consequence is well-run, with low operating costs, laudatory audit reports, and the mayor even received top ranking in the Department for being effective and enthusiastic (Faguet 2003).

Even if governments resist introducing participation into governmental decisions, the World Bank can introduce participation in the design of its own projects. The Kecamatan Development Program (KDP) in Indonesia used participation to reduce project costs and improve the prioritization of resources (Woodhouse 2002). The KDP disbursed Bank loans by giving loans to localities and requiring community participation in prioritization and design. The program has reportedly had a large poverty impact, producing roads, bridges and irrigation systems at 30% less cost than usual, and has used labor intensive production methods which directly increased the incomes of millions of poor Indonesians. Olken (2004) has evaluated the impact of participation in this program, and found that participation reduces leakages in wage funds, which the poor may care most about (see section 5.1 for more discussion of this study).

## **Section 6. NGOs, Institutions and Pro-poor growth**

In recent years, Non-Government Organizations, and Civil Society Organizations have become increasingly involved in the process of development: they provide services like micro-finance, health and education; they advocate for greater allocation of resources to the poor; and they seek to increase accountability in government.

NGOs have been involved in providing microfinance services, health services and education services to the poor. There are a number of evaluations that show the effectiveness of many—but not all—of the microfinance programs. Montgomery and Weiss (2004) review a number of microfinance programs, and their review suggests that many programs were successful in terms of increasing the incomes of the borrowers, but also that microfinance may have had some difficulty in reaching the poorest of the poor (see section 4.3 on finance for some more discussion of micro-finance).

In many developing countries there are substantial leakages in government funds allocated to education and health services. These leakages take the form of financial leakages and shirking, and can add up to well above 50% (as discussed in section 5.3 on PETS). The non-profit sector provides a substantial amount of health and education services in many developing countries and may have led to improvements in the delivery of health and education services in some countries. BRAC, for instance, operates over 31,000 schools in Bangladesh. Bobonis, Miguel and Sharma (2003) show the impact of an NGO led child health program on health and educational outcomes in India using randomized techniques. Angrist et al. (2005) show that vouchers for the attendance of non-profit schools significantly improved student performance in Colombia. Kremer (2004) contains a review of some other randomized evaluations of education programs run by the non-profit sector.

Given the rates of leakage and absenteeism in many government provided services, NGOs may be a better conduit for donor funds. But care must be exercised. The management of NGOs can also steal funds, and funds can be lost through mismanagement. NGOs can also have nepotistic hiring practices and absenteeism. An IRIS survey in West Java found that the majority of households though NGOs were corrupt—though less so than the government (Azfar 2002). The same study found that more 15% of the clients of microfinance organizations have to give bribes to get their loans. Donors should exercise substantial oversight and share experiences about the NGOs they work with.

The sheer magnitude of the problem of reaching the poor with financial, health and education services is such that NGOs cannot fully substitute for government provision of services. Another approach civil society organizations can take is to improve pro-poor outcomes by increasing the accountability and responsiveness of governments to the needs of the poor. For instance, as discussed above, civil society organizations have been involved in participatory budgeting, budget oversight, citizen report cards of government services and school management.

There are a number of reports of the success of many of these experiences (Clark 2005, and Narayan 2002). There are also a few scientific studies, which provide mixed but generally positive evidence on the question of whether civil society oversight has led to improvements in pro-poor outcomes (Nabeshima 2003 reviews studies related to education provision, and Olken 2004 examines the impact of participation on leakages in road building).

While NGOs may affect the quality of government by holding it to account, the government can also affect the workings of NGOs. Like any other organization, NGOs are regulated by laws, and poor law enforcement means that citizens and donors who provide funds can have greater difficulty in monitoring them and in ensuring that the NGOs allocate the funds to the tasks they are supposed to. NGOs can also face malicious interventions from governments who seek to close down organizations challenging their authority or making government improprieties publicly known. One policy recommendation that emerges from thinking separately about NGOs that provide services, and NGOs that provide oversight is that government oversight of NGOs devoted to service delivery should be stricter than government oversight of NGOs that seek to discipline government actions.

In broad terms, reports suggest that some but not all NGOs are successful in service delivery, and in improving the quality of government provided services. To the best of our knowledge, the determinants of NGO success in reaching these goals in developing countries have not been carefully studied. Reasonable conjectures of the determinants for success are the presence of committed leaders, sincere donor interest in pro-poor outcomes, adequate resources, and governments that do not undermine the workings of NGOs.

## **Section 7. Lessons learnt and recommendations for the future**

This paper has several messages:

First, institutions have a large impact on the welfare of the poor. There is a huge variation across the World in terms of institutional quality, with poor countries having much worse institutional quality than rich countries. If developing countries had had the institutional quality of developed countries since independence, there would be very few people in the World living on less than a dollar a day. This is readily apparent from both looking at a cross sectional pattern of institutional quality and poverty rates, and from regressions of “Growth of the poor” on institutional quality measures.

Second, there are various mechanisms by which institutions can improve the welfare of the poor. Good institutions lead to the following: lower transaction costs and higher the farm gate prices for poor farmers without raising consumer prices for poor consumers; improved infrastructure; improved educational outcomes; greater ease in business formation, and financial transactions; to lower rates of crimes affecting the poor; and more effective redistribution policies.

Third, the nature of present-day governance is not an accident but rather strongly affected by a country’s colonial legacy, and social structure. Settler mortality strongly predicts the quality of present-day institutions. Other scholars have also found that institutional quality is persistent over the years: Treisman, for instance, argues that it takes 50 years of democracy to make a serious dent in corruption levels. The likely mechanism by which settler mortality affects modern-day government effectiveness is via elite capture of the state. In countries with high settler mortality, colonists created extractive institutions that supported predation. These institutions were inherited by the new elites after independence, who used them to continue preying on the economy. One implication of understanding this structure is that many administrative fixes that improve accountability up an administrative pyramid are likely to be ineffective or worse at making government pro-poor. Rather steps must be taken to empower the poor.

Fourth, in terms of institutional reforms that may improve the welfare of the poor, we focus on reforms that improve information transmission, and accountability to the poor, in the production of education and infrastructure. Public Expenditure Tracking Surveys (PETS) appear to have reduced leakage of educational finances. Community participation in local governments and Bank projects may have led to improved education and infrastructure and sometimes also to increased employment of the poor in producing the infrastructure.

Another important development over the past few years has been the increased attention to measuring outcomes. If the effort to measure poverty rates, and pro-poor growth, is systematized and expanded, then the issue is likely to get more attention and mobilize more resources. There have already been some successes with the “Dollar a day” figures, but if comparable data were available for all countries in the world, poverty rankings may get as much attention as corruption rankings, and “Doing Business” rankings do now.

Finally, while we have found a lot of indicative evidence on the roles of institutions in increasing the growth of the poor, there is a lot of room for improvement. To produce really compelling evidence on what institutional reforms improve the rate of pro-poor growth, we would have to measure the incomes of the poor before the reform, conduct the reform in a randomized way, and measure the incomes of the poor after the reform. The spread of decentralization, and improvements in the technology of measuring the living standards of the poor, have now made this a feasible exercise. If this were operationalized, in a few years we could reconvene with hard scientific evidence on whether institutions affect the rate of pro-poor growth, and perhaps more importantly, exactly which institutions affect the rate of pro-poor growth.

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