

What is Inclusive Growth?*

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The purpose of this note is to define the meaning of the term ‘inclusive’ growth. It is often used interchangeably with a suite of other terms, including ‘broad-based growth’, ‘shared growth’, and ‘pro-poor growth’. The paper clarifies the distinctions between these terms as well as highlights similarities.

The paper argues that inclusive growth analytics has a distinct character focusing on both the pace and pattern of growth. Traditionally, poverty and growth analyses have been done separately. This paper describes the conceptual elements for an analytical strategy aimed to integrate these two strands of analyses, and to identify and prioritize the country-specific constraints to sustained and inclusive growth.

Defining Inclusive Growth

Rapid and sustained poverty reduction requires inclusive growth that allows people to contribute to and benefit from economic growth.¹ Rapid pace of growth is unquestionably necessary for substantial poverty reduction, but for this growth to be sustainable in the long run, it should be *broad-based* across sectors,² and *inclusive* of the large part of the country’s labor force.³ This definition of inclusive growth implies a direct link between the macro and micro determinants of growth. The micro dimension

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¹ This statement is in line with the OECD Development Assistance Committee’s policy statement on pro-poor growth. However, a difference between pro-poor and inclusive growth is that the pro-poor approach is mainly interested in the welfare of the poor while inclusive growth is concerned with opportunities for the majority of the labor force, poor and middle-class alike.

² Imb and Wacziarg (2003) show that countries diversify over most of their development path. Countries start specializing quite late in the development process, and the turnaround point occurs at a robust level of income per capita (around constant 1985 \$10,000). They conclude that increased sectoral specialization applies only to high-income economies. It is important to note that some countries may not broaden their economic base as they develop due to their specific economic conditions (e.g. small states).

³ Encouraging broad-based and inclusive growth does *not* imply a return to government-sponsored industrial policies, but instead puts the emphasis on policies that remove constraints to growth and create a level playing field for investment.

captures the importance of structural transformation for economic diversification and competition, including creative destruction of jobs and firms.

Inclusive growth refers both to the pace and pattern of growth, which are considered interlinked, and therefore in need to be addressed together. The idea that both the pace and pattern of growth are critical for achieving a high, sustainable growth record, as well as poverty reduction, is consistent with the findings in the *Growth Report: Strategies for Sustained Growth and Inclusive Development* (Commission on Growth and Development, 2008). The commission notes that inclusiveness – a concept that encompasses equity, equality of opportunity, and protection in market and employment transitions – is an essential ingredient of any successful growth strategy. Here we emphasize the idea of equality of opportunity in terms of access to markets, resources, and unbiased regulatory environment for businesses and individuals.⁴ The Commission on Growth and Development (2008) considers systematic inequality of opportunity “toxic” as it will derail the growth process through political channels or conflict.

The inclusive growth approach takes a longer term perspective as the focus is on productive employment rather than on direct income redistribution, as a means of increasing incomes for excluded groups. In the short run, governments could use income distribution schemes to attenuate negative impacts on the poor of policies intended to jump start growth, but transfer schemes cannot be an answer in the long run and can be problematic also in the short run.⁵ In poor countries such schemes can impose significant burdens on already stretched budgets, and it is theoretically impossible to reduce poverty through redistribution in countries where average income falls below US\$ 700 per year. According to a recent OECD study, even in developed countries, redistribution schemes cannot be the only response to rising poverty rates in certain segments of the population.⁶

⁴ According to the report of the Commission on Growth and Development, persistent, determined focus on inclusive long-term growth by governments is one of the ingredients of a successful growth strategy. Yet, there is limited analytic work integrating the literature on growth and productive employment.

⁵ The term ‘shared growth’ can be misunderstood as implying a focus on income distribution schemes, which is why inclusive growth is preferred.

⁶ Source: *Growing Unequal? Income Distribution and Poverty in OECD Countries*, OECD (2008).

The inclusive growth definition is in line with the absolute definition of pro-poor growth, but not the relative definition. Under the *absolute* definition, growth is considered to be pro-poor as long as poor people benefit in absolute terms, as reflected in some agreed measure of poverty (Ravallion and Chen, 2003). In contrast, in the *relative* definition, growth is “pro-poor” if and only if the incomes of poor people grow faster than those of the population as a whole, i.e., inequality declines. However, while absolute pro-poor growth can be the result of direct income redistribution schemes, for growth to be inclusive, productivity must be improved and new employment opportunities created. In short, inclusive growth is about raising the pace of growth and enlarging the size of the economy, while leveling the playing field for investment and increasing productive employment opportunities.

By focusing on inequality, the relative definition could lead to sub-optimal outcomes for both poor and non-poor households. For example, a society attempting to achieve pro-poor growth under the relative definition would favor an outcome characterized by average income growth of 2 percent where the income of poor households grew by 3 percent, over an outcome where average growth was 6 percent, but the incomes of poor households grew by only 4 percent. While the distributional pattern of growth favors poor households in the first scenario, both poor and non-poor households are better off in the second scenario. *There is broad recognition that when poverty reduction is the objective, then the absolute definition of pro-poor growth is the most relevant* (DFID, 2004). Using the absolute definition, the aim is to increase the rate of growth to achieve the greatest pace of poverty reduction.

Inclusive growth focuses on ex-ante analysis of sources of, and constraints to sustained, high growth, and not only on one group – the poor. The analysis focuses on ways to raise the pace of growth by utilizing more fully parts of the labor force trapped in low-productivity activities or completely excluded from the growth process. This is in contrast to the pro-poor growth literature, which has traditionally focused on measuring the impact of growth on poverty reduction by tracking various poverty measures.

Box 1 What is Inclusive Growth (IG) About?

IG focuses on **economic growth** which is a necessary and crucial condition for poverty reduction.

IG adopts a long term perspective and is concerned with **sustained growth**.

(a) For growth to be sustained in the long run, it should be **broad-based** across sectors.

Issues of structural transformation for economic diversification therefore take a front stage. Some countries may be an exception and continue to specialize as they develop due to their specific conditions (e.g. small states).

(b) It should also be **inclusive** of the large part of the country's labor force, where inclusiveness refers to equality of opportunity in terms of access to markets, resources and unbiased regulatory environment for businesses and individuals.

IG focuses on **both the pace and pattern of growth**. How growth is generated is critical for accelerating poverty reduction, and any IG strategies must be tailored to country-specific circumstances.

IG focuses on **productive employment** rather than income redistribution. Hence the focus is not only on employment growth but also on productivity growth.

IG has not only the firm, but also **the individual** as the subject of analysis.

IG is in line with the **absolute definition of pro-poor growth**, not the relative one.

IG is **not** defined in terms of specific targets such as employment generation or income distribution. These are potential outcomes, not specific goals.

IG is typically fueled by market-driven sources of growth with the government playing a facilitating role.

Policies for inclusive growth are an important component of most government strategies for sustainable growth. For instance, a country that has grown rapidly over a decade, but has not seen substantial reduction in poverty rates may need to focus specifically on the inclusiveness of its growth strategy, i.e. on the equality of opportunity for individuals and firms.⁷ Other examples can be drawn from resource-rich countries.

⁷ See for example *What Are the Constraints to Inclusive Growth in Zambia?* Report No. 44286-ZM (World Bank, 2008).

Extractive industries usually do not employ much labor and the non-resource sectors typically suffer contractions associated with Dutch disease effects during boom periods. These cases may call for analysis of constraints to broad-based growth with a particular emphasis on the non-resource sectors in the economy.⁸ Moreover, in countries starting at a very low income level and low growth, an inclusive growth approach would be very close to an approach for speeding up the pace of growth, as the main focus should be on getting the fundamentals for growth right.

What does the literature tell us?

A high pace of growth over extended periods of time is a necessary, and often the main contributing factor in reducing poverty as found by a sizable body of literature including Deininger and Squire (1998), Dollar and Kraay (2002), White and Anderson (2001), Ravallion (2001) and Bourguignon (2003). In a frequently cited cross-country study, Kraay (2004) shows that growth in average incomes explains 70 percent of the variation in poverty reduction (as measured by the headcount ratio) in the short run, and as much as 97 percent in the long run. Most of the remainder of the variation in poverty reduction is accounted for by changes in the distribution, with only a negligible share attributed to differences in the growth elasticity of poverty. Lopez and Servén (2004) suggest that for a given inequality level, the poorer the country is, the more important is the growth component in explaining poverty reduction.

Sustained, high growth rates and poverty reduction, however, can be realized only when the sources of growth are expanding, and an increasing share of the labor force is included in the growth process in an efficient way. From a static point of view, growth associated with progressive distributional changes will have a greater impact in reducing poverty than growth which leaves distribution unchanged. Evidence in White and Anderson (2001) suggests that in a significant number of cases (around a quarter)

⁸ See, for example, *Mongolia: Sources of Growth* Report No. 39009-MN (World Bank, 2007).

distribution has been as important as growth in explaining the income growth of the poor.⁹

Some policies may have a positive effect on both growth and inequality. The empirical cross-country literature suggests that growth has neither a positive nor a negative effect on inequality,¹⁰ and that the impact of inequality on growth is ambiguous.¹¹ These results do not imply the absence of links when looking at a specific policy or a specific country. Lopez (2004b) surveys the empirical literature and concludes that macroeconomic stability related to inflation, as well as education and infrastructure-related policies seem to be win-win or ‘super pro-poor’ policies that have both a positive effect on growth and a negative effect on inequality.

Moreover, asset inequality rather than income inequality may matter for growth outcomes. Deininger and Squire (1998) use land distribution as a proxy for asset inequality and show that high asset inequality has a significant negative effect on growth. Controlling for initial asset inequality, Birdsall and Londono (1997) show that income inequality does not seem to play a role in expanding growth outcomes.

The cross-country literature on both growth and pro-poor growth has been criticized for not giving enough guidance to policy makers. Much of the so-called pro-poor growth agenda has been focusing on aggregated income and poverty statistics, measuring to what extent growth was reducing poverty, and analyzing whether and why poverty was reduced in an absolute or relative sense. In the beginning of the 2000’s, however, a new wave of literature emerged focusing on the importance of the context and

⁹ White and Anderson (2001) constructed the data set using the Deininger and Squire database. They identify 143 growth episodes in all, of which about half are from developing countries. Coverage of Africa was weak, with only Zambia appearing from Sub-Saharan Africa. Data for the countries of the former Soviet Union and Eastern Europe were only up to the 1980s, thus pre-dating the large increases in inequality which took place in the early 1990s.

¹⁰ See Deininger and Squire (1996), Ravallion and Chen (1997), Easterly (1999), and Dollar and Kraay (2002).

¹¹ Alessina and Rodrik (1994) and Perotti (1996) find a negative relationship, Li and Zhou (1998) and Forbes (2000) find a positive relationship, and Barro (2000) and Lopez (2004a) find no relationship.

ex ante analysis of constraints to future economic development.¹² Several cross-country studies have shown that growth determinants are highly dependent on initial conditions such as levels of income, poverty, and asset inequality, but also a host of other factors such as geography, demography, governance, politics, social considerations, and the set of existing policies. These differ not only between countries, but also over time within the same country.

One key example of the post-1990s literature is the volume *Economic Growth in the 1990s: Learning from a Decade of Reform* (World Bank, 2005). It concludes that although the necessary fundamentals for growth, such as a stable macroeconomic environment, enforcement of property rights, openness to trade, and effective government, are key factors in the growth process, they are not the whole story. This work and the work of the Growth Commission highlight the diverse ways in which the fundamentals can interact with policies and institutional setups in different country contexts.

An important insight from this stream of research is that numerous distortions exist at any time in a given country, and that some are more important than others. Moreover, as posited in the theory of the second best, it can actually be *welfare reducing* to institute reforms that remove some distortions as long as other distortions remain, which is the case in all real economies.¹³

Targeting the distortion associated with the biggest multiplier,¹⁴ and therefore the largest direct welfare impact, is a good alternative since the second best effects are typically hard to estimate with accuracy. Other options include targeting all distortions

¹² Analyses of sources of growth, such as growth decomposition and poverty decomposition, are important to our understanding of country-specific context and past sources of growth.

¹³ In formal terms, $du / d\tau_i = -\lambda_i + \sum_j \lambda_j \partial(\mu_j^s - \mu_j^p) / \partial \tau_i$, where u is welfare, τ_i is a distortion in activity i ,

λ_i is the Lagrange multiplier corresponding to the constraint associated with the distortion in activity i , μ_i^s represents the net marginal valuations of activity i by society s , and μ_i^p by private agents. The direct effect is always welfare improving, but the indirect effect may not be, implying a possibility that welfare may decline if the indirect effect is negative and larger than the direct effect.

¹⁴ The distortion associated with the biggest multiplier effect is the binding constraint.

at once (a strategy sometimes associated with the Washington Consensus approach) - often an infeasible option due to financial and capacity constraints, especially in low-income countries. But targeting the biggest distortion or a number of distortions may not lead to a welfare improvement, because of the possibility of large second best effects.

It is against this background that Hausmann, Rodrik, and Velasco (HRV) (2005) develop a heuristic approach to identifying the most binding constraint to growth, i.e., the one with the largest shadow price so as to increase the chance of a positive welfare effect. They use a decision tree framework based on the “Euler equation” or “Keynes-Ramsey rule” which captures many of the most important factors affecting growth of an economy in the short-run.¹⁵

$$\frac{\dot{k}_t}{k_t} = \frac{\dot{c}_t}{c_t} = \sigma(c_t)(r_t(a_t, \theta_t, x_t)(1 - \tau_t) - \rho),$$

which holds in the case of balanced growth equilibrium. In this equation, c is consumption per capita; k is capital per worker, a is technological progress; θ is index of externality; x is availability of complementary factors of productions, such as infrastructure or human capital; τ is the tax rate; $\rho = z + n$ is the real interest rate; n is population growth; z is the rate of time preference; σ is the inverse of the negative of the elasticity of marginal utility;. If the cost of capital ρ is high for any return on investment, investment is low and the economy is considered *liquidity constrained*. If the rate of return r is low, for any cost of capital, investment is low and the economy is *considered inefficient*.¹⁶

¹⁵ This is the Hamiltonian for the simplest Ramsey-type optimal growth model which assumes that households have perfect foresight and need to decide how much labor and capital to rent to firms, and how much to save or consume by maximizing their individual utility subject to their budget constraint. Firms maximize profits at each point in time and produce a single good. In their production function, technology is exogenous, and so are the complementary factors of production and the index of externality. The government spending requirements are assumed to be fixed exogenously, the government imposes a tax on the rental price of capital, so the after-tax return to capital is $r(1-\tau)$.

¹⁶ The cost of finance ρ may be high because the country has limited access to external capital markets or because of problems in the domestic financial market. A country may have difficulties accessing external capital markets for a variety of reasons including high country risk, unattractive FDI conditions, vulnerabilities in the debt maturity structure, and excessive regulations of the capital account. Bad local finance may be due to low domestic saving and/or poor domestic financial intermediation. Return to capital r may be low due to insufficient investment in complementary factors of production, such as infrastructure and human capital, low land productivity due to poor natural resource management, or low private returns to capital due to high taxes, poor property rights, corruption, labor-capital conflicts, macro instability, and

There are important lessons to learn from this approach including that development policy is country-specific, may involve just a few reforms that can be optimally sequenced to relax binding constraints, and it may lead to large positive welfare impacts. However, finding the binding constraints requires careful thinking. Some of the criticisms of this approach emphasize that it is (i) in practice impossible to estimate shadow prices; (ii) very difficult to reject constraints as not binding; and that (iii) the analysis is focused on the short term, and therefore ignores factors important to sustainable growth such as human capital accumulation.

The analysis is also undertaken at an aggregate level, offering little insight about constraints affecting different sectors, types of firms or the obstacles to economic transformation in the long run. Economic transformation is important for sustained, broad-based growth as it allows economies to catch up by sustaining high growth rates over extended periods of time (Romer 1990, Aghion and Howitt 1992, Aghion *et al.* 2005). Empirical evidence shows that not a single country has been able to achieve significant income growth and poverty reduction without structural transformation and economic diversification (Imbs and Wacziarg, 2003). For low income countries and countries with small domestic markets, structural transformation implies export diversification as access to foreign markets enables countries to realize economies of scale (Hausmann, Hwang and Rodrik 2007). The HRV framework also abstracts from conditions affecting the ability of individuals to engage productively and contribute to economic transformation.¹⁷

The Inclusive Growth Approach

The HRV framework is just one among many approaches to inclusive growth analytics. It is particularly relevant in cases where the income level is low, growth is slow and investments are low. Against this background, the HRV framework is an appropriate framework to study issues of inclusive growth since growth is the main driver

market failures, such as coordination externalities and learning externalities affecting negatively the country's ability to adopt new technologies.

¹⁷ The HRV framework includes human capital as a likely constraint from the perspective of firms, but does not look at whether skills limit the ability of certain groups to engage in economic development, and the constraints limiting investment in human capital.

of poverty reduction. In cases when growth is concentrated in a few sectors or specific types of economic actors, the HRV framework should be modified and supplemented with analysis of constraints to growth in the slow-growing and emerging sectors, and constraints to individuals to contribute and benefit from growth. The final appropriate framework will depend on country and time specific factors.

In cases when growth is high but poverty reduction stagnates, the analysis could be carried out using an inclusive growth analytics framework which is eclectic in spirit.¹⁸ It blends the diagnostic approach with different techniques applied to time-series, firm and household survey data, and cross-country benchmark comparisons to answer questions about trends, constraints to, and sources of sustainable, broad-based growth. The economic agent in an inclusive growth analytics framework is the individual rather than the firm, but individuals employed in firms earn returns to their employment – either as self or wage employed. The analysis does not need to be limited to the poor, but could be done from the perspective of different groups in the labor force, e.g. people living in a lagging region, migrants, and others. If one defines the income of any individual i as:

$$y_i \equiv w_1 E_1 \omega_{i1} + \dots + w_j E_j \omega_{ij}$$

where w_j and E_j are the prices and endowments of each of the economy's j factors, and ω_{ij} is the share of the j^{th} factor owned by individual i . Then, dividing each side by total income and summing over the poor individuals, one obtains:

$$\psi_P \equiv \lambda_1 \omega_{P1} + \dots + \lambda_j \omega_{Pj}$$

where ψ_P is the share of income received by the poor, λ_j is the share of factor j in total income, and ω_{Pj} is the share of factor j owned by the poor. This identity indicates the variables which affect the income share of the poor.

¹⁸ This framework was inspired by the framework of the “Integrated Economic Analysis for Pro-Poor Growth” (Sida 2006).

The main instrument for a sustainable and inclusive growth is assumed to be *productive employment*.¹⁹ *Employment growth* generates new jobs and income for the individual - from wages in all types of firms, or from self employment, usually in micro firms - while *productivity growth* has the potential to lift the wages of those employed and the returns to the self-employed. After all, in many low-income countries the problem is not unemployment, but rather underemployment. Hence, inclusive growth is not only about employment growth, but also about productivity growth.²⁰ Moreover, it is not only about wage-employment but also about self-employment which means that returns to capital, land and other assets matter to the income potential of the focus group as shown in the identity above.

The ability of individuals to be productively employed depends on the opportunities to make full use of available resources as the economy evolves over time. The analysis therefore looks at ways to strengthen the productive *resources and capacity* of the individual on the labor supply side as well as ways to open up new *opportunities* for productive employment on the labor demand side. If the main problem is lack of employment opportunities for a particular group of individuals due to limited supply of certain types of labor skills, the constraints are related to the productive resources and capacity of individuals rather than the environment in which they can use these resources. This situation calls for an in-depth employability analysis that will shed light on the resources of the individuals, e.g. the individuals' education, health and the other productivity attributes they bring to a job. If the main problem is low labor productivity or lack of employment opportunities for the individuals due to limited demand for labor, an analysis of the bottlenecks in the business environment is necessary (the HRV approach being one example).

The analysis distinguishes between self- or wage-employed, and further looks at employment by sector, size of firm, rural/urban, formal/informal, and other

¹⁹ According to the Commission on Growth and Development report (2008), sustained high growth requires rapid incremental productive employment.

²⁰ There is no preconception or bias in favor of labor-intensive industry policies. Indeed, the self-employed poor need improvements in productivity and leveling of the business environment in order to raise their incomes.

relevant characteristics. A disaggregate look is necessitated by our main objective to identify the incidence of growth across the income distribution and the bottlenecks to the productive employment of individuals. If the focus is on the poor, in the case of the self-employed, we undertake business environment analysis through the lenses of the small and micro enterprises. In the case of the wage employed, we undertake an employability analysis as well as a business environment analysis through the lenses of a representative firm, potentially employing the poor.²¹

An important question is the extent to which the current employment status of an individual has a potential for future income growth, or if moving out of a low-income situation means finding another type of employment or employment in another sector. The analysis therefore looks at external factors explaining the country's growth and poverty reduction pattern, the overall productivity dynamics in the country, the major challenges and opportunities, and possibilities for economic transformation and diversification. The analysis also considers constraints to those sectors with opportunities for productive employment, constraints affecting the ability to gain employment in these sectors, and constraints affecting labor mobility across sectors and regions.

The inclusive growth approach takes a longer term perspective. This is necessary because of the emphasis on improving the productive capacity of individuals and creating conducive environment for employment, rather than on income redistribution as a means of increasing incomes for excluded groups. Due to this longer term perspective, there is an explicit focus on structural transformation and internal migration in the inclusive growth analytics framework.²² The goal is to identify a bundle of binding constraints rather than the binding constraint, and then sequence these constraints to maximize inclusive growth in a country.²³

²¹ Note that the analysis of labor skills as a potential constraint for the self-employed is captured in the business environment analysis where it is analyzed as a constraint to growth of the small firm.

²² In developing countries a significant part of growth is generated through reallocation of labor from low-productivity to high-productivity sectors.

²³ This does not mean we go back to the "laundry list" approach, but rather to a limited set of constraints. Sequencing of these constraints however may require further in-depth studies of the feasibility and costs of specific policies.

With this longer term perspective, it is important to recognize the time lag between reforms and outcomes. A good example is the lag between the time when investments in education are made and the time when returns from improved labor skills are collected. This implies that the analysis must identify future constraints to growth that may not be binding today, but that may need to be addressed today in order to ensure sustainable and inclusive growth. Inclusive growth analytics is about policies that should be implemented in the short run, but for sustainable inclusive growth in the future.

Concluding remarks

This note defines the meaning of the term ‘inclusive’ growth, and argues that a program on inclusive growth has a distinct character focusing on both the pace and pattern of growth. Rapid pace of growth is unquestionably necessary for substantial poverty reduction, but for this growth to be sustainable in the long run, it should be increasingly broad-based across sectors, and inclusive of the large part of the country’s labor force. This definition of inclusive growth implies a direct link between the macro and micro determinants of growth and captures the importance of structural transformation for economic diversification and competition.

Inclusive growth is about raising the pace of growth and enlarging the size of the economy, while leveling the playing field for investment and increasing productive employment opportunities. It focuses on ex-ante analysis of sources, and constraints to sustained, high growth, and not only on one group – the poor. The analysis looks for ways to raise the pace of growth by utilizing more fully parts of the labor force trapped in low-productivity activities or completely excluded from the growth process.

Policies for inclusive growth are an important component of any government strategy for sustainable growth and the frameworks for inclusive growth analytics are eclectic in spirit. The main instrument for a sustainable and inclusive growth is assumed to be *productive* employment. *Employment growth* generates new jobs and income for the individual - from wages in all types of firms, or from self employment, usually in micro firms - while *productivity growth* has the potential to lift the wages of

those employed and the returns to the self-employed. The ability of individuals to be productively employed depends on the opportunities to make full use of available resources as the economy evolves over time. The analysis therefore looks at ways to strengthen the productive *resources and capacity* of the individual on the labor supply side as well as ways to open up new *opportunities* for productive employment on the labor demand side.

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