MECHANISMS OF GROWTH: EMPOWERING HOUSEHOLDS TO BREAK OUT OF POVERTY

POLICY LESSONS FROM THE iiG PROGRAMME

iiG
IMPROVING INSTITUTIONS FOR PRO-POOR GROWTH

Links from national to local policy impacts are central to iiG research. Several iiG projects investigated the conditions under which policy that impacts on poverty can empower the poor to make more effective use of their resources.

KEY FINDINGS

- **Policies for sustainable growth that impacts on poverty must operate effectively at the level of the household, not just at the level of the macroeconomy.** Policy can play useful roles in encouraging households' goals, mitigating household risk effectively and providing valuable assets. Such policies are an essential complement to policies focused at the national level.

- **Aspirations matter for development.** Households that hold timorous hopes for the future are less likely to invest in factors that drive growth – in particular, education of children and expansion of household enterprises. Policy has a valuable role to play in encouraging youth in poor communities to aspire to greater heights.

- **High risk can lock households into poverty, but effective policy can overcome this problem.** In many poor communities, insurance companies can operate effectively through 'index insurance' products. These products can be very valuable, but cannot be treated in the same way as traditional insurance products. Policy needs to weigh carefully the potential downside of 'basis risk', which may limit the widespread adoption of these policies. Alternatively, communities can sometimes self-insure effectively, and policy may have a useful role in supporting such informal risk-sharing mechanisms.

- **Assets matter for growth.** Poor households can use asset grants effectively to increase wealth and income. But the form of grant may matter: there is a difference between providing wealth in the form of an illiquid asset and providing that wealth in aid that can be consumed quickly. Further, some government policies may act to limit the expansion of small or informal firms; policy reforms may prove valuable for stimulating long-run firm growth.

POVERTY AND THE CHALLENGES OF EMPOWERMENT

Poverty can be a self-perpetuating phenomenon. There are many costs to poverty: for example, in terms of hunger, poor health and diminished life expectancy. But some of the greatest costs of poverty are the costs of lost opportunities: opportunities for education, for savings, for entrepreneurship and so on. In this way, some of the greatest costs of poverty are that it can be self-perpetuating: the factors that drive households into poverty can also serve to keep them there.

Government policy has an important role in helping households to escape such poverty traps – for example, by providing services, such as education. The effective delivery of services as mechanisms for growth is an important aspect of Phase I of the iiG research programme, and the contributions of the research programme on that issue are summarised in a companion paper.

The problems of poverty traps require more than just government spending, or even the effective provision of government services. Effective policy must also seek to *empower the poor themselves* – by providing the poor with mechanisms and opportunities to escape poverty through their own efforts and their own creativity. This must be a central aspect of any policy agenda that seeks to improve economic institutions for effective pro-poor growth.

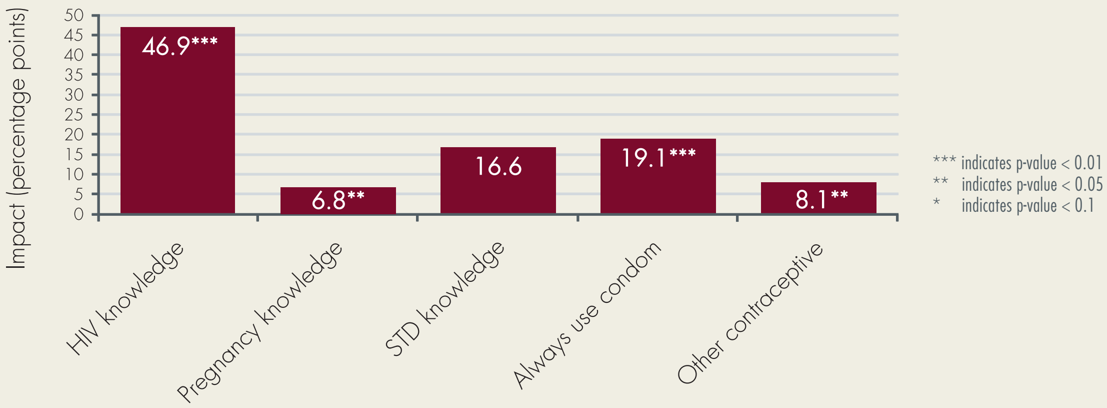
This paper summarises the key findings from the iiG programme on questions of how households may break out of poverty themselves, beginning with the issue of aspirations. iiG research has shed valuable light on the way that higher aspirations can encourage households to invest in their futures. This is closely related to the problem of risk – the next issue that this paper summarises – for risk can impose insurance costs that limit households' investment. Finally, the paper considers the encompassing issues of capital, entrepreneurship and skills.

ASPIRATIONS

Economists increasingly recognise the role that aspirations can play in determining economic opportunity. Most economic opportunities require an important degree of self-belief – for example, a belief that education is valuable, or a belief that a household can viably run a small enterprise. This is particularly important in developing economies, for at least two reasons. First, opportunities in developing countries are often very costly – for example, education may impose large opportunity costs in terms of lost income, and creating a household enterprise may require substantial initial outlays. Second, many people in developing economies – particularly the young – may lack proximate role models to persuade them that their dreams are achievable. For example, many girls in developing economies may dream of completing secondary education even though their mothers never had the same opportunities. For these reasons, aspirations matter in developing economies: they matter as an *explanation* for poverty, and they also matter as a potential *policy tool*. If policy makers can encourage people in developing economies to dream grander dreams for their future – that is, to believe that investment in human and physical capital is worthwhile – then this can create opportunities for the poor to help themselves to escape poverty traps.

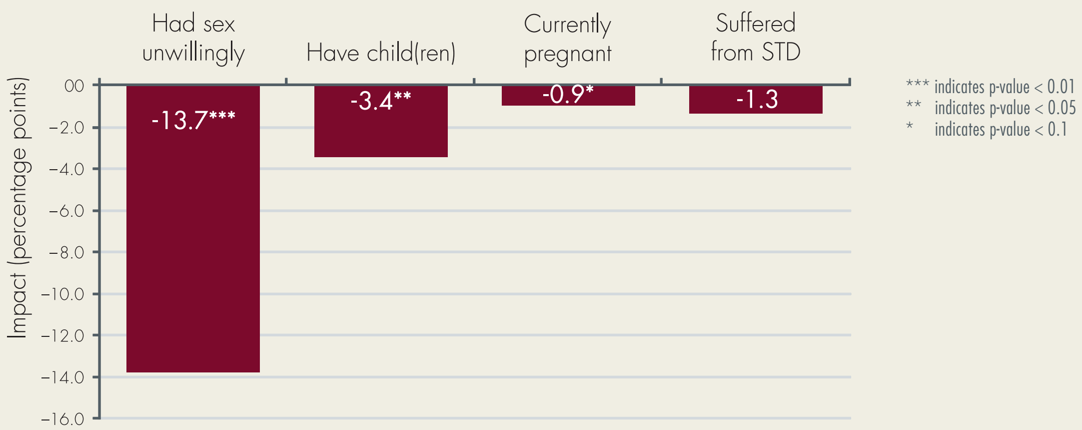
Phase I of the iiG research programme has made important empirical contributions to understanding the role of aspirations and the ways in which aspirations can be shifted. iiG research in rural Ethiopia has studied the relationship between fatalistic beliefs and economic outcomes; the research found that holding fatalistic beliefs (that is, limited aspirations) correlates closely with lower demand for credit. This suggests that policy programmes designed to shift aspirations may have an important role in encouraging households to make greater investments in future growth.

One example of how policy programmes might do this is suggested by the BRAC Adolescent Development Programme (ADP) – an initiative evaluated as part of the iiG programme. The ADP involved about 150 villages in Tanzania and 150 villages in Uganda, and involved the provision of microfinance, training in life skills and training in income generation. An initial evaluation of girls' decisions to enrol in the programme in Uganda showed that girls who were more likely to benefit from the programme were also more likely to enrol. This suggests that girls in poor communities are open to the potential benefits of such programmes, and that such programmes may therefore have a valuable role in shifting participants' aspirations. Initial analysis of results from Uganda also suggests valuable outcomes from such programmes. Results suggest that girls offered participation in the programme were likely to know more about the challenges of HIV, pregnancy and sexually transmitted diseases; they were therefore substantially more likely always to use a condom during intercourse, and were substantially less likely to have had sex against their wishes or to have had children. The following figures show these initial impact estimates.



Source: BRAC
Note: ITT estimates, standard errors are clustered at village level

FIGURE 1 - Impact on health knowledge and practices



Source: BRAC
Note: ITT estimates, standard errors are clustered at village level

FIGURE 2 - Impact on health knowledge and practices

Similarly, research in the slums of Bombay looked at Akanksha, a programme designed to improve children's self-esteem and self-efficacy. Specifically, Akanksha involves informal lessons outside school time, designed to encourage students' aspirations and their preparation for the workforce. Analysis of the programme suggested that it improved children's aspirations substantially, and that such improvements in aspirations are positively related to success in school examinations and initial labour market outcomes.

RISK

Risk is an important mechanism by which poverty traps can arise. Households facing high exposure to risk often invest in ex-ante 'risk management' strategies. Such strategies generally involve forsaking higher expected levels of consumption in order to decrease expected *variability* of consumption; this may involve, for example, diversifying crop planting in order to limit the consequences of any single crop's failure, or withdrawing children from schooling in order to generate precautionary savings. In this way, risk can impose two types of costs – short-term costs of tolerating high consumption volatility, but also long-term costs from not making productive investments (for example, investments in children's education). For this reason, effective insurance against risk is important in helping households to break out of poverty traps; a household that can manage risk well is likely to be a household that can take long-term investments in children's education or in the development of a small enterprise.

The iiG programme considered several aspects of risk management. One important part of the research developed the theory of 'index insurance' products. Such products are one means by which poor households – particularly farming households – might manage risk. The products provide a payout to households depending on the value of some index measure – for example, an insurance company might pay farmers if an index of rainfall in a particular region reports values below some minimum acceptable level. Intuitively, it is tempting to describe this kind of arrangement as an 'insurance contract', and to consider such a product using ideas and insights from insurance in other contexts. However, iiG research has emphasised that such products expose farmers to different kinds of risk than standard insurance products – because there is always a risk, for example, that a farmer will suffer a poor crop but that the rainfall index will *not* record a particularly low value (if, say, the crop is lost due to disease). This is known as 'basis risk' and is an important part of any 'hedge contract' – although it is not part of a traditional insurance contract. iiG research has therefore made several important contributions to thinking about such products. First, the research emphasises that index insurance products may not be very attractive to the most risk-averse households – because the worst outcome under an index insurance contract may be worse than the worst outcome under a traditional insurance contract. Second, the research draws attention to the importance of using better insurance indices; for example, indices that provide a more nuanced record of local weather conditions, or indices that also record exposure to crop disease. In this way, iiG research provides useful guidance on the ways in which index insurance products can be improved – and, in doing so, suggests important avenues to encourage households to invest more in their future.

Of course, formal insurance products will not always be available to assist poor households; in many contexts, households must rely upon community-based insurance mechanisms. Such mechanisms may involve groups of households co-operating in order to share risk. A central issue in this context is whether such groups can co-operate effectively over time; because participants cannot resort to the formal court system if agreements collapse, such groups can only be sustained if the value of future co-operation is strong enough to discourage any member from leaving. This issue was also considered, in the context of Ethiopian funeral societies. Research using detailed survey data from six villages in Ethiopia showed that funeral groups can be important mechanisms for sharing risk, and that trust among members appears to be important in describing the kinds of groups that form.

In these ways, iiG research has illuminated several important aspects of risk in poor communities. First, the research has helped to *describe* risk – using both theoretical and empirical methods, the work highlights the importance of risk for life in many poor households, and emphasises aspects of that risk that are often not considered (namely, the role of basis risk, and the possibility that informal risk-sharing groups may collapse). Second, in doing so, the research helps to suggest *policy improvements* to support risk-sharing – for example, through the design of better index insurance products, or through the possibility of better supporting informal risk-sharing organisations.

CAPITAL, ENTREPRENEURSHIP AND SKILLS

Aspirations matter in encouraging households to break out of poverty, and risk imposes unnecessary costs that may anchor households in poverty traps. But escaping from poverty ultimately also requires households to find productive mechanisms for increasing their income; that is, it requires opportunities for worthwhile investments. Several iiG projects explored the dimensions of household investment.

Many poor households lack access to basic assets. One important aspect of understanding poverty traps is to understand whether positive asset shocks can have sustained impacts upon households' wealth; can asset grants push households on to sustained paths for growth? To explore this question, iiG research in Bangladesh transferred income-generating assets (such as goats, cows and chickens) to very poor households. The programme, implemented by BRAC, was designed to measure the effect of asset transfers on households' wealth and growth. Researchers learned that the transfers increased incomes. However, the transfers did not cause the targeted households to increase children's school attendance. This suggests several important insights for development policy. First, transfer of assets to the poor *can* have sustained effects on household income. Second, however, such transfers do not necessarily lead households to invest more in their children's education; for that, policy makers need to turn to alternative mechanisms (for example, making grants conditional on school attendance, or increasing the quality of schooling or encouraging higher aspirations).

Similar iiG research in South Sudan, however, showed quite different results. In that work, BRAC researchers provided households with food and small loans, in addition to training in the basic skills of vegetable growing, tailoring and cattle raising. The programme in South Sudan cost approximately the same as the programme in Bangladesh. However, the programme in South Sudan had very different effects; unlike in Bangladesh, researchers in South Sudan were unable to identify any positive effect of the programme. This is an important result, because it prompts researchers and policy makers to consider carefully the causes of the different outcomes. One explanation may be that the grants in South Sudan were provided in the form of food aid, rather than in the form of tangible assets. The programmes therefore provide suggestive evidence that the form of grants may matter; if households are given larger assets, this may discourage them from selling their asset for consumption purposes. Alternatively, the differences may be explained in terms of the economic context; it may be that households in South Sudan showed no positive effect of the programme because that nation's economy has not grown fast enough to provide any additional opportunities for business creation.

Grants for poor households provide one important mechanism by which growth may be encouraged. A related mechanism is through the reform of government policies directed at small firms, particularly in urban settings. Further research in the iiG programme has highlighted the potential gains from policy reforms – particularly in the reform of policies that may constrain small business expansion. Such reforms could be implemented in several ways. First, policy often imposes barriers to formal registration; in Ghana, for example, business registration can take several months and cost more than US$5,000. Lowering these barriers to registration may encourage more households to develop their businesses, and may broaden the government tax base. Second, in many African countries, taxes paid by small firms are proportionately higher than taxes on larger firms; if taxes were reformed so that the tax burden were shared proportionately to firm size, small firms would often have greater economic incentives to grow. In turn, this would probably encourage more employment, greater investment and improved growth.

IMPLICATIONS FOR POLICY: MECHANISMS FOR GROWTH

- **In order for growth to be 'pro-poor', policy must operate at the level of the household, not just at the level of the entire nation.** Policy should consider the role of aspirations in any policy directed at youth; encouraging greater aspirations may be an important mechanism in encouraging households to invest more in their future. Policy should help poor households to insure risk effectively.

- **Policy interventions at the household level are likely to have very different impacts in different circumstances; one size does not fit all.** This may be particularly true in the case of asset accumulation, where the form of assets may matter substantially depending upon the economic circumstances of the recipient household. Similarly, these kinds of differences may be particularly pronounced between firms of different sizes: policy should lower barriers to registration for small firms, and ensure that tax policy does not discriminate against small firms in favour of larger firms.

FOR MORE INFORMATION

For more on insurance products, see iiG Briefing paper 17 *'Insurance products for the poor should not be poor products'*, November 2011 and CSAE Working paper WPS/2009-04 'Contract design in insurance groups', by Tessa Bold and Stefan Dercon.

For discussions on aspirations, see CSAE Working paper 2011-03 *'Beyond fatalism – an empirical exploration of self-efficacy and aspirations failure in Ethiopia'*, by Tanguy Bernard, Stefan Dercon and Alemayehu Seyoum Taffesse and iiG Briefing Paper 19 *'Aspirations matter: Shaping aspirations can play a crucial role in enabling people to pull themselves out of poverty'*, February 2012.

Research on grants and human capital is discussed in iiG Briefing papers 12 and 14 *'To feed or to educate: Hard choices for the extremely poor'*, June 2010, and *'Can you successfully teach people how to run small businesses?'*, January 2011.

Issues of small firms and government policy are discussed in iiG Briefing paper 11 *'The informal economy and growth'*, June 2010.

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Department of Economics · University of Oxford · Manor Road · Oxford OX1 3UQ
T: +44 (0)1865 271084 · F: +44 (0)1865 281447 · E: iig.enquiries@economics.ox.ac.uk
W: www.iig.ox.ac.uk