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DEVELOPMENT STRATEGY AND GOVERNANCE DIVISION

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DSGD Discussion Paper No. 30

Does Good Governance Contribute to Pro-Poor Growth?: A Review of the Evidence from Cross-Country Studies

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TABLE OF CONTENTS

LIST OF TABLES AND FIGURES

Tables

Figure

ABSTRACT

Even though both "good governance" and "pro-poor growth" have become important concepts in development thinking and practice, studies that assess to which extent and how good governance contributes to pro-poor growth are still relatively scarce. After reviewing the two concepts, this paper develops a conceptual framework that specifies the linkages between different aspects of governance and pro-poor growth. Using this framework, the paper reviews a range of quantitative cross-country studies that include measures of governance as independent variables and focuses on the dependent variable in at least two of the three dimensions of pro-poor growth: poverty, inequality, and growth. The review shows that governance indicators that capture a sound decision-making environment for investment and policy implementation, such as political stability and rule of law, are associated with growth but provide mixed results in regard to poverty reduction. On the other hand, governance indicators that refer to transparent political systems, such as civil liberties and political freedom, tend to be conducive for poverty reduction, but the evidence is rather mixed, and the relationship of these variables with growth remains unclear. The paper discusses the methodological challenges inherent in this literature and suggests areas for future research.

Key words: Governance, pro-poor growth, cross-country studies

DOES GOOD GOVERNANCE CONTRIBUTE TO PRO-POOR GROWTH?: A REVIEW OF THE EVIDENCE FROM CROSS-COUNTRY STUDIES

Danielle Resnick and Regina Birner [1]

"Good governance is perhaps the single most important factor in eradicating poverty and promoting development."

Kofi Annan, Secretary General of the United Nations[2]

I. INTRODUCTION

Since the 1990s, the concept of "good governance" has taken center stage in development thinking and practice. This is reflected not only by Kofi Annan's statement above but also by donors' increasing dependence on governance performance indicators for allocating overseas development assistance (ODA).[3] Several reasons account for the increasing attention to governance and institutions by the international development community, among them research findings demonstrating that the effectiveness of financial aid depends on "a good policy environment" (Burnside and Dollar 1997; World Bank 1998: 2).[4] According to Wolfensohn and Bourguignon (2004), the lackluster performance of structural adjustment programs, the end of the Cold War and the funding of proxy states, political problems associated with reforming the economy of the former Soviet Union, and institutional weaknesses revealed during the East Asian financial crisis have also contributed to the new focus on governance.

The authors wish to thank Shenggen Fan, Director, Development Strategy and Governance Division (DSGD), International Food Policy Research Institute (IFPRI), for his valuable comments.

[1] Daniel Resnick is a former Research Analyst and Regina Birner is a Research Fellow, DSGD, IFPRI.

[2] The Secretary-General made this statement in 1998 in his Annual Report to the General Assembly on the work of the organization. See http://www.unsystem.org/ngls/documents/pdf/go.between/gb71.pdf.

[3] For example, the World Bank allocates grants of the International Development Association (IDA) according to a Country Policy and Institutional Assessment (CPIA), which includes indicators such as transparency, accountability, and corruption in the public sector. The US Millennium Challenge Account also distributes assistance to countries based on "performance in governing justly, investing in their citizens, and encouraging economic freedom." (see http://www.mca.gov/about_us/overview/index.shtml).

[4] These findings, however, have been contested. For example, see Easterly *et al.* (2003).

While good governance is increasingly viewed as a key ingredient for development, the 1990s also witnessed a renewed focus on poverty reduction as the major goal of development. The first of the Millennium Development Goals (MDGs) clearly places reducing poverty and hunger at the top of the international agenda. Poverty had already been a major focus of development in the 1970s, highlighted in the 1973 Nairobi speech by former World Bank President Robert McNamara, but the 1980s were dominated by a focus on structural adjustment policies aimed at promoting growth. More recently, there has been broad consensus in the development community that growth must be accompanied by redistributive policies in order to eliminate poverty. While this thinking was popularized in the 1970s as "redistribution with growth" (Chenery *et al*., 1974), a new term encompassing this idea became popular at the end of the 1990s: pro-poor growth. Promoting pro-poor growth has now become a major goal in the strategies of international donor organizations.[5]

Since both governance and pro-poor growth are high on the development policy agenda, the question arises as to whether and how they are related to each other. While it is commonly assumed that good governance promotes pro-poor growth (World Bank 2001), testing this assumption empirically is challenging for several reasons. First, there is no consensus on how to define and measure governance and pro-poor growth. Secondly, since growth and income distribution are influenced by many factors, it is not easy to isolate the influence of governance. Thirdly, the direction of causality is far from clear. In fact, the link between economic growth and democracy, typically considered as one dimension of governance, has puzzled economists and political scientists for decades. (see Bardhan 1999, for a review). Fourth, while there is a considerable body of literature on the relationship between governance and growth, there are still relatively few cross-country studies that link governance indicators with the joint outcomes of growth,

[5] See, for example, the websites of DFID (http://www.dfid.gov.uk/pubs/files/propoorbriefnote2.pdf), GTZ (http://www.gtz.de/de/themen/wirtschaft-beschaeftigung/6642.htm), and OECD (http://www.oecd.org/document/62/0,2340,en_2649_34621_31549822_1_1_1_1,00.html).

inequality, and poverty reduction, which together underlie the concept of pro-poor growth.[6]

Considering how strongly both concepts feature on the international development agenda and influence ODA allocations, it is troubling that there is not a more comprehensive understanding of the mechanisms linking governance and pro-poor growth. As such, the objective of the present paper is twofold. First, a conceptual framework is presented that identifies the possible linkages and feedback effects between governance and pro-poor growth. Secondly, the available cross-country literature dealing with these linkages is discussed from both a methodological and an analytical perspective. Based on the assessment of the findings from this literature, areas for further research are proposed.

The paper is organized as follows. Section 2 provides a brief overview of attempts to define and measure governance and pro-poor growth, while Section 3 presents the conceptual framework. Section 4 reviews the available cross-country studies based on this framework. The limits of these studies and areas for further research are discussed in Section 5. Section 6 presents conclusions.

[6]An impressive annotated bibliography compiled by the World Bank (1998) highlights at least 50 empirical studies on the impact of governance on economic growth. This bibliography can be accessed from the following website: http://www1.worldbank.org/publicsector/annotedbibliography.pdf

II. DEFINING AND MEASURING GOVERNANCE AND PRO-POOR GROWTH

Governance

Although governance is an oft-used term in international development, there are numerous interpretations of what the term actually describes.[7] For example, the United Nations Development Program (UNDP) defines governance as "... the exercise of economic, political, and administrative authority to manage a country's affairs at all levels. It comprises mechanisms, processes, and institutions through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations, and mediate their differences" (UNDP 1997). The World Bank refers to governance as " the traditions and institutions by which authority in a country is exercised for the common good. This includes the process by which those in authority are selected, monitored and replaced, the capacity of the government to effectively manage its resources and implement sound policies, and the respect of citizens and the state for the institutions that govern economic and social interactions among them."[8] Although such definitions appear neutral, they are implicitly based on normative assumptions, such as that those in authority should be monitored. Of course, definitions of "good governance" explicitly have a normative content, identifying what the organization or author proposing the definition considers desirable. Citizen participation, accountability, transparency, rule of law and stability are common elements in many definitions of good governance. Some definitions of good governance go beyond these components and include the adoption of specific policies, such as policies promoting private-sector led growth, as elements of good governance.[9] A distinction has to be made between (1) identifying governance

[7] The authors refer here to the concept of governance as used in the development literature and discourse. The concept was originally used by specialists in medieval English society, which was characterized by cooperation between the different sources of power (church, nobility, merchants, peasants, etc.). The term has also been widely used by scholars in economics and in the social and political sciences who study coordination mechanisms. For example, Williamson's (1985) transaction costs approach deals with governance structures, and Ostrom (1990) refers to "Governing the Commons."

[8] World Bank, http://www.worldbank.org/wbi/governance/about.html#approach.

[9] See, for example, the definition of "good governance" presented by AusAid, the development organization of the Australian Government at http://www.ausaid.gov.au/publications/pdf/simons/chp13.pdf.

elements that are instrumental to reach other goals, such as poverty reduction, and (2) defining governance elements that constitute values in their own right. To quote an obvious example, democracy is widely considered a goal in its own right, but the case of China shows that it is not a necessary condition to reduce poverty.[10] In this paper, the authors attempt to analyze how and to which extent different dimensions of governance defined in the literature (either as goals in their own right or as instrumental) can influence pro-poor growth.

The definitional ambiguity surrounding the notion of governance is particularly challenging when trying to measure governance. Governance-related donor and research initiatives have been accompanied by a surge in indicators that aim to measure governance. The World Bank Institute's Governance website lists approximately 130 datasets attempting to quantitatively capture various aspects of the concept. These datasets include indicators that measure not only familiar aspects of governance, such as corruption and human rights violations, but also more specific issues, including the degree of decentralization, labor rights, gender equality, and press freedom. The following sections review three of the most commonly-used data sets in the cross-country research on governance.

Aggregate Governance Indicators Dataset (World Bank)

Considered the most comprehensive dataset on governance, the dataset developed by World Bank researchers Daniel Kaufmann, Aart Kraay, and colleagues, hereafter called the KK Dataset, is based on governance measures from different data sources, including Freedom House's civil liberties and political rights indices, and the International Country Risk Guide (ICRG), both of which are described in detail below.

AusAid claims that there is a "widespread agreement among donors" on some of the essential elements of good governance. The document lists the "need for responsible fiscal and economic policies which encourage open and efficient trading systems and private sector-led growth" as one such element. (p. 224). The World Bank's CPIA criteria also include a range of structural and social policies.

[10] For a comprehensive review of theories and case studies on democracy, "good governance," and development, see Potter (2000).

Datasets are available for the periods 1996, 1998, 2000, 2002 and 2004. The number of measures and data sources used to construct this dataset has increased over time. The 2004 dataset covers 209 countries and territories, and the indicators are based on several hundred individual variables, drawn from 37 separate data sources constructed by 31 different organizations (Kaufmann et al., 2005). The KK Dataset tries to capture three dimensions of governance: (1) "the process by which governments are selected, monitored, and replaced; (2) capacity of government to effectively formulate and implement sound policies, and (3) the respect of the citizens and the state for the institutions that govern the economic and social interactions among them" (Kaufmann et al. 2003). An unobserved components model is used to reduce the 250 measures into six indicators that correspond to these dimensions.

The indicator *voice and accountability* refers to whether citizens participate in the selection and monitoring of their governments while the *political stability* indicator captures whether the government is vulnerable to change through violent or unconstitutional means. Both indicators fall under the first dimension of governance. *Government effectiveness* and *regulatory quality* both belong to the second dimension. *Government effectiveness* examines the capacity of civil servants, the quality of public service provision, and the credibility of government commitment to policies. *Regulatory quality* focuses on whether the policies promoted are "market-friendly" in the areas of trade and business. The final dimension of governance includes *rule of law* and *control of corruption*. *Rule of law* includes the enforcement of property rights and the predictability of rules governing social and economic interactions. Lastly, *control of corruption* refers to whether there is evidence of the "exercise of public power for private gain" in the business environment and in the broader political arena.

Although the KK Dataset is one of the most widely used in cross-country research, and has been employed by the Millennium Challenge Account (MCA) to determine country eligibility for funds, it is not without its flaws. For instance, the aggregation procedure results in indicators with wide margins of error (Hyden, Court, and Mease 2002). In addition, countries may change over time because of increased data

availability rather than any substantive changes within that country. While Kaufmann, Kraay, and Mastruzzi (2003) believe that these problems are not very significant, they encourage caution when using the indicators to make cross-country comparisons.

The Freedom House Dataset

Since 1972, Freedom House has produced Freedom in the World Ratings, which reflect the combined score of a political rights and civil liberties index. Also known as the Gastil indices after their creator, Raymond Gastil, Freedom House compiles these indices for 192 countries and 18 territories. The political rights index attempts to capture the extent to which citizens can participate in the political process by competing for public office and exercising a right to vote, particularly for representatives who actually have a decisive vote on public policies. The civil liberties index has a broader aim, namely, to measure whether citizens have sufficient freedom to develop opinions and personal autonomy without state interference.

A number of Freedom House analysts determine the extent of political rights and civil liberties based on secondary materials, such as foreign and domestic news reports, scholarly analyses, and Non-Governmental Organization (NGO) publications, as well as through visits to and communication with their contacts in each region. The analysts then assign points from 0 to 4 for 10 questions related to political rights and 15 regarding civil liberties. The points are translated into a rating system from 1 to 7, with a higher rating corresponding with a worse performance. The separate ratings for political rights and civil liberties are then averaged to determine whether a country can be classified as Free, Partly Free, or Not Free. However, in empirical research, the separate index ratings are usually retained, and the civil liberties index is used more frequently than the one for political rights (Freedom House 2003).

International Country Risk Guide (ICRG)

Covering 140 countries from 1980 to the present, the ICRG is a product of the Political Risk Services (PRS) Group that analyzes and forecasts risk for international

investors. According to the company's website, the ICRG model helps determine how risk can affect the business and investments of "institutional investors, banks, multinational corporations, importers, exporters, foreign exchange traders, shipping concerns, and a multitude of others" (PRS website).

The ICRG contains 22 components that are grouped into three categories of risk: political, financial, and economic. For all components in the three categories, higher points are assigned if the potential risk for that component is lower. While the financial and economic assessments are based on objective data, using variables such as foreign debt as a percentage of GDP and exchange rate stability, political risk assessments are performed subjectively by the ICRG's editors. In determining the composite rating, political risk contributes 50 percent to the rating while the other two categories contribute 25 percent each.

The ICRG, the Freedom House indices, and the KK dataset have proven to be the most popular source of governance indicators for cross-country econometricians. Yet, as discussed in section 5.1, they are all based on subjective perceptions of government performance, or outcomes, than on objective understandings of government processes. As such, it is difficult to determine what governance inputs are required to facilitate pro-poor growth, which in turn creates ambiguity with regards to interpreting the collective policy implications of these studies for the broader development community.

Pro-Poor Growth

Like governance, the term "pro-poor growth" is relatively new but the concept very much reflects the notion of "redistribution with growth" popularized by Chenery *et al.* (1974) in a joint World Bank/IDS publication with the same name. Both the earlier and more recent re-formulation affirm the primacy of growth in reducing poverty while also acknowledging that inequality can prevent growth from being pro-poor. In other words, there are two main channels by which growth becomes pro-poor: either growth occurs under situations where very little inequality exists or inequality diminishes even if

growth is stagnant. Obviously, a combination of increased growth and reduced inequality would also lead to pro-poor outcomes.

Although organizations such as the Organization for Economic Cooperation and Development (OECD) (2001) and the UN (2000) have employed a very broad definition by classifying it as growth that benefits the poor, most technical conceptualizations of pro-growth fall into either one of two categories: relative and absolute. The relative category emphasizes that pro-poor growth occurs when economic growth *disproportionately* benefits the poor and highlights that achieving pro-poor growth requires ameliorating inequality (Cord *et al*. 2003). One approach for capturing pro-poor growth is measuring whether the per capita income growth rate of the poor surpasses the average income growth rate (Klasen 2001). The poverty bias of growth (PBG) measure used by McCulloch and Baulch (1999) subtracts the real change in the poverty headcount between two time periods from the predicted change if there was an equal distribution of income. If PBG is positive, then pro-poor growth occurred. Kakwani and Pernia (2000) also developed a pro-poor growth index based on taking the poverty elasticity with respect to per capita income as a ratio of the poverty elasticity with respect to per capita income, assuming no change in income distribution.

Others, however, argue that growth is pro-poor if the poor benefit in absolute terms, as reflected by a chosen measure of poverty. More specifically, the rate of growth and the way in which it is distributed both determine the rate of change in poverty and reveal the degree to which growth is pro-poor. A well-known measure of pro-poor growth that adheres to this definition is the mean growth rate of the income of the poor (Ravallion and Chen 2003). Thus, the main difference between these two definitions is that, while the former emphasizes that the poor must benefit more from growth than the nonpoor, the latter assumes that growth is always pro-poor unless the incomes of the poor decline or stagnate. The cross-country studies included in this review span both the relative and absolute approaches.

III. LINKAGES BETWEEN GOVERNANCE AND PRO-POOR GROWTH: A CONCEPTUAL FRAMEWORK

Figure 1 displays a conceptual framework that attempts to identify the linkages and mechanisms through which governance interacts with pro-poor growth.[11] In line with the literature on economic growth, the framework distinguishes between initial conditions, drivers, and outcomes. The **outcome** relevant to this paper, pro-poor growth, is represented by **Box H**.

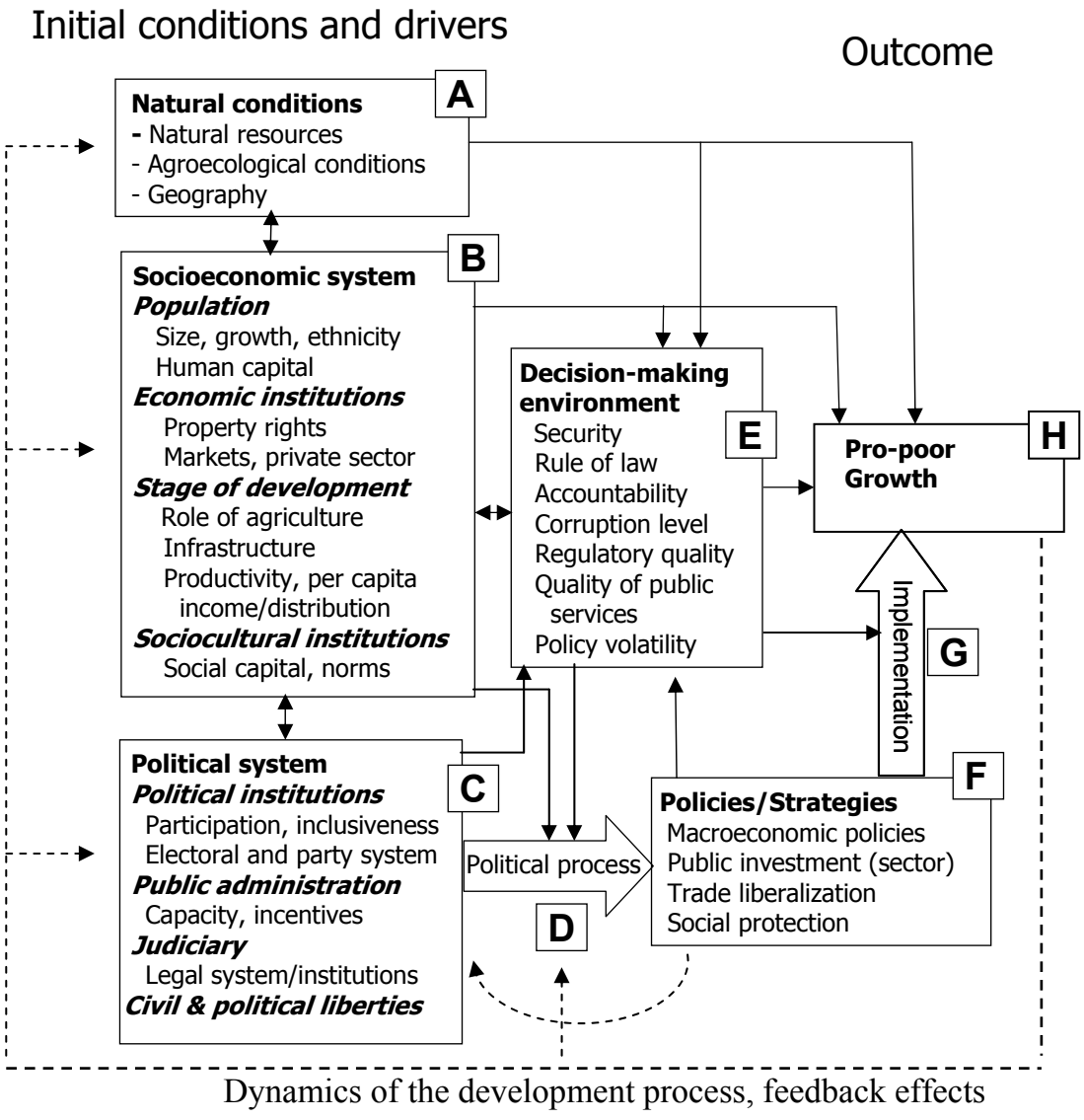
Achieving pro-poor growth partially depends on the **policies** (**Box F**) a country adopts, including policies related to trade, investment, social protection, and redistribution. The impact of these policies on pro-poor growth is influenced by their **implementation (Arrow G)**. Policy choice is often considered an aspect of "good governance." However, determining which policies promote pro-poor growth, depending on a country's circumstances, remains an empirical question. Policy recommendations that are frequently advocated in the pro-poor growth literature include creating a stable macroeconomic environment, stimulating growth in the agricultural sector, integrating backward areas, reducing asset inequality, and improving human capital (Bigsten and Shimeles 2004; Dorward et al. 2004; Klasen 2001; Lopez 2004a).

Many of the policy recommendations, however, are embedded in an apolitical framework. The framework proposed here acknowledges that policies are outcomes of a political process (**Arrow D**), even though this process remains a "black box" in most of the cross-country literature. The political process is influenced both by the **political system** (**Box C**) and by the **socioeconomic system (Box B)**. Political system refers to a country's political institutions, public administration, and judiciary. Key political institutions that help distinguish amongst various political systems include the ability of citizens to elect representatives, the degree of competitiveness within the electoral system, the freedom of the media, and checks and balances between various branches of government. These institutions determine the space for participation and debate in the

[11] This framework is based on an approach developed jointly with IFPRI's Country Strategy Team led by Xinshen Diao.

political process (link C-D) and influence the types of policies that a government selects and implements (link D-F-G).

Figure 1. Conceptual Framework



Indicators that capture a political system's degree of openness and participation include the civil liberties and political freedom indices by Freedom House and the voice and accountability index in the KK Dataset. Importantly, these indicators are actually measuring governance outcomes, or performance.

Along with a country's socioeconomic conditions and policy choices, the political system influences the "**decision-making environment**" (**Box E**), which encompasses those governance indicators that are assumed to influence the decisions of economic agents, such as private investors. The decision-making environment also influences the decisions of the different actors involved in implementing policies and programs, thus influencing the effectiveness of policy interventions (see arrow from Box E to Arrow I). Both the political stability and rule of law indices in the KK Dataset as well as the political risk component of the ICRG capture elements of the decision-making environment. Specifically, these indices examine crime levels, vulnerability to coups, ethnic and religious tensions, protection of property rights, corruption, and quality of the bureaucracy. The governance indicators constituting the decision-making environment may also influence the political processes (link E-D). For example, if the poor lack confidence in the state's ability to meet their needs, they may refrain from engaging in the political process (Moore and Putzel 1999).

The **socioeconomic system (Box B)** captures some of the initial conditions that are important with regard to stimulating growth and determining the poor's access to growth opportunities. They include demographic characteristics, economic institutions, the stage of development at the starting point of the period under consideration, and socio-cultural institutions. The socioeconomic system influences growth and poverty outcomes directly (link B-H) as well as indirectly via the political system and the decision-making environment (links B-C, B-E and C-E). These links acknowledge that governance performance (an outcome variable) is influenced by the interaction between the political institutions, civil society actors, and the private sector. For instance, citizen engagement is necessary to make democratic institutions function effectively. In an ethnically divided society, stability may be more difficult to achieve. Whether rule of

law exists depends not only on the judiciary system, but also on the degree to which citizens are willing to obey laws and regulations voluntarily, which in turn may depend on the legitimacy of the government. Likewise, the socioeconomic system obviously has a strong influence on the political processes (link B-D) and the policies to which they lead.

Finally, a country's **natural conditions** (**Box A**) play an important role for growth and poverty outcomes. They include natural resources (e.g., whether a country has minerals and oil), agroecological conditions, and other geographic conditions, such as a country's size and whether it possesses a coastline. The influence of natural conditions on governance is widely documented. For example, the "resource curse" theory suggests that richness in natural resources biases the political process in such a way that the outcomes with regard to pro-poor growth are unsatisfactory.[12] This would suggest a line of causality from A to E, D, F, G and finally H.

Admittedly, many more factors could be incorporated into this framework, including the role of external factors such as the international trading environment. Nevertheless, the present framework incorporates many of the variables considered within the pro-poor growth literature without becoming unwieldy. Moreover, this framework highlights the feedback effects between these variables and pro-poor growth. Significantly then, this framework emphasizes that the relationship between governance and pro-poor growth not only manifests itself through multiple channels but also is nonlinear and dynamic.

[12] For examples, see Auty and Gelb (2001), Karl (1997), and Moore (2004).

IV. WHAT DO CROSS-COUNTRY STUDIES TELL US REGARDING THE LINKAGES BETWEEN GOVERNANCE AND PRO-POOR GROWTH?

The framework described above guides the review of cross-country empirical studies that focus on at least two of the three dimensions of pro-poor growth: poverty, inequality, and growth. Moreover, the chosen studies include governance indicators that correspond to the decision-making environment (Box E) and political system (Box C) as presented in the framework above. While some of the studies also examine the relationship between policies (Box F) and pro-poor growth, the authors only provide a brief review of the country study findings in this area. Cross-country studies examining the interaction between the political process (Box D) and pro-poor growth are notably absent from this literature. A more detailed description of the selected studies can be found in **Table A.1** of the Appendix.

Decision-Making Environment

A number of cross-country studies examine the link between the decision-making environment and pro-poor growth (E-H in Figure 1). Based on a sample of 92 countries, Dollar and Kraay (2002) use ordinary least squares (OLS) to estimate econometrically whether the policies and institutions traditionally associated with growth also have an impact on poverty. To account for possible endogeneity, they average each of their explanatory variables over the five-year time span preceding the period of their growth data. As a result of this approach, they find that the rule of law indicator from the KK dataset is positively and significantly correlated with growth in average per capita incomes and positively but insignificantly related to growth in per capita incomes of the poorest quintile. They conclude that while greater rule of law may be associated with a greater share of growth accruing to the poorest 20 percent of the population, this is predominantly due to the indicator's influence through growth rather than through improving distribution. These findings are partially reinforced by Kraay (2004) in which he uses univariate regressions and a sample of 58 countries to understand the relationship between a set of explanatory variables and their individual effects on growth in average

incomes, changes in the Gini coefficient, and changes in poverty for four different poverty measures.[13] Kraay argues that univariate rather than multivariate regressions are more appropriate considering the level of measurement error for his dependent variables. Yet, he also notes that his approach could obscure unobserved country-specific characteristics. Notwithstanding this caveat, this method reveals that rule of law is positively correlated with the growth component of poverty changes but also significantly with poverty-increasing shifts in relative incomes, leading Kraay to conclude surprisingly that "poverty-increasing distributional change is more likely to occur in countries with better institutional quality" (p.25). Nevertheless, the association with the growth component is larger, leading to net reductions in the poverty headcount. Similarly, Lopez (2004b) finds that the distribution of income could actually be exacerbated when the decision-making environment is less vulnerable to risk. Based on growth and inequality panel data for 41 countries and using a two-step generalized methods of moments (GMM) estimator, he discovers that a better rating on the ICRG index is associated with greater inequality.

This contradicts Chong and Gradstein (2004) who examine the impact of political institutions on income inequality for 121 industrial and developing countries. While they recognize the endogeneity inherent within this relationship, they reject using an instrumental variables approach to control for this problem. Instead, they use vector autoregressions on a set of panel data, which allow them to explore how the behavior of their independent variables affects the future behavior of their dependent ones. As a result of this method, they discover that the political stability and the rule of law indicators from the KK dataset, as well as the ICRG index, all exhibit a negative and significant relationship with inequality as measured by the Gini coefficient. In other words, better governance indicators lead to a decrease in inequality. When they examine the reverse relationship, Chong and Gradstein find that inequality negatively impacts these governance variables, as well.

[13] Poverty is measured according to four different indicators: the headcount poverty rate (P0), depth of poverty (P1), the poverty gap (P2), and the Watts index.

Studies that included dependent variables focused on poverty or broad measures of development likewise yield contradictory results. The econometric analysis by Arimah (2004) uses a linear functional form and an OLS estimation technique to examine the relationship between governance and poverty for a sample of 30 African countries. He finds that the political stability indicator from the KK dataset has a negative and statistically significant impact on reducing the percentage of the population below the national poverty line. Yet, he provides no explanation for this surprising result nor does he justify why he uses poverty data that precedes the time period of his governance data poverty data. His study contradicts Dollar and Kraay (2002) who lagged their governance variables. Nevertheless, Arimah's (2004) findings are echoed in a study by Moore *et al.* (1999) that also uses an OLS technique to uncover which political variables are most effective in converting income into human development. In order to achieve this, the authors constructed for 61 developing countries a relative income conversion efficiency (RICE) index, which captures variations in the education and health components of a country's Human Development Index (HDI)[14] Unlike Arimah, Moore *et al.* adjust for endogeneity by averaging their explanatory variables over the 1980s and constructing their RICE index for 1995. Consequently, they find that greater performance on the ICRG index is actually correlated with a worse score on the RICE index.

On the other hand, Dollar and Kraay (2002) find that rule of law has a positive, albeit insignificant, relationship with the growth of the incomes of the poorest 20 percent of the population. Likewise, Christiaensen *et al.* (2003) focus on poverty dynamics during the 1990s in a small sample of African countries and discover that an improvement in the political component of the ICRG index was generally accompanied by reductions in the headcount poverty. For countries where political risk declined but

[14] The HDI is calculated annually by the United Nation's Development Program. There are three elements of the HDI: life expectancy at birth; a combination of the adult literacy rate and the gross school enrollment ratios at the primary, secondary, and tertiary levels; and GDP per capita in purchasing power parity USD. After removing the GDP per capita element, Moore *et al*. (1999) calculated the difference between the actual level of the HDI and the level one would predict for a country based on its income per capita. The RICE index represents this difference.

poverty increased, including Madagascar, Nigeria, Zambia, and Zimbabwe, the authors speculate that other events, including macroeconomic instability and environmental shocks, played a larger role. This study is notable for rejecting formal econometrics and rather employing simple bivariate correlations, which is understandable given the small size of the authors' sample set.

Collectively analyzing these disparate studies reveals that the rule of law indicator may have little impact on a more equitable income distribution but impact poverty reduction by stimulating growth. The political risk component of the ICRG index appears to provide few conclusive results. Indeed, it is associated with greater income inequality and lower human development outcomes but appears to be correlated with poverty reduction in a few African countries. These inconclusive and contradictory results probably reflect the inappropriate use of the ICRG index for analyzing poverty impacts. Indeed, confirming a concern mentioned in Section 2, it might indicate that the political factors that attract foreign investors are not necessarily indicative of a decision-making environment that actively includes the poor in the growth process (Moore *et al* 1999). Lastly, the finding that greater political stability is associated with higher poverty reflects the lack of adequate theory linking this variable with poverty outcomes (linkages C-E and E-D-F-G-H). An unstable political environment certainly reduces confidence and the credibility of government policy commitments. On the other hand, long-ruling, autocratic regimes can create political stability but may lack a developmental vision that promotes the interests of the poor. Indeed, this highlights that one shortcoming of the governance indicators included in these studies is that they do not capture the political orientation of the governments in power.

Political System

As postulated in the conceptual framework of Figure 1, the decision-making environment prevailing in a particular country is shaped by a country's political system (Box C). Empirical research has shown that growth is associated with a wide range of political systems (Alesina and Perotti 1994; Moore and Putzel 1999; Potter 2002) but it is

not clear that the same is true with regard to poverty reduction. Achieving pro-poor outcomes often depends on whether the poor can effectively organize to influence policy (Klasen 2002). Notwithstanding the difficulties of collective action caused by information asymmetries and geographic isolation, the opportunity for the poor to actively influence policy is severely circumscribed under closed regimes that limit political participation and competition. Open and competitive political environments may not only empower the poor on their own behalf but also reduce inequality by diminishing the ability of the rich to lobby exclusively for policies in their own favor (Li *et al.* 1998; White and Anderson 2001).

As indicated above, governance indicators that refer to a political system's degree of openness and participation include the civil liberties and political freedom indices by Freedom House and the voice and accountability index of the KK Dataset. The empirical results show that the choice of indicator as an independent variable matters, especially since the results are less consistent using the Freedom House indices than they are using the World Bank index. Specifically, Li *et al.* (1998) use a sample of 49 countries spanning the period from 1947 to 1994 and employ an OLS estimation to examine the relationship between the civil liberties index and various dependent variables capturing inequality, including the Gini coefficient, the real income of the top quintile of the population, and the real income of the bottom 80 percent of the population. They discover that improvements in civil liberties are positively and significantly associated with increases in the incomes of both the poor and the rich as well as a decrease in the Gini coefficient. Their study suggests that a one standard deviation decrease in the civil liberties index could lead on average to a 0.77 percent increase in the poor's income and a 0.40 percent increase in the rich's income.[15] Similarly, Chong and Gradstein (2004) note that improved performance on the civil liberties and political freedoms index, as well as a simple average of the two, yields a significant and negative correlation with the Gini coefficient.

[15] As noted in the discussion on indicators in Section 2, the civil liberties and political freedom indices are constructed in such a manner that a higher score actually implies worse performance.

However, these two studies are contradicted by White and Anderson (2001), who analyze 143 growth episodes to determine which variables have the greatest impact on the share of incremental income received by the poorest 20 and 40 percent of the population as well as changes in their share of income. Because their dependent variables are expressed as first differences, they attempt to reduce multicollinearity by expressing all of their explanatory variables, including civil liberties and political freedoms, as first differences as well. They discover that an improvement in civil liberties over time actually demonstrates a negative and statistically significant correlation with the incomes received by the poor. In fact, a one standard deviation decrease in the civil liberties index results in a 0.13 percent decrease in the share of incremental income received by the poorest 40 percent of the population. On the other hand, they also find that a negative change that results in the deterioration of political freedoms is significantly correlated with a decrease in the share of income that accrues to the poor. The authors claim that this disparity may be because civil liberties provide a voice for well-organized interest groups while political freedoms are advantageous to a broader group of individuals. However, this explanation is not very satisfactory considering that greater examination of the variables that constitute the civil liberties and political freedom indices does not suggest this.[16] Even more confusingly, they also find that civil liberties are positively associated with growth while political freedoms are negatively associated with it. Yet, neither governance variable is statistically significant in these growth regressions.

In order to assess the joint determinants of growth and inequality, Lundberg and Squire (2003) examine a sample of 125 countries and use both the GDP per capita in 1985 purchasing power parity (PPP) terms and the Gini coefficient as their dependent variables. In order to reduce reverse causality between a number of their policy variables and the dependent variables, as well as to correct for correlations with omitted

[16] Indeed, the political freedoms index is comprised of the following components: electoral process, political pluralism and participation, and functioning of government. The civil liberties components are: freedom of expression and belief, assocational and organizational rights, rule of law, personal autonomy and individual rights (Freedom House 2003).

characteristics, the authors rely on a three-stage least squares (3SLS) technique and incorporate a number of instrumental variables. Regardless of this different approach, they support the finding of Li *et al.* (1998) that a better rating in the civil liberties index is positively and, significantly, associated with a reduction in the Gini coefficient. However, they contradict White and Anderson (2001) by showing that greater civil liberties are negatively, and in their case significantly, correlated with growth in per capita incomes. In particular, a one standard deviation decrease in the civil liberties index leads to a 0.56 percent decrease in the growth of per capita incomes.

Freedom House's civil liberties and the political freedom indices, along with indicators from six other sources are integrated into the voice and accountability index of the KK Dataset. Research by Dollar and Kraay (2002) shows that the voice and accountability indicator is positively correlated with income growth amongst the poorest quintile of the population. While the relationship is significant at the ten percent level, the magnitude of the coefficient is quite small, such that a unit increase in a country's voice and accountability indicator will lead on average to a 0.095 percent increase in the poor's incomes. Likewise, in Arimah (2004), voice and accountability is negatively correlated with the percent of the population living below the national poverty line and is significant to the one percent level. When examining poverty spells, Kraay (2004) found that the voice and accountability indicator is positively correlated with the growth component of the poverty changes but also positively correlated with the poverty-increasing distributional component. Neither correlation, however, is statistically significant.

Altogether, these studies suggest that a more open political system is pro-poor in terms of increasing incomes and reducing the poverty headcount. Yet, they are less clear about what the intervening mechanism is, i.e. increased growth, improved equity, or a combination of both, that leads to such outcomes.

Policies and Strategies

In the framework proposed here (see Figure 1), development policies and strategies are considered to be conceptually different from governance. However, as mentioned in Section 2.1, the adoption of "sound" policies is often considered an element of good governance, especially by donor organizations.[17] Against this background, it appears useful to briefly review what the studies examined in this paper found regarding the impact of different policies on pro-poor growth. The authors concentrate on two major policy areas often considered to be related to good governance: macroeconomics and trade policies, and the provision of public goods.

Macroeconomics and Trade:

Macroeconomic stability is already widely accepted as a crucial component of pro-poor growth (Klasen 2001). For instance, both Lundberg and Squire (2003) as well as Lopez (2004b) show that lower inflation is negatively and significantly correlated with the Gini coefficient while positively and significantly correlated with growth. Thus, by increasing growth and reducing inequality, low inflation would presumably also be pro-poor. Dollar and Kraay (2002) confirm this assumption by showing that higher inflation is associated with a lower share of income that accrues to the poor, although the relationship is not significant. Using a broader measure of macroeconomic stability, namely, an index that combines fiscal, monetary, and exchange rate policies, Christiaensen *et al.* (2003) find that the poverty headcount decreased in the African countries in their sample that experienced an improvement in this macroeconomic policy index.

The results are more ambiguous regarding trade openness. In Dollar and Kraay (2002), trade openness, measured as the ratio of exports plus imports to GDP, is correlated with growth and appears to be poverty-reducing. Using the same measure, Kraay (2004) observes that trade openness is associated with reduced poverty through both its growth and distribution components. Yet, using the Sachs-Warner index, which

[17] See footnote 9.

captures a country's exchange rate, tariffs, and nontariffs barriers, Lundberg and Squire (2003) find that trade openness is positively and significantly related to both growth *and* the Gini coefficient. This implication of a potential trade-off between growth and inequality is also supported by Lopez (2004b) who measures trade openness as the volume of trade adjusted by a country's size and population and according to whether it is landlocked and an oil exporter. Although these conflicting results are probably due to the use of different trade openness measures, they may also reflect that the impact of trade openness on the poor may vary according to the sectors in which the poor are concentrated. Moreover, some portions of the population better adjust during the process of trade openness. As such, examining the relationship between trade openness and inequality over the short and long terms could add more insight about the dynamics of this variable. Lopez (2004b) did exactly this and found that while trade openness appears to increase poverty in the short run, it is negatively correlated with poverty in the long run.

Provision of Public Goods:

Public goods can play an important role for promoting growth and reducing poverty, but their provision may also involve trade-offs with regard to growth and poverty reduction. The studies included in this review focus on two elements of public goods provision: the impact of overall government spending as well as the benefits from the actual public goods.

Total government spending appears to be uniformly antigrowth in the three studies in which it was examined but, the impact on the poor is less clear. For Dollar and Kraay (2000), total government consumption is negatively associated at a statistically significant level with both growth and with growth in incomes of the poor. Interestingly, while Kraay (2004) also found a negative correlation between government consumption and growth, his study unveiled that government consumption appears to improve distribution in a manner that reduces poverty. This echoes Lopez (2004b) where reductions in government spending correlate positively with income growth but

negatively with inequality. These results are significant to the 1 percent level. Thus, it appears that high levels of government spending diminish growth but also shift the income distribution in a manner that is more pro-poor.

Obviously, the relationship between government spending, growth, inequality, and poverty depends on how the resources are actually allocated. Aggregating all government consumption together prevents a comprehensive understanding of which areas have the greatest pro-poor potential. Unfortunately, only two studies actually focused specifically on social expenditures and arrived at very different results. While Arimah (2004) finds that expenditures on health and education are positively correlated with reductions in poverty, Dollar and Kraay (2000) uncover a negative association between these expenditures and the income growth of the poor. They argue that this finding may indicate that the rich and middle class are more likely to benefit from these expenditures and, therefore, the share of public spending devoted to social sectors does not accurately capture whether a government is pro-poor.

On the other hand, a key area for social expenditures, education, has been extensively studied with uniformly positive results. Both Arimah (2004) and Dollar and Kraay (2000) observe a positive correlation between primary schooling and poverty reduction, although the correlation is only significant in the former study. Nevertheless, Dollar and Kraay (2000) do note a positive and significant correlation between the number of years of secondary schooling per worker and growth. Measuring human capital as a log of gross secondary school enrollment, Lopez (2004b) finds the same results with growth as well as a positive and statistically significant relationship with reduced income inequality. Likewise, Lundberg and Squire (2003) discover that the number of years of schooling is negatively and significantly correlated with inequality.

Summary

Examining the admittedly scant cross-country literature linking governance with pro-poor growth reveals some contradictory and even counterintuitive findings. Tables 1 and 2 synthesize the findings from the cross-country studies about the relationship

between pro-poor growth and those governance variables capturing the "decision-making environment" and the "political system." The pluses indicate that improvements in the respective governance variable will impact the corresponding measure of pro-poor growth in a favorable manner. For instance, one study (Chong and Gradstein, 2004) found that greater political stability is associated with a lower Gini coefficient, which is a positive outcome and, therefore, represented with a plus sign. On the other hand, since one study (Arimah, 2004) found that greater political stability actually leads to a larger share of the population below the national poverty line, a negative sign is used to indicate this negative outcome. Asterisks signify that the relationship was statistically significant. Multiple plus or minus signs in one particular box indicates that more than one study examined the relationship between that particular governance indicator and the corresponding pro-poor growth measures. As the tables show, few studies used the same measures of both governance and pro-poor growth. Moreover, there are many empty cells in these tables, which emphasizes that the relationship between governance and pro-poor growth has yet to be explored along these dimensions.

With regard to policies and strategies, the picture is only slightly clearer. According to the findings described above, only macroeconomic stability and education policies appear to promote simultaneously growth, equity, and poverty reduction. Trade openness may increase growth but at the expense of greater equality. On the other hand, government spending may contribute to greater equality but also reduce growth and increase poverty.

Table 1. Synthesis of Findings between Variables Describing the Decision-Making Environment and Pro-Poor Growth Measures

Components of Pro-Poor Growth	*Independent Variables*		
	Political Stability	ICRG Political Risk Index [a]	Rule of Law
Growth		+ *	+ * +
RICE		-- *	
Population below national poverty line	-- *		
Population on less than 1USD per day	+		
Human Poverty Index	+		
Incomes of the poorest 20%			--
Distribution component of change in the poverty headcount			--
Ratio of top to bottom quintiles	+ *	+ *	
Income share of the middle quintile	+ *	+ *	
Gini Coefficient	+ *	+ *	
Change in the Gini coefficient			--
Change in log of Gini coefficient		-- *	

Notes: [a] The results presented indicate have been adjusted to assume that a greater value on the ICRG Index is equivalent to greater performance. Asterisks signify that the relationship uncovered was statistically significant.

Table 2. Synthesis of Findings between Political System Variables and Pro-Poor Growth Measures

Components of Pro-Poor Growth	*Independent Variables*				
	Voice and Accountability	Gastil Index of Liberties[a]	Civil Liberties Index	Political Freedom Index	Change in Political Freedom
Growth	+		-- *		
Population below national poverty line	+ *				
Population on less than 1USD per day	--				
Human Poverty Index	+				
Incomes of the poorest 20% of the population	+ *		+ *		
Change in share of income for poorest 20%					+
Change in share of income for poorest 40%			-- *		+ *
Distribution component of change in the poverty headcount	--				
Share of incremental income received by the poorest 40%			-- *	+	+ *
Share of incremental income received by poorest 20% of the population					+
Incomes of the richest 80%			+ *		
Ratio of top to bottom quintiles		+ *			
Income share of the middle quintile		+ *			
Gini Coefficient		+ *	+ * + *		
Change in the Gini coefficient	--				

Notes: a The results presented have been adjusted to assume that a greater value on the Gastil, Civil Liberties, and Political Freedom Indices is equivalent to greater performance.

V. DISCUSSION

This review highlights that, despite the general assumption that good governance promotes pro-poor growth, there is relatively little evidence from cross-country research unequivocally confirming the linkages between these two concepts. This is not to deny that such a link exists but rather to identify the challenges faced by cross-country studies in understanding *how* these vaguely-defined concepts are linked. Below, the methodological challenges in these studies are addressed and recommendations for further research in this area are presented.

Methodological Challenges

Problems of Comparison

Econometric studies typically suffer from biases created by omitted variables, the ubiquitous problem of endogeneity, and time lags between changes in governance and changes in income and poverty. Poverty dynamics not only are influenced by a number of factors that lie outside the realm of governance but also impact the decision-making environment and the political system. As the framework presented in **Figure 1** suggests, the decision-making environment, political system, and policies/strategies may also be highly correlated with each other. Moreover, the lack of adequate theory linking governance with pro-poor growth precludes determining the proper functional form that regression analyses should adopt. As described above, the studies reviewed here use different econometric methods (see also Table A.2 in the Annex for a summary). While it is to be expected that various econometric techniques are used to meet the methodological challenges inherent in cross-country studies, this contributes to the difficulties in comparing the findings of these studies.

The challenges of comparison are further compounded by other methodological differences. The impact of governance on pro-poor growth undoubtedly varies across countries and over time. As **Appendix 1** clarifies, the studies reviewed here range from including 42 countries to 193; from an Africa-only sample to samples that incorporate

only one African country; from a period of five years to one of fifty. Moreover, no two studies use the same measurement for both governance and poverty or inequality, which more generally reflects the lack of consensus regarding how to define governance and pro-poor growth discussed in Section 2.

Interpreting Governance Indicators

Despite the many differences among the studies, they all exclusively incorporate subjective governance indicators that are derived from expert polls or surveys. The benefits and disadvantages of subjective indicators, as opposed to objective ones, are critical because the choice of approach has significant implications for not only how governance is measured but also what a governance indicator is actually capturing. Implicit within subjective indicators are normative assessments about the most preferable types of governance. In some respects, this is a practical approach since for many dimensions of governance, only a few objective indicators are available for a small group of countries (Besançon 2003). This is especially true for those dimensions of governance, such as corruption, that are characterized by their illegality and therefore purposely not quantified (Kaufmann 2002; Kaufmann et al., 2003).

Subjective indicators may also better capture a government's success at achieving certain outcomes since *de facto* and *de jure* performance may diverge significantly (Aron 2000; Kaufmann 2002). Simply because a country has written laws protecting property rights does not necessarily mean that they are enforced in practice, nor does the existence of elections indicate a functioning democracy. Moreover, objective measures may only capture a narrow element of *government* performance without providing a broader understanding of *governance* (Kaufmann et al., 2003).

However, in order to understand processes, which are related to the underlying factors and institutions that determine *how* rather than *what* outcomes are achieved, objective indicators may be preferable (Besançon 2003; Court, Hyden, and Mease 2002; Henisz 2001). One advantage of objective indicators is that they offer practical implications for policy (Besançon 2003). Indeed, while a subjective indicator may show

that a country demonstrates extreme policy volatility, an objective indicator could reveal that this is due to lack of checks and balances between various branches of government. Moreover, the choice and construction of objective governance indicators is often embedded in political and political economy theory, while subjective indicators may instead reflect the biases or client needs of the organizations that created them (Besançon 2003). This can diminish their legitimacy among developing country governments, who can in turn blame their poor rankings on Western-imposed ideas of "good governance."

Objective indicators are also usually more transparently constructed and therefore more easily replicated (Knack and Kugler 2002). It is difficult to replicate the construction of subjective indicators that are based on surveys since the respondents' answers can vary according to their cultural and socioeconomic backgrounds (Court, Hyden, and Mease 2002). With both surveys and polls, there is always the possibility that answers are influenced by recent changes in growth, highly publicized political events, or hysteresis, i.e. countries cannot escape past perceptions of their performance (Aron 2000).

Lastly, subjective indicators are more amenable to aggregation than objective ones. On the one hand, this helps reduce the impact of idiosyncratic factors and provides a more accurate view of governance within a country than each of its component variables (Kaufmann, Kraay, and Mastruzzi 2003). Yet, as Keefer (2004a) notes, aggregation only makes sense "if all good things go together," and in many cases, they do not. From a policy standpoint, improving governance requires addressing each of its components separately and understanding which components deserve priority, a step that can be hindered by aggregation (Besançon 2003; Keefer 2004a).

The problems caused by aggregating indicators are well reflected in this review. For instance, why does improving voice and accountability appear to increase the incomes of the poor? And why do some studies find this is not the case when two components of the voice and accountability index, civil liberties and political freedom, are examined separately? These ambiguities are often exacerbated by the mixture of inputs and outcomes in these indicators. The ICRG's political risk component, for

example, includes among other variables the extent of the military in politics, ethnic tensions, democratic accountability, and bureaucratic quality. All three variables influence each other, but by aggregating them together there is little understanding of where trade-offs exist among them.

Areas for Further Research

In spite of the methodological challenges inherent in such research, empirical work on the interaction between governance and pro-poor growth remains a worthwhile undertaking, particularly since donors often base policy decisions on the assumption that a relationship exists. There are, however, opportunities to make such research more policy-relevant and to offer greater understanding of how these two concepts are related.

Linking Political Systems and Policies

The studies included in this review focus on how Boxes C, E, and F each separately affect pro-poor growth without examining their interaction with the political process (Box D). Political processes implicitly are dynamic phenomena that are difficult to capture with static methods, but theory and cross-country research in political economy offers some preliminary ideas about how to understand the links between the political institutions and policy choices.

For example, there is a growing literature on whether and how autocracies and democracies vary in regards to their spending on and provision of public goods. Deacon (2002) claims that economic and political resources are more likely to be concentrated among a small elite in autocracies, and this elite will have few incentives to use their resources to fund public goods that benefit the broader populace. Using data on autocracies and democracies from Polity IV, he finds that democracies tend to provide significantly more roads, schools, safe water, and sanitation facilities than autocracies.[18]

[18] Polity IV is a dataset compiled by the Center for International Development and Conflict Management at the University of Maryland, College Park that assesses the extent to which a democracy is institutionalized. Based on historical, social science works, and national constitutions, Polity IV calculates indicators of democracy and autocracy on a 0 to 10 score where 10 indicates a high degree of that system and 0 a low degree. By subtracting the autocracy score from the democracy 1, a polity score can be derived ranging

On the other hand, Keefer and Khemani (2003) note that while the median voter theorem would predict broad social service provision in democratic developing countries where a majority of the population is poor, the reality is much different. They highlight three factors that explain this phenomenon: information asymmetry among voters, identity-based voting caused by social fragmentation, and the difficulty of discerning the credibility of political promises to citizens. Mulligan *et al*. (2004) substantiates these assumptions by also using the Polity IV database and analyzing panel data for 142 countries divided between two periods, 1960-1974 and 1975-1990. They find no difference between democracies and autocracies in relation to their total government consumption, education spending, and social spending, such as on pensions and social security programs.

The heterogeneity among democracies, especially in regard to electoral institutions, might partially explain these divergent findings. Based on panel data for approximately 61 countries between 1960 to 1998 and using social security and welfare spending as either a percentage of GDP or as a ratio to spending on goods and services, Persson (2002) finds that both presidential regimes and majoritarian electoral systems are correlated with lower government spending than parliamentary regimes and proportional electoral systems.

Further political economy research that focuses on how to achieve the policies and strategies that have been shown to be pro-poor would offer important insights on governance processes. This would also involve integrating into the cross-country research more objective indicators that, as noted above, capture *process* much better than subjective ones that assess *performance*. One source of these indicators is the Database of Political Institutions, which contains for 177 countries 108 variables related to elections, election rules, the type of political system, level of military influence on the

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from -10 to 10. The dataset also examines the durability of the polity according to the number of years since the last transition as well as the regulation, competitiveness and openness of executive recruitment; the regulation and participation in the political system, and the level of constraints on the executive (Marshall and Jaggers 2002). Currently, the Polity IV dataset covers 161 countries from 1800 to 2003.

government, measures of checks and balances, political stability, and composition of ruling and opposing government coalitions. As such, it can assist with analyzing the political institutions conducive to development and the conditions under which such institutions emerge (Beck *et al* 2001).

It is important to note, however, that political economy models also face limitations in terms of capturing the role that differences in education, ethnicity, religion, and culture, play in determining political processes. Moreover, the power of ideas, such as political ideologies and public discourse, are not adequately captured in models focusing on political institutions. In addition, incorporating political economy models on political systems and policy into cross-country analyses that ultimately aim to explain pro-poor growth will certainly pose even more methodological challenges than those highlighted above.

Taking the Role of External Actors into Account

Besides exploring political economy approaches to understand political processes, there is also scope for examining the diversity of actors influencing the political system. In particular, the studies reviewed here tend to focus on how governments alone should achieve pro-poor growth, and the subjective indicators they use are predominantly intended to assist donors in allocating resources to well-governed countries and to help investors avoid volatile portfolios.

There is little examination of how external actors, such as donors and foreign investors, impact the behavior of national governments and, in turn, indirectly influence the opportunity for pro-poor outcomes. Yet, there is growing evidence that they play a role. For instance, Moore *et al.* (1999) show that foreign aid as a share of GNP reduces RICE, and Leonard and Strauss (2003) argue that foreign aid can contribute to the same negative effects often associated with enclave economies by reducing government's accountability to their citizens. Knack's (1999) cross-country analysis likewise reveals that higher levels of foreign aid, even after controlling for income levels, erode the quality of political institutions. Similarly, while the private sector can be adversely

affected by unpredictable decision-making environments and weak political institutions, it can also contribute to these problems (Kaufmann 2003). Examining how the quality of governance is affected by external actors offers a fruitful area for future research and exploring how to make research on governance and pro-poor growth more relevant for policymakers in terms of identifying priority areas for intervention.

Grouping Countries and Other Approaches

Cross-country analyses that distinguish *ex-ante* among countries with similar characteristics and uncover priority areas that are specific to a country's economic or political development level represent another avenue for potential research. Indeed, Kaufmann (2003) highlights that the priorities for mature democracies will vary quite substantially from those that are quite young. Grindle (2004) advocates examining the governance needs for achieving poverty reduction and growth by dividing developing countries into collapsed states, poor but stable countries, and emerging market economies. Another approach to be considered to study the relationship between governance and pro-poor growth is to conduct analyses at the subnational level (cross-region regressions). This appears useful in large countries that display substantial variations in regional governance as well as growth and poverty outcomes. China, India, Indonesia and Nigeria would be examples. There is also a considerable potential to learn from pair-wise comparisons of countries. Research on other issues showed that by comparing India and China, it was possible to gain insights that could not have been derived from either cross-country regressions or cross-region regressions in one country (Gulati et al., 2005).

In addition, innovative approaches in econometrics could be incorporated to examine thresholds and nonlinearities in the development process and thereby help address sequencing issues.[19]

[19] Zhang (2004) offers a useful example of this approach. Using household data from Uganda, Zhang found that there is a threshold level of security below which public investments in infrastructure and education have little impact on growth.

VI. CONCLUSIONS

The concepts of governance and pro-poor growth in relation to developing countries are not necessarily new. Indeed, during the early postcolonial period, numerous theories emerged about the relationship between political systems and economic growth, which continue to be debated and researched today. Likewise, the notion of "redistribution with growth" in the 1970s highlighted that without ameliorating inequality, growth alone would only benefit a narrow segment of the population. Various studies subsequently explored whether and how growth and inequality affect each other.

Yet, these topics have recently reemerged in a more nuanced fashion. "Governance" is no longer confined to debates over democracy and authoritarianism but rather concerned with, among other things, the interaction between different stakeholders within the state, policy processes, and the evolution and maintenance of political institutions. Hundreds of indicators, both subjective and objective, have emerged to capture these new conceptualizations. Similarly, the pro-poor growth literature has helped focus attention on the importance and measurement of the growth-inequality-poverty nexus as well as the distinction between relative and absolute notions of pro-poor growth.

Despite the importance of governance and pro-poor growth on the current development agenda, however, there have been few attempts thus far to comprehensively explore their interactions with each other. As a result, a majority of the pro-poor growth discourse remains embedded in an apolitical framework, focusing predominantly on which policies should be pursued rather than on the political institutions that best foster these policy outcomes. On the other hand, the good governance literature does not adequately distinguish between which aspects of governance are conducive to growth and which determine whether the poor are capable of participating in the growth process. As a result, Grindle (2004) notes that there is little understanding of what should be the governance priorities if poverty alleviation is the objective: "Among the governance reforms that 'must be done' to encourage development and reduce poverty, there is little

guidance about what's essential and what's not, what should come first and what should follow, what can be achieved in the short term and what can only be achieved over the longer term, what is feasible and what is not" (p.526).

This review examined a small sample of empirical studies that, while not exclusively focused on uncovering the relationship between governance and pro-poor growth, offer a number of important insights about the challenges of such an undertaking. In particular, countries are at different economic and political stages of development, and there is a lack of theory regarding the time lags and direction of causality between good governance and pro-poor growth. Moreover, the lack of consensus over the definition and measurement of both governance and pro-poor growth precludes arriving at any concrete conclusions from a comparative analysis. Indeed, the studies reviewed here often yielded counterintuitive and, when compared with each other, even contradictory results.

The definitional ambiguity regarding governance is reflected in the choice of indicators (subjective versus objective, aggregated versus nonaggregated) used as explanatory variables and, in turn, affect the overall policy relevance of these studies. Specifically, by using aggregate indicators that capture governance outcomes, it is difficult to discern from these studies how such outcomes are achieved and which aspects of governance are most important. Although they pose additional methodological challenges, political economy models that incorporate objective, process-oriented indicators are a promising approach for understanding how the political system affects policy choices and ultimately pro-poor growth. Likewise, integrating more disaggregated indicators that focus on specific aspects of governance, such as freedom of the press or the form of democracy, would highlight which components of the good governance concept are most conducive to pro-poor growth.

Ultimately, however, arriving at a more comprehensive understanding of the linkages between governance and pro-poor growth involves combining cross-country regressions with micro-level analyses, case studies, and historical narratives (Grindle 2004; Kraay 2004). This is particularly important since the notion and relevance of good

governance varies according to the sociocultural and political contexts prevailing in a particular country or community. Case studies can, in turn, inform the choice of structure and variables included in cross-country research.[20] Otherwise, "good governance" and "pro-poor growth" will remain donor buzzwords describing the goals of international development initiatives but whose relationship with each other is actually poorly understood.

[20] For example, David Laitin (2002) advocates the tripartite method in the subfield of comparative politics. This method uses formal theory and narratives to complement statistical analyses.

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APPENDIX

Table A.1. Cross-country Studies Examining Dimensions of Governance and Pro-poor Growth

Source	Objective and Methodology	Main Findings
1. Arimah, Ben C. 2004. "Poverty Reduction and Human Development in Africa," *Journal of Human Development*, Vol. 5, No.3: 399-415.	Analysis of how different variables commonly associated with promoting development impact poverty across approximately 33 African countries. The dependent variable, poverty, is measured in three ways: percent of population below the national poverty line, percent below the international poverty line, and the human poverty index. The independent variables include expenditures on health and education, primary school enrollment, HIV/AIDS, economic growth, voice and accountability, and political stability.	The social expenditures have a positive impact on reducing poverty levels, and this finding is significant for education expenditures. HIV/AIDS has a negative and statistically significant impact on reducing poverty levels. While voice and accountability has a positive and statistically significant impact on reducing poverty levels at the national level, political stability actually has a negative and statistically significant impact on reducing poverty levels at the national level. The author attributes this counterintuitive result to the fact that there is high correlation between the political stability and voice and accountability indicators.
2. Chong, A. and M. Gradstein. 2004. "Inequality and Institutions," Working Paper No.506, Inter-American Development Bank: Washington, DC.	Using vector autoregressions in a panel setting, this study focuses on the linkages between political institutions and income inequality for 121 countries. Gini coefficients proxy for inequality while the six indicators in the KK dataset, the ICRG, civil liberties and political freedom indices, and country credit ratings are used to measure political institutions.	Regardless of the measure of political institutions used, the authors discover that poor institutions and income inequality reinforce each other. In fact, the impact of inequality on institutions is actually greater than the reverse direction of causality. The political stability indicator from the KK dataset appears to play the largest role in both cases, i.e., it is the variable that has the largest influence on inequality and the one that deteriorates the most the more unequal the income. Moreover, the impact of income distribution on political institutions is greater in developing countries than in industrialized ones.
3. Christiaensen, L., Demery, L., and S. Paternostro. 2003. "Macro and Micro Perspectives of Growth and Poverty in Africa," *The World Bank Economic Review*, Vol. 17, No.3: 317-347.	Combines macroeconomic and policy/ institutional data with household survey data from the 1990s for Ethiopia, Ghana, Madagascar, Mauritania, Nigeria, Uganda, Zambia, and Zimbabwe to uncover correlations with poverty reduction. The macroeconomic index draws on Bouton et al 1994 and combines fiscal, monetary, and exchange rate	They find that the poverty headcount (P0) decreased in countries that also experienced an improvement in their macroeconomic policy score. The two exceptions are Zambia and Zimbabwe, which experienced an increase in poverty despite improvements in macro-policy and which might hint at the time-lag between implementing reforms and ensuring that they are not reversed. They also find

Source	Objective and Methodology	Main Findings
	policies. The policy/institutional data is based on the ICRG index.	that P0 decreased in those countries that experienced an improvement in their political risk score. For those that didn't experience a P0 decrease despite improvements, other factors such as droughts played a role.
4. Dollar, D. and A. Kraay. 2002. "Growth is Good for the Poor," *Journal of Economic Growth*, Vol. 7: 195-225.	Using income and inequality data for 92 countries between 1950-1999, the authors examine the impact of growth in per capita incomes on the incomes of the poor, who are defined as the poorest 20% of the population (bottom quintile). They, then examine whether the policies and institutions associated with growth also have an impact on poverty. Thus, they include inflation, government consumption, exports and imports relative to GDP, financial development, and rule of law as independent variables in bivariate regressions. In order to determine whether certain policies considered pro-poor have a greater impact on the incomes of the poor, they also analyze bivariate relationships using primary education, agricultural productivity, total government consumption, social spending, and voice and accountability.	There is a one-to-one relationship between the growth in mean incomes and the growth of poor incomes. Moreover, the policies and institutions that promote growth also benefit the poor. Specifically, secondary education, financial development, and rule of law are all positively and significantly associated with growth while inflation and government consumption are negatively associated with growth, with only the latter statistically significant. Among the variables traditionally associated with poverty reduction, primary education, agricultural productivity, and voice and accountability are positively associated with growth in the incomes of the poor, with only the latter statistically significant at the 10% level. Social spending and total government consumption are negatively associated with growth in incomes of the poor, with only the latter statistically significant at the 1% level.
5. Kraay, A. 2004. "When is Growth Pro-Poor? Cross-Country Evidence." World Bank Policy Research Working Paper 3225, Washington DC.	Uses poverty surveys to look at short- and long-term poverty spells that cover 58 countries. He then proceeds with univariate regressions where the dependent variables are the distribution component of change in growth, the Gini, and in P0, P1, P2, and Watts poverty measures. The independent variables include rule of law, CPIA, openness to international trade, inflation, the size of government, the ratio of M2 to GDP, voice and accountability, relative productivity in agriculture, and primary educational attainment.	Between 60 and 95 percent of poverty changes are due to growth in average incomes. In the short-term, however, changes in income distribution are relatively more important. In the univariate regressions, most of the variables were insignificant. Nevertheless, the general pattern is that rule of law as well as voice and accountability are both positively correlated with growth and with distributional changes (this means that they are correlated with poverty-increasing shifts in relative incomes). Openness to international trade has a positive correlation with growth and correlated with more poverty-reducing shifts in incomes. Government consumption is negatively correlated with growth and negatively correlated with distributional change (meaning more poverty-reducing).

Source	Objective and Methodology	Main Findings
		Relative productivity in agriculture is uncorrelated with growth but tends to be positively correlated with distributional change (i.e., more poverty-increasing).
6. Li, H., Squire, L., and H. Zou. 1998. "Explaining International and Intertemporal Variations in Income Inequality," *Economic Journal*, Vol. 108: 26-43.	This article's objective is to examine factors that influence inequality. The political economy literature emphasizes that the rich have the resources to lobby for policies that benefit themselves. The capital imperfections literature stresses that credit constraints prevent the poor from making productive investments and exacerbate inequality. Thus, using data for 49 countries over the period from 1947 to 1994, the dependent variables are alternatively the Gini coefficient, the real income of the top quintile of the population, and the real income of the bottom 80 percent of the population. To examine the political economy argument, they use the civil liberties index and level of secondary schooling and for the capital imperfections argument, they use land inequality and financial market development as explanatory variables.	Financial development is negatively related to income inequality, and land inequality is positively related to future income inequality. Years of schooling and high levels of civil liberties are both negatively related to income inequality. All of these correlations are statistically significant. They confirm these findings with their alternative dependent variables. Indeed, years of schooling, financial development, and improvements in civil liberties are positively and significantly correlated with the income of the rich. Land inequality is not significant for the rich. For the poor, years of schooling, improvements in civil liberties, and greater financial depth are also positively correlated with income. However, land inequality is negatively and significantly correlated with income. Thus, for both rich and poor, years of school, civil liberties, and financial depth are associated with greater income growth and lower inequality. Land inequality is associated with greater inequality, particularly since it reduces the incomes of the poor.
7. Lopez, J.H. 2004. "Pro-growth, pro-poor: Is there a tradeoff?" World Bank Policy Research Working Paper 3378, World Bank: Washington, DC.	The goal of this paper is to assess whether policies that are pro-growth are also pro-poor. Using growth and inequality panel data for 41 countries, the author examines differences in the impact on growth and changes in the Gini coefficient caused by the following independent variables: human capital, financial development, government burden (log ratio of government consumption to GDP), infrastructure, the political risk component of the ICRG, trade openness, inflation rate, cyclical volatility, real exchange rate misalignment, banking crisis, and terms of trade changes.	Human capital, infrastructure, and low inflation both promote growth and reduce inequality. The ICRG however seems to increase inequality, which he speculates might be because once he controls for policies, the level of inequality is not related to the level of governance. Financial development, trade openness, and reductions in government spending appear to lead to faster growth but also increase inequality. Using growth-poverty elasticities, he finds that while these three policies might not be poverty-reducing in the shortrun, they are in the longrun. However, he claims that political economy constraints could prevent these three policies from staying in place long enough to reach that poverty-reducing level.

Source	Objective and Methodology	Main Findings
8. Lundberg, M. and L. Squire. 2003. "The Simultaneous Evolution of Growth and Inequality," *The Economic Journal*, Vol. 113: 326-344.	The objective of this paper is to uncover joint determinants of growth and inequality. Using data on inequality for 125 countries and on GDP per capita in 1985 PPP terms, they examine the impact of the following independent variables: share of government consumption, trade openness (Sachs Warner index), years of schooling, civil liberties, land distribution, and an interaction term between land distribution and a dummy for developing countries. They run a number of different regression forms, ranging from base, structural, and reduced-form models.	In general, they find that improving land inequality, reducing inflation, and improving education are correlated with both higher growth and lower inequality. However, greater trade openness is correlated with higher growth and higher inequality. On the other hand, increases in civil liberties are correlated with greater equality but lower growth.
9. Moore, M., Leavy, J., Houtzager, P., and H. White. 1999. "Polity Qualities: How Governance Affects Poverty," IDS Working Paper 99, University of Sussex: Sussex, England.	This paper examines which political variables are most effective in converting income into human development. Using data for 61 developing countries over the period 1980-1995, the authors construct an index called RICE (relative income conversion efficiency), which represents the difference between the actual level of the HDI (with GDP removed) and the level one would predict for a country on the basis of its income per capita (with 1995 as the base year). RICE was used as a dependent variable and it was regressed on five main independent variables: population density, contribution of mining/quarry to GDP, ratio of aid to GNP, quality of government institutions (ICRG), and Africa-related dummies.	They find that minerals as a share of GDP is negatively and significantly correlated with RICE. Aid as a share of GNP was also negative and sometimes significant. Surprisingly, the higher quality of institutions scored according to ICRG correlated negatively with RICE.
10. White, H. and E. Anderson. 2001. "Growth versus Distribution: Does the Pattern of Growth Matter?" *Development Policy Review*, vol. 19, no.3: 267-289.	Cross-country regressions for 143 growth episodes examine which variables impact changes in income inequality (based on shares of income and changes in shares of income). Main explanatory variables included GDP per capita growth, Gini coefficient, civil liberties, political rights, ethnic fragmentation, annual inflation, and trade openness. The authors also examine sectoral patterns of growth.	The higher the initial Gini, the less the poor benefit from growth. There are apparent trade-offs between growth and distribution. More civil liberties tend to have a less pro-poor impact while more political freedom tends to have a more pro-poor impact. Ethnic fragmentation appears to increase the poor's participation in the growth process. Agricultural growth tends to be *less* pro-poor while the opposite is true for growth in the service sector.

Table A.2. Examining the Magnitude of Governance Variables on Dimensions of Pro-Poor Growth[1]

Source	Estimation Technique	Explanatory Variable	Dependent Variable	Magnitude and Direction of Coefficient	Statistically Significant?
1.Arimah (2004)	OLS with a linear functional form; No techniques for endogeneity described	Voice and Accountability	Population below national poverty line	-9.379	Yes
			Population on less than 1USD per day	9.12	No
			Human Poverty Index	-0.937	No
		Political Stability OLS with a linear function form;	Population below national poverty line	13.972	Yes
			Population on less than 1USD per day	-4.59	No
			Human Poverty Index	-0.347	No
2. Chong and Gradstein (2004)	Vector autoregressions	Political Stability	Gini coefficient	-0.08	Yes
		Rule of Law	Gini coefficient	-0.016	Yes
		ICRG Political Risk Index	Gini coefficient	-0.051	Yes
		Civil Liberties Index[2]	Gini coefficient	-0.01	Yes
		Political Freedom	Gini coefficient	-0.01	Yes
3. Dollar and Kraay (2002)	OLS with a linear function form; Endogeneity addressed by averaging the explanatory variables over a five-year time span for the period preceding their data for the dependent variables	Rule of Law	Growth	0.18	Yes
			Incomes of the poorest 20%	0.032	No
		Voice and Accountability	Incomes of the poorest 20%	0.095	Yes
4. Kraay (2004)	Univariate regressions	Rule of Law	Growth	0.012	No
			Change in Gini	0.002	No
			Distribution component of change in poverty headcount	0.016	No
		Voice and Accountability	Growth	0.002	No
			Change in Gini	0.006	No
			Distribution component of change in poverty headcount	0.003	No
5. Li, Squire, and Zou (1998)	OLS with a linear functional form; Instrumental variables used to address endogeneity for other explanatory variables not addressed here, such as financial depth	Civil Liberties Index *(A higher index value indicates worse performance)*	Gini coefficient	1.61	Yes
			Incomes of poorest 20%	-0.77	Yes
			Incomes of richest 80%	-0.4	Yes

Source	Estimation Technique	Explanatory Variable	Dependent Variable	Magnitude and Direction of Coefficient	Statistically Significant?
6. Lopez (2004)	Two-step generalized methods of moments (GMM) estimator developed by Arellano and Bond (1991) to ensure that the error term is not correlated with the lagged dependent variable	ICRG Political Risk Indicator *(A higher index value indicates worse performance)*	Growth	0.006	Yes
			Change in log of Gini coefficient	0.006	Yes
7. Lundberg and Squire (2003)	3 Stage Least Squares (3SLS) with a growth function to examine growth and a linear function to examine the Gini coefficient; Instrumental variables employed to account for endogeneity	Civil Liberties Index *(A higher index value indicates worse performance)*	Growth	0.567	Yes
			Gini coefficient	1.3207	Yes
8. Moore *et al* (1999)	OLS with a linear functional form; A time-lag is applied to the explanatory variables	ICRG Political Risk Index *(A higher index value indicates worse performance)*	RICE	-0.02	Yes
9. White and Anderson (2001)	OLS with a first differences functional form	Civil Liberties *(A higher index value indicates worse performance)*	Change in share of income for poorest 40%	0.001	Yes
			Share of incremental income received by poorest 40% of pop	0.134	Yes
		Political Freedom *(A higher index value indicates worse performance)*	Share of incremental income received by poorest 40% of pop	-0.103	No
		Change in Political Freedom	Change in share of income for poorest 40%	-0.006	Yes
			Change in share of income for poorest 20%	-0.002	No
			Share of incremental income received by poorest 40% of pop	-0.464	Yes
			Share of incremental income received by poorest 20% of pop	-0.069	No

Notes: [1] *The study by Christiansen, Demery, and Paternostro (2003) is excluded from this table since they did not employ econometrics but rather examined bivariate correlations and reviewed multivariate studies performed by others.* [2] *Chong and Gradstein (2004) rescaled the civil liberties and political freedoms indices from Freedom House such that in their study, higher scores on these indices imply greater performance.*

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