

Making Markets Work for the Poor

(Short Talk before the Society of International Development on 6/18/03, Noon-2PM at Chemonics International, 1133 20th St. NW).

I. **Poverty applies to households** (households, not individuals, are rich or poor);

II. Poor households will benefit sustainably when there is **greater competition (participation) in both output and factor (labor and capital) formal markets**. Because I am an economist, I (must) use demand and supply concepts in this talk.

My aim is to suggest that greater domestic private investment and the associated increased domestic competition in output and factor (labor and capital) markets will improve the incomes and economic security of the poorest twenty percent of households. I take a "closed economy" view: That domestic demand will expand without increased international trade. [Actually, I assume increased international trade is **derived from growth in the domestic economy.]**

I. POVERTY IS A HOUSEHOLD CONCEPT

- A. All of the survey data on poverty is collected household by household.
- B. \$1 per day is a poverty measure. For a household of seven people this is \$7 per day or \$2555 per household per year. Also, poor = lowest quintile (lowest 20% of households ranked by income).
- C. Poor Households get **richer and more economically secure** in four main ways:
 - 1. Increased employment (hours worked) by household members
(Increased demand for labor will reduce poverty)
 - 2. Increased compensation (e.g., wages) of employed household members
(Increased demand for labor will raise wages with full employment)
 - 3. Increased saving and investment
(Increased household ownership of capital will increase household income and economic security)
 - 4. Reductions in costs of food, which typically accounts for 65% of budgets of poor
(Increased Total Factor Productivity-TFP in Agriculture will lower real food costs)

II. IMPROVEMENT COMES WITH GREATER COMPETITION (PARTICIPATION) IN BOTH OUTPUT & FACTOR MARKETS

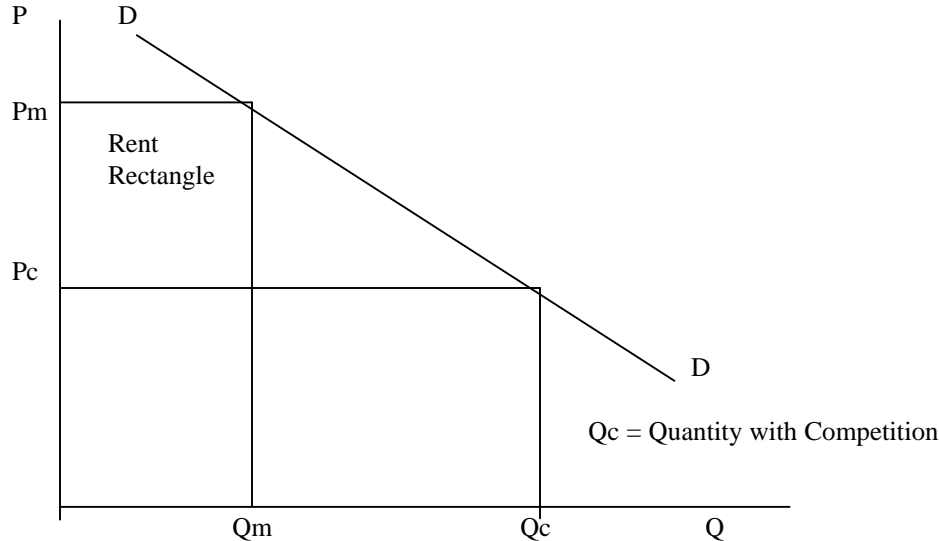
Below I first describe the existing, high poverty, monopoly situation that exists in most developing countries. I then set out the counterfactual: a description of the structure of an economic system that will reduce poverty. Finally I discuss some policies that will move economies from A to B.

A. Monopoly Means Low Employment (Participation) in Formal Economy

1. Rent-seeking through restrictions in output and employment
Monopolists move up the D curve and prevent more investment. This limits employment in the formal sector. They rely on foreign borrowing/grants for growth in Demand (shifting DD to left). Nigeria tires = example.

Figure 1: Monopoly Restricts Output (Q_m) & Employment

(Q_c = Output w/ easy entry [competition] & P_c = Price w/ competition)



2. A key is what is done with the Rent Rectangle. In Socialist theory it is supposed to accrue as a surplus that's reinvested. In fact it doesn't materialize as profits/surpluses. Instead it is used to finance **inefficiency** and prevent competing investment through payments for corruption, etc.
3. Formal versus Informal economies.
Vibrant informal economies are proof that formal economies are monopolized. Informal economic activity **proves** that the poor are entrepreneurs and that they save and invest.

B. The Counterfactual: Greater Private Investment and Competition

All economic theory and empirical studies¹ show that more private investment increases employment, productivity and wages (all three together!) **as long as** there is competition in output, labor and capital markets. (See Table 1-below)

¹ See Arnold C. Harberger, "A Vision of the Growth Process." AMERICAN ECONOMIC REVIEW; Vol. 88, No. 1: 1-30, March, 1998 and James Tybot, "Manufacturing "Firms in Developing Countries: How Well Do They Do, and Why?" JOURNAL OF ECONOMIC LITERATURE: Vol. 38, No.1, March 2000, pp. 11-44.

Table 1: Impact on Employment and Labor Earnings of Deregulating Competition in Transportation and Telecommunications:

<u>Industry</u>	<u>1973</u>	<u>1978</u>	<u>1983</u> *	<u>1988</u>	<u>1991</u>	<u>1996</u>
<u>A. Trucking</u>						
1. Work Force Size ('000)	997	1,111	1,117 *	1,544	1,617	1,907
2. Weekly Earnings (1983/84 dollars)	\$499	\$491	\$404 *	\$386	\$405	\$353
3. Wage Bill ('000) (1. X 2.)	\$497503	\$545501	\$451268 *	\$595984	\$654885	\$673171
<u>B. Airlines</u>						
1. Work Force Size ('000)	368	465	464 *	683	696	800
2. Weekly Earnings (1983/84 dollars)	\$499	\$498	\$455 *	\$420	\$443	\$435
3. Wage Bill ('000) (1. X 2.)	\$183632	\$231570	\$211120 *	\$286860	\$308328	\$348000
<u>C. Telecommunications</u>						
1. Work Force Size ('000)	949	1,075	1,060 *	1,114	1,107	1,126
2. Weekly Earnings (1983/84 dollars)	\$399	\$442	\$457 *	\$447	\$458	\$488
3. Wage Bill ('000) (1. X 2.)	\$378651	\$475150	\$484420 *	\$497958	\$507006	\$548488

Source: Adapted from Table 1 of article entitled, "Deregulation and the Labor Market," By James Peoples, Journal of Economic Perspectives, Summer, 1998 (pp. 111-130).

1. **Liberalized Output & Factor Markets** will cause growth in output (supplies of GDP) **and** growth in demand. (Note: external trade lib. not necessary for freer output markets)
 - a. **Ease of Entry and Exit & Increased Freedom of Calling** (will increase private investment (domestic & foreign) & competition & TFP growth and will lower output prices - move down the DD curve.)
 1. Will private investment increase? Yes. Informal economy = frustrated private investors waiting in the wings.
 2. Will TFP increase? Yes. Increased competition **always** increases TFP, primarily through outsourcing or increased service content of production processes.
 3. Will demand for output increase (leftward shifts in demand)? Yes. The **endogenous growth literature** shows that liberalization of **all markets together** (but not output or factor markets alone) will cause clever entrepreneurs to market or "create" wants and shift DD leftward.²

² This is an inescapable conclusion in William J. Baumol, The free-market innovation machine: analyzing the growth miracle of capitalism: Princeton University Press, 2002, 318 pp. This summarizes a lot of the endogenous growth literature.

III. IMPLIED POLICY MENU

- A. Make Investor (domestic & foreign) Entry & Exit simple through deregulation and reductions in corruption. Only requirement to start a business is registration with tax authorities (minimal other regulations later on).
- B. Domestic Trade Liberalization (liberalize linkages between formal and informal economies- anyone can buy foreign exchange and import)
- C. Small Grants (in-kind, lump-sum) to Start-Up Private Investors