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Poverty and Low Earnings in the Developing World

Gary S. Fields
Cornell University ILR School, gsf2@cornell.edu

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Keywords

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gsf2@cornell.edu

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[*] This chapter is based on my forthcoming book *Working Hard, Working Poor: A Global Journey,* to which the reader is referred for additional details and sources. I am grateful to Philip Jefferson for constructive and insightful comments on an earlier draft.

I. Introduction

Nearly half of humanity is poor by international standards. The poor are concentrated in the low- and middle-income countries of Asia, Africa, and Latin America – what is often called "the developing world," though the sad truth is that quite a number of these countries are not developing at all. By global standards, there is essentially no absolute poverty at all in the higher-income countries, here called the "developed world."[1]

People can be lifted out of poverty in a number of ways. One is by consuming socially provided goods and services. In the developing countries, though, governments are too poor to be able to provide very much. Another is by receiving transfers from members of their families and communities. But when most people around them are poor, the scope for such transfers is modest. Yet another possibility is to migrate to countries where their labor would be better rewarded. However, the richer countries do not exactly welcome the tired, the poor, and the huddled masses yearning to breathe free. (These words are from Emma Lazarus's poem "The New Colossus," which is inscribed on the Statue of Liberty in New York harbor.) So what is left is for the poor to find some way to earn more from the work they do.

Studies have shown repeatedly that the main and often the sole asset of the poor is their labor. It follows that to understand global poverty, one must understand labor markets and labor earnings in the developing world.

The issues dealt with in analyzing poverty and low earnings in the developing world are quite different from those in the developed world. As many of the chapters in this volume illustrate, the discourse in the developed world is about incentive effects of social welfare programs, cultures of poverty, single-parenthood, homelessness, drug and alcohol abuse, ill health, mental illness, domestic violence, and the like. But in the developing world, different issues predominate: among them, self-employment and household enterprises, agricultural work, casual employment, and informal work. And some of the policy issues - stimulating economic growth, harnessing the energies of the private sector, increasing paid employment, and raising the returns to self-employment – take a different twist.

The rest of the chapter proceeds as follows. The first section details the labor markets and types of work in which the poor are engaged. The second section gives an overview of lessons from around the world on what has helped improve earning opportunities for the poor. A brief conclusion highlights some areas for future research.

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[1] Absolute poverty denotes a person's inability to attain a specified standard, often measured in terms of income or consumption, while relative poverty compares people's income or consumption levels. To learn more about the technical differences between absolute poverty and relative poverty and between poverty, inequality, and other aspects of economic well-being, see Fields (2001), Ravallion (this volume), and Ferreira (this volume)..

II. Poverty, Labor Markets, and Types of Work

Absolute poverty: a problem of enormous proportions

The primary concern of this chapter is absolute poverty – that is, the inability to attain a specified standard of living, often measured in terms of income or consumption. Absolute poverty is what the United States uses when it gauges poverty according to a fixed amount of real income: $21,756 a year for a family of four in 2009, the latest year available. It is also what India uses when it gauges poverty according to a set amount of monthly per capita consumption: 580 rupees in urban India and 446 rupees in rural India, reflecting cost-of-living differences between urban and rural India. (The exchange rate is approximately 45 Indian rupees to the U.S. dollar.)

Absolute poverty is to be distinguished from relative poverty, which dominates public discourse in Europe. The European Union identifies as poor those whose incomes adjusted for household composition fall below 60% of the median. To see what difference it makes to use an absolute poverty or a relative poverty measure, consider what would happen if everyone's real incomes grew by the same percentage. In terms of absolute poverty, some households would cross the poverty line and the households that remain poor would be less poor, and therefore absolute poverty would fall. However, in terms of relative poverty, a constant percentage increase in income for all households would leave the same percentage of households below the median, and therefore relative poverty would be unchanged. To me as an American, it seems more natural to think of poverty as falling in such a circumstance, and so I use absolute poverty concepts and measures in preference to relative poverty ones in this chapter.

Absolute poverty is also to be distinguished from relative inequality, which involves a comparison between some individuals' or households' economic conditions and others' and is measured by the income share of the richest x% or poorest y% or a more comprehensive measure such as the Gini coefficient or Theil index. In many countries around the world, absolute poverty has fallen at the same time that relative inequality has risen (Fields, 2001; Asian Development Bank, 2007; Lopez-Calva and Lustig, 2010). Here too, analysts and policy makers must decide which to emphasize in their judgments, absolute poverty or relative inequality. My own answer is to concentrate on absolute poverty.

More than three billion people in the world live in absolute poverty: specifically, 1.4 billion people consume less than 1.25 U.S. dollars per person per day, and another 1.7 billion between 1.25 and 2.50 dollars a day (Chen and Ravallion, 2010). These dollars are adjusted for what money will buy in different countries and at different times. (The technical name for this is Purchasing Power Parity.) All of the poverty figures presented in this chapter are PPP-adjusted.

In 2008, the world had an estimated 6.5 billion people, so 3.1 billion poor people is nearly half the world's population. 3.1 billion poor people is three times the total population of China or India, six times the total population of Europe, or ten times the total population of the United States. Absolute poverty is a problem of massive dimensions.

Where do the world's poor live? Using the $1.25 line, the Chen-Ravallion data show that half the world's poor are concentrated in just two countries, India (456 million) and China (208 million). Another fourth of the world's poor are in sub-Saharan Africa (391 million). The remaining fourth are to be found in the rest of South Asia, the rest of East Asia, Latin America and the Caribbean, Eastern Europe and Central Asia, and the Middle East and North Africa.

Chen and Ravallion have also estimated the amount of extreme poverty in the world (that is, poverty measured using the $1.25 a day line).These data show that global poverty has been reduced both absolutely and relatively since 1981. Despite the addition of two billion people to the world's population since 1981, the number living below $1.25 in constant PPP dollars fell by half a billion. Consequently, the percentage of the world's population living below $1.25 was cut in half, from 41.9% to 21.4%. Extreme poverty in China fell by six hundred million people during that period, while in the rest of the world taken together, the number in extreme poverty was unchanged. Thus, both in absolute numbers and as a percentage of the world's population, progress has been toward reducing extreme global poverty.

Notwithstanding the progress that has been recorded, global poverty remains an enormous challenge. This chapter adopts a labor market perspective on that challenge.

Labor markets, employment, and unemployment: the importance of the working poor

The concepts of "labor market," "employment," and "unemployment" are central to this chapter. These terms are used here in ways that are standard to labor economists and labor statisticians but that do not necessarily accord with everyday understanding. They should therefore be explained.

As used here, the "labor market" is the place where labor services are bought and sold. Some labor markets involve paid employment, in which workers sell their labor services to employers in exchange for a wage or salary. Other labor markets involve self-employment (sometimes called "own-account work"), in which workers sell their labor services to themselves.

"Employment" and "unemployment" are used here following the definitions prescribed by the International Labour Organisation (ILO), which is the specialized agency of the United Nations responsible for workplace issues. A person is said to be "employed" if, in the preceding week, he or she worked in paid employment for even one hour or worked in a family business or on a family farm for fifteen or more hours. A person is said to be "unemployed" if he or she is of working age (sometimes age 16, age 14, or even age 12 depending on the country), was not employed last week, but was actively looking for work. Then there are people who were not working but are neither employed nor unemployed by these definitions; these people are said to be "out of the labor force" or, equivalently, "economically inactive."

The "unemployment rate" is defined as the ratio of number unemployed to labor force. The ILO (2011(b)) reports the world unemployment rate at 6.2%. Given these definitions, it is easy to understand why an unemployment rate of 6.2% does *not* mean that 93.8% of the world's people are fully and gainfully employed. Not everybody of working age is in the labor force. Not everybody in the labor force is working full time in any given week. Not everybody working this week is able to work every week. And many of those who work full-time, full-year still earn so little that they are poor by the standards of their country and/or in terms of an internationally comparable poverty line.

There is another reason to believe that the unemployment rate is a flawed measure of economic distress: the fact that the unemployment rate is *lower* in the developing countries than it is in the developed countries. The unemployment rates in the developed economies and the European Union are above the world average (8.4%) while those in China and India are below the world average (4.2% and 4.3% respectively). Why do the developing countries exhibit lower unemployment rates? The main reason is that few people in the developing world can afford to spend an entire week doing absolutely no work, which is what is required to be counted as unemployed using the ILO definition. On the other hand, those who can afford to remain unemployed for a week or longer tend to come from economically advantaged households or to be well-educated. "Luxury unemployment" is another reason to regard the unemployment rate as a poor signal of the extent of labor market distress.

What the developing countries have is an employment problem – that is, poverty among those who work – rather than an unemployment problem. While more than 200 million people were unemployed in the world in 2011, some 1,300 million people (i.e., 1.3 billion) belonged to the working poor, which the ILO defines as workers who lived in families below the internationally-used two dollar a day poverty line. In other words, 85% of the world's poor are working. The relevance of these numbers for policy will be discussed further later in this chapter.

How people in the developing countries are working

In the developed countries, the guiding paradigm for the analysis of labor markets is the wage labor market. We picture employees going to the same office, store, or factory day after day and earning a wage or salary that is payable each week or month. But as we move down the income scale to middle-income countries and then to low-income countries, other types of work arrangements gain in importance. In the developing countries, steady wage employment of the type found in the developed countries is the exception, not the norm.

Here are some of the salient features of how people are working in the developing countries:

The poor want to work in good jobs. Workers in poor countries want jobs that are steady and secure, pay well, offer benefits, meet labor standards, and offer social protections – ones that might be called "good jobs." The problem they face is that there are not enough good jobs for all who want them and are capable of performing them. Some of the ways in which jobs are not good jobs are detailed below.

Earnings levels are very low despite long work hours. In most of Asia, Latin America, and Africa, daily wages are no more than one or two U.S. dollars per day. Laborers earn $145 a month in central China, $104 a month in Vietnam, and $87 a month in India (Hamlin, 2008). To hire a manufacturing worker for a day in Argentina costs 26% of what it costs in the United States; the corresponding percentages are 23% in Brazil, 13% in Mexico, and 4% in the Philippines (ILO, 2010).

People in the developing world are working – more often than not, working very long hours. In countries such as Peru, the Republic of Korea, Thailand, and Pakistan, 45% or more of workers work more than forty-eight hours in a week. In countries such as the United Kingdom, Israel, Australia, Switzerland, and the United States, the corresponding percentages are in the range of 18 to 26%. (ILO, 2007(a)). It follows that the poor in the developing world are poor despite working long hours and not, for the most part, because they are not working.

The ILO defines "a working poor household" as one in which at least one member of the household is working but the household lives on less than $2 per person a day. The working poor constitute 39% of total employment in the world (ILO, 2011) with rates reaching as high as 80% in South Asia and sub-Saharan Africa.

Incomes are also uncertain. Informal employment predominates in the developing world.[2] The ILO tells us, "The informal economy comprises half to three-quarters of all non-agricultural employment in developing countries. . . Some of the characteristic features of informal employment are lack of protection in the event of non-payment of wages, compulsory overtime or extra shifts, lay-offs without notice or compensation, unsafe working conditions and the absence of social benefits such as pensions, sick pay and health insurance." Virtually all agricultural employment is also informal. A recent OECD study tells us that in the poorer countries "informal is normal," including more than 90% of non-agricultural and agricultural employment (Jütting and deLaiglesia, 2009).

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[2] Unfortunately, informality is defined differently by different authors. Following the lead of the International Conference of Labor Statisticians, the International Labor Organization, and Women in Informal Employment: Globalizing and Organizing (WIEGO), the following definitions are used here. "The unorganized sector [also called the informal sector] consists of all unincorporated private enterprises owned by individuals or households engaged in the sale and production of goods and services operated on a proprietary or partnership basis and with less than ten total workers." "Unorganized workers consist of those working in the unorganized enterprises or households, excluding regular workers with social security benefits, and the workers in the formal sector without any employment/social security benefits provided by the employers."

The poor face a "triple whammy": low incomes when they are working, irregular and unpredictable income flows, and a lack of suitable financial tools (Collins, Morduch, Rutherford, and Ruthven, 2009). Knowing this, the majority of the poor manage their money carefully and cleverly.

Women are disadvantaged in developing country labor markets. Their labor market outcomes are less good. They face many different types of discrimination. They have less access to inputs including land and credit, capital and technology. They have special demands placed on them through tasks such as fetching water and searching out firewood.

The composition of employment is very different in developing countries from what it is in developed countries. As compared with the developed countries, the developing countries have a larger percentage of people working in agriculture and a smaller percentage working in offices and factories. Agriculture's share of total employment is 66% in sub-Saharan Africa, 49% in South Asia, and 44% in Southeast Asia. In the developed economies and the European Union, agriculture's employment share is just 4%.

In the developing countries, self-employment and unpaid family work are more important, and paid employment is less important, than in the developed countries. The shares of working people who earn their livelihoods in these ways are more than 80% of women and 70% of men in South Asia and sub-Saharan Africa, more than 50% of both men and women in East and Southeast Asia, and more than 30% in the Middle East and North Africa and in Latin America and the Caribbean (Kucera and Roncolato, 2008). The ILO combines the self-employed and unpaid family workers into a category they call "vulnerable employment." Vulnerable employment accounts for half of the world's employment, with rates ranging from 77% in South Asia and sub-Saharan Africa to 32% in Latin America and the Middle East to 10% in the developed economies and the European Union (ILO, 2009).

Most of those working in developing countries work in the private sector, not the public sector. A large majority of those who work in the private sector are not registered with the government and therefore do not receive job-related social protections. Nine out of ten workers in the developing world are to be found in the private sector. Sometimes, it is hard to keep this fact in mind, because so many of the statistics and so much of the policy attention is paid to the formal sector, in which the public sector features disproportionately. In India, for example, government is the dominant employer in the formal sector, accounting for two-thirds of that nation's formal employment. Yet, 86% of all workers are engaged in informal employment in the informal sector and another 7% in informal employment in the formal sector, rendering government only a minor employer overall (National Commission for Enterprises in the Unorganised Sector (NCEUS), 2009).

In a 2009 report, the NCEUS called for three pillars of a social floor which is now lacking in India: universal minimum social security, a national minimum wage, and minimum conditions of work. Such protections remain a distant dream for the vast majority of workers in India and other developing countries at present.

The problem the poor face is that not enough wage employment is available for all who would like wage jobs and are capable of performing them. Would-be wage employees could respond to the lack of wage jobs by remaining unemployed and continuing to search. However, few do, for the simple reason that they cannot afford to. This is luxury unemployment in action. For the most part, the poor find it better to create their own self-employment opportunities. Banerjee and Duflo (2007, p. 162) write: "Nothing seems more middle class than the fact of having a steady well-paying job. While there are many petty entrepreneurs among the middle class, most of them do not seem to be capitalists in waiting. They run businesses, but for the most part only because they are still relatively poor and every little bit helps. If they could only find the right salaried job, they might be quite content to shut their business down."

One important exception to the pattern just described is South Africa (Cichello, Fields, and Leibbrandt, 2005). That country has a frightful unemployment problem. Using the ILO definition, the unemployment rate is 25.5%, but when discouraged workers (those who are not working, not actively looking for work, but report that they would take a job if one became available) are also included, the so-called "broad unemployment rate" reaches 38.3%. An estimated 46% of the labor force earns less than a South Africa-specific low earnings line. The unemployed, defined broadly, make up about half this group and the working poor the other half. South Africa's one-to-one ratio of low earners to unemployed is in marked contrast to the six-and-a-half-to-one ratio found elsewhere. As a consequence, policy-makers in South Africa are much more justified in concentrating attention on the country's unemployment problem than are policy-makers in other countries.

Developing country labor markets are usually thought to be segmented. While definitions differ, the one I prefer has two core features: first, for workers of any given skill level, some jobs are decidedly better than others; and second, access to the better jobs is rationed in the sense that not all who want those jobs and who are capable of performing them are able to get them.

The Chief Economist of the Inter-American Development Bank, Santiago Levy, put it graphically for his native country, Mexico, when he said to me: "Of course, they all want to work for the telephone company." What Levy meant by this is that the same worker, given his or her skill, would do better in terms of pay and/or working conditions if s/he is fortunate enough to be hired by the telephone company. But of course, the telephone company does not want to hire all who would like to work there. Those workers not able to be hired by the telephone company then have to do the best they can elsewhere.

For labor market segmentation to exist, it must be that <u>comparable</u> workers get paid more in some parts of the labor market than in others. Using multiple regression and other statistical techniques, researchers have tried to establish comparability by controlling for other wage-determining factors that can be observed in the data such as education, firm size, sector of employment, and so on. (Workers who are comparable in this way are said to be "observationally equivalent.") When such controlled studies have been done - examples are Appleton, Song, and Xia (2005) for China, Glinskaya and Lokshin (2005) and Hasan and Magsombol (2005) for India, and Stroll and Thornton (2002) for several African countries - wage differentials for observationally equivalent workers, often very large ones, have been found. Such evidence is consistent with labor market segmentation but can and has been challenged by analysts who contend that the earnings differentials are found because workers who look comparable to researchers have unobservable characteristics that make them different from one another in fact (Rosenzweig, 1988).

Not all microenterprise operators and family workers are doing such work involuntarily. Some could be working as wage employees but choose not to for reasons such as wanting to be their own bosses, trying to make it big on their own, and (especially for women) simultaneously working and fulfilling child-care responsibilities. Surely, some of the self-employed are doing so by choice, but how large a percentage they are remains unsettled in the literature. Maloney (2003, 2004) and the World Bank (2007(a)) take the view that the percentage is quite large in Latin America in general and Mexico in particular, but this is a minority view. A more typical position is that of Banerjee and Duflo (2007, 2011), whose analysis of data for eighteen developing countries has led them to label such people "penniless entrepreneurs" or "reluctant entrepreneurs," engaging in such work because of few skills, little or no capital, and a shortage of wage jobs.

Apart from low earnings levels and lack of social protections, a large number of jobs are downright miserable. The ILO has set a "Decent Work Agenda," which seeks four strategic objectives: creating jobs, guaranteeing rights at work, extending social protection, and promoting dialogue and conflict resolution. The director-general of the ILO reports regularly on the decent work deficit.

Fields (forthcoming) presents some examples of outrages in the workplace. Included are a group of fifteen Indian men who were held in captivity while their blood was drained for sale to private medical clinics, a Kenyan sex worker who engages in unprotected sex knowingly because the pay is better and she has to feed her baby, and an Indian museum that encourages customers to purchase weavings in the museum shop so that the teen-agers who had gone blind producing them would have some means of support.

Even leaving such egregious outrages aside, literally billions of people in the world work in extremely bad conditions. Compared to most others, we in the developing countries work and therefore live very well indeed.

Labor markets in a globalized world

Globalization has been defined as businesses "competing with everyone from everywhere for everything" (Sirkin, Hemerling, and Bhattacharya, 2008). What globalization means for labor markets is that it is possible for employers almost anywhere in the world to hire workers almost anywhere in the world to manufacture goods and produce services that can be sold almost anywhere in the world. Indeed, <u>not</u> to be involved with the global trading system and the global labor market can be seriously problematic (Ghose, 2003; Collier, 2007).

I would make four points about labor markets in today's globalized world.

First, poor people in the developing world are well aware that their labor would command a higher return elsewhere. Many take action: by moving to nearby towns and cities, to the growing industrial and commercial areas of their own countries, and to the richer countries. Some of these actions are legal, others not.

Context is all-important. Whether a worker is absolutely poor or not depends in large part on where in the world that person is able to work.

Second, labor markets throughout the world are linked by an unprecedented degree of labor market competition. Two main factors are responsible. One is that the world's labor force effectively doubled owing to the incorporation of China, India, and the countries of the former Soviet Union into the world economy (Freeman, 2005). The other is that the costs of accessing labor in other countries have fallen sharply compared to what they were a decade or two ago. Offshoring, facilitated by today's modern technologies, is about penetrating other countries' product markets, lowering labor costs, and obtaining talent globally.

Third, labor markets are highly competitive because of an unprecedented degree of product market competition in many industries. In sectors such as consumer electronics, autos, and airlines, global competition is shifting production across countries, within countries, and across firms.

And fourth, in today's globalized world, few competitive advantages are sustainable. Exceptions to this generalization arise when there are insurmountable barriers to entry, historically-conferred advantages, or network economies. Thomas Friedman (2005) narrates a traditional African proverb:

> Every morning in Africa, a gazelle wakes up.
> It knows it must run faster than the fastest lion or it will be killed.
> Every morning a lion wakes up.
> It knows it must outrun the slowest gazelle or it will starve to death.
> It doesn't matter whether you are a lion or a gazelle.
> When the sun comes up, you better start running.

As a sign of the globalized world in which we live, this proverb had been translated into Mandarin and posted in a factory owned by an American auto parts manufacturer operating in China!

These factors lead us to expect, using the Hicks-Marshall laws, that the demand for labor has become more elastic (Ehrenberg and Smith, 2009), and empirical evidence shows that it indeed has (Bertrand, 2004; OECD, 2007). The consequences for policy are profound. Countries are limited in the social programs that they can put into effect because of what other countries might do. State and local governments, facing heightened competition within their own countries, have to adjust their positions accordingly. Labor unions' bargaining positions are weakened because more workers elsewhere can compete for their jobs. Heightened labor market competition in today's globalized world is an inescapable fact.

III. Helping the Poor Earn Their Way Out of Poverty

The previous section linked global poverty to how people in the developing countries are working. This section examines policies that have been put into effect to help the poor earn their way out of poverty. They include: growth, trade, and aid; harnessing the energies of the private sector; expanding paid employment; and increasing the returns to self-employment. But before turning to these policy areas, let us first direct our attention to objectives and tradeoffs.

Setting objectives, facing tradeoffs

In policy discussions like these, it is important to be explicit about what is the policy objective. Let us assume that one overarching objective is to help the poor. Other development objectives, important though they may be, will presumably be considered as well and a higher-level decision will be made about what share of the available resources will be devoted to each of the objectives. Let us also assume that it has been decided that some of the available resources will be devoted improving the poor's labor market opportunities. How to help the poor through government-provided or –financed goods and services will not be considered here.

Suppose, then, that we want to help the poor earn their way out of poverty. As the field has now evolved, four objectives are prominent in labor market policy discussions. One is to increase employment. A second is to raise the earnings of those who work so that they and their families can achieve acceptable standards of living. A third is to increase social protection and provide security against the loss of labor market earnings. And a fourth is to insure that core labor standards in the workplace are honored.

When there are multiple objectives like these, tradeoffs are likely. These tradeoffs arise on both the policy side and the budgetary side.

On the policy side, a policy intervention that is helpful for one labor market policy objective may be harmful to another. For example, policies to increase the amount of paid employment and policies to increase the earnings of those employed may run exactly counter to one another. The policies considered below should then be thought of in conditional terms: <u>if</u> we want to expand paid employment, here are some things that might be done; <u>but if</u> we want to increase the earnings of those employed, here are some other things that might be done instead. A higher-level decision would then need to be made about which of these objectives would be the most important one or ones to be pursued in any given context.

Turning to the budgetary side, resources are always limited, and the poorer the country, the more limited they are. Even if creating more paid employment is a good thing, using scarce resources to raise the returns to self-employment may be even better (or worse). Here too, a higher-level decision would need to be made about which of the competing policy measures would have the greatest effect on the ultimate policy objective, which is taken here to be poverty reduction.

One good way of thinking about these higher-level issues is to consider the social benefits and social costs of the various policy options under consideration. Three questions need to be asked. First, what are the extra social benefits from each possible use of a development budget? Second, what are the extra social costs from each possible use? And third, how do the extra social benefits and extra social costs compare for each possible use? These are not easy questions to answer, but it is better to answer the right questions approximately than the wrong questions exactly.

Finally, we may not know what specifically works or does not work in any particular policy context, and so research may be needed in order to find out. Some researchers favor statistical and econometric approaches (Deaton, 1997; Heckman, 2001; Ravallion, 2008), while others favor experimental approaches (Banerjee and Duflo, 2011; Karlan and Appel, 2011). No researcher today can afford to ignore either approach.

Growth, trade, and aid

Economic growth is central for poverty reduction. Growth can reduce poverty through improved labor market conditions, through expanded government-provided goods and services, or both. This chapter is about the labor market channel.

From my reading of the international evidence (e.g., World Bank, 1995(a); Finance and Development, 2007; ILO, 2011), I conclude that the relationship between economic growth and improvement in labor market conditions is a positive one. Three patterns emerge. First, those developing countries that have achieved the highest rates of economic growth tend to have achieved the highest rates of real wage growth. Second, countries that have achieved rapid economic growth have also seen a growth in manufacturing and service employment (relatively high-paying sectors of the economy) and a reduction in agricultural employment (a relatively low-paying sector). And third, real wages tend to rise faster when exports grow.

To understand economic growth better, a blue-ribbon Commission on Growth and Development was created under the chairmanship of Nobel Prize-winning economist Michael Spence. The Commission reported (Commission on Growth and Development, 2008, 2009; el-Erian and Spence, 2008) that thirteen developing economies achieved sustained and rapid economic growth over several decades. These economies – which include Botswana, Brazil, China, Hong Kong, Indonesia, Japan, Korea (South), Malaysia, Malta, Oman, Singapore, Taiwan, and Thailand – share a number of features. The Commission tells us that they made the most of opportunities in the world economy, maintained macroeconomic stability, achieved high rates of savings and investment, relied on markets to allocate resources but intervened to affect what people brought to markets, and had committed, credible, and capable governments. The Commission also identifies policies that have proved harmful for economic growth such as protecting certain sectors of the economy in an open-ended manner, banning exports in order to try to keep domestic prices low, and ignoring the need for a more equitable distribution of gains and losses.

As the preceding paragraphs have made clear, international trade features importantly in the growth-labor market-poverty nexus. Fears have been expressed that to achieve outward-oriented economic growth in today's globalized world, labor must be repressed so that wage costs remain low. But in China and other countries that have achieved rapid export-led growth, real wages have been growing rapidly.

More open international trade, if carefully managed, can help reduce global poverty. Two of the developing world's greatest successes are China and India. Writing about these two economies, Rodrik ((2006) states: "China and India increased their reliance on market forces, of course, but their policies remained highly unconventional. With high levels of trade protection, lack of privatization, extensive industrial policies, and lax fiscal and financial policies through the 1990s, these two economies hardly looked like exemplars of the Washington Consensus."

Freer trade is not necessarily fair. While much has been written about this issue - three illuminating books are Stiglitz and Charlton (2005), Chang (2007), and Rodrik (2007) – I will limit myself here to just two issues.

The first is developed-country trade subsidies. With the advent of the North America Free Trade Agreement, subsidized U.S. corn was permitted to enter the Mexican market, devastating large numbers of Mexican corn farmers. The United States and Europe heavily subsidize their cotton farmers despite a World Trade Organization ruling that these subsidies violate global trade rules, directly harming cotton farmers in Africa, India, and elsewhere. And then there are cattle subsidies, which amount to two-and-a-half U.S. dollars a day in Europe and seven U.S. dollars a day in Japan. Three billion of the world's people live on less than two-and-a-half dollars a day. I am not the first to say that it is better to be a cow in Europe or Japan than a person in Africa or South Asia, nor am I likely to be the last.

The second issue is compensating the losers from freer trade. Failure to solve the compensation issue has led to a stalemate since 2003 in the Doha round of world trade talks. Analysts and commentators across the political spectrum are now calling for expanded trade adjustment assistance, wage insurance, and other mechanisms for compensating the losers from globalization and otherwise overcoming protection.

Another area of policy concern is foreign aid. The aid given by the richer countries is well below the oft-repeated target of 0.7% of GDP; the U.S. gives just 0.19% and Japan just 0.20%. There is much controversy today about whether foreign aid makes things better or worse; see, for example, Sachs (2005) on the one hand and Easterly (2006) on the other.

I support increased foreign aid, because I am convinced that many more worthwhile things are waiting to be done in the fight against global poverty and that the benefits from doing them outweigh the costs. The Bill and Melinda Gates Foundation has committed massive resources to this effort but has also insisted on measurability and scalability of results in all that it does.

If we really wanted to help the poor rather than just stimulate GDP growth, we would do things differently. Most importantly, we would focus our efforts directly on the poor rather than pursue general purpose interventions – for example, targeted job-creation rather than tax cuts for higher-income individuals and corporations which do not directly help the poor in developing countries because they do not pay taxes in the first place. Targeted interventions in three areas are discussed in the balance of this section: harnessing the energies of private companies, generating more wage employment, and increasing the returns to self-employment.

Harnessing the energies of private companies

As we saw in Section II, ninety percent of workers in the developing world work in the private sector. Their jobs range from steady, regular wage employment to casual wage employment to self-employment to operating micro-enterprises, often at the household level.

Private companies make important contributions to economic development – most importantly, through creating employment and paying taxes. Nonetheless, I do not see that contributing to the fight against poverty is a bottom-line objective for them. I believe that the best way to understand what they do is to see the bottom-line objective as being to achieve the highest possible profits.

Profit-maximizing companies will hire workers or not, pay them well or not, train them or not, employ "high road" human resource practices or not, and make many other decisions based on the effects that these decisions will have on profits. Policymakers need to think how profit-seeking businesses are likely to respond to policies that might be put into effect and make their policy choices with the likely responses in mind.

One way in which governments have made a difference is by creating a favorable business environment and investment climate so that companies will want to operate in their countries and employ their people. Businesses have always had a choice about where to operate, but in today's globalized world the choices are even more numerous. Laws, regulations, and other institutions need to be set in view of this reality.

It has often been said that companies operate in locations like the United States where labor costs are high because of the high productivity of its labor force combined with excellent infrastructure. Turning it around, economists have formulated the idea that many factors must be operating well for economic development to take place and that the failure of any one of these factors could result in the failure of the entire development effort. This view has been labeled graphically "the O-ring theory of economic development," so called by Kremer (1993) after the Challenger spacecraft exploded due to the failure of a simple part called an O-ring.

China and India fundamentally reformed their business environments. In China, Deng Xiao Ping famously said, "Black cat, white cat, all that matters is that it catches mice." In 1978, he led China in the Four Liberalizations – liberalizations of agriculture, industry, technology, and defense. Economic growth took off, averaging 9.8% in the subsequent thirty years. Meanwhile, in 1991, India embarked on a market-oriented liberalization program that included greater reliance on the private sector, opening the economy to foreign trade and foreign direct investment, reorienting government activities toward those not likely to be performed by the market, and ensuring macroeconomic balance and a well-run financial sector (Ahluwalia, 2007). By 2008, India's real national income had grown to three times the size it had been in 1991. The Chinese and Indian reforms have helped drive the greatest reductions in poverty the world has ever seen.

Another important factor influencing the private sector is burdensome regulation. In poor countries, administrative costs are three times as large as in richer countries, and twice as many bureaucratic procedures are in place. The reported consequences are harmful for those involved, leading to a call for reforms in five areas: simplify and deregulate in competitive markets; focus on enhancing property rights; use the internet more; reduce court involvement in business matters; and make reform a continuous process. (Klein and Hadjimichael, 2003; International Finance Corporation and the World Bank, 2005).

Finally, the energies of businesses may be rechanneled through consumer movements and corporate social responsibility efforts. Sportswear manufacturers such as Nike have been the targets of numerous protests in which consumers have pledged to buy products only from factories that pay a living wage, follow adequate labor standards, and allow workers to form independent unions or other worker-sponsored organizations. Nike responded to such pressure by issuing a Corporate Responsibility Report criticizing its own supply chain and pledging to improve conditions (Dreier and Appelbaum, 2006; Locke et al. 2007a, 2007b). But as this paper was being finalized, the University of Wisconsin – Madison announced that it is ending its relationship with Nike because the company had not done enough to remediate conditions in its factories in Honduras. For similar reasons, my university, Cornell, decided in 2009 to sever its relationship with sportswear manufacturer Russell.

Actions such as these may affect companies' enlightened self-interest, because <u>not</u> to profess a concern for worker rights and working conditions (as well as healthy products, honest dealings, and environmental concerns) may harm a company's image and hurt its profits. Corporate social responsibility (CSR) movements take a variety of forms today including company codes of conduct, social labeling, CSR audits, and licensing. Some companies engage in "strategic corporate social responsibility" and try to turn it into a source of competitive advantage (Porter and Kramer, 2006). Companies such as Citibank, Merck, Wal-Mart, Starbucks, Monsanto, Interface, and others have found that "principles pay" (Heal, 2008). A review of the evidence concludes that the link between CSR and financial performance is positive but weak, stating: "Precisely because CSR is voluntary and market-driven, companies will engage in CSR only to the extent that it makes business sense for them to do so . . . In the final analysis, CSR is sustainable only if virtue pays off." (Vogel, 2006).

In summary, private companies play an essential role in economic development as employers and taxpayers. Those governments, development institutions, non-governmental organizations, and ordinary citizens who are interested in helping the poor would want to explore ways of harnessing the energies of private companies toward mutually advantageous ends.

Labor market policies for generating more paid employment

Suppose that policymakers in a country give priority to expanding the number of jobs in paid employment. What specific actions should they undertake? International experience suggests a number of policy measures.

First, *avoid prematurely high labor costs.* What I mean by this is labor costs that are higher than they would have been if they had been set by supply and demand in the labor market. Evidence from all over the world shows that the wage elasticity of demand for labor is significantly negative (Hamermesh, 1993). Higher wages and other benefits – whether brought about by minimum wages, trade unions, public sector pay policies, multinational corporations, or labor codes – are therefore likely to reduce employment below what it otherwise would have been. There may be other development reasons that higher wages, more generous benefits, and greater labor market protections should be sought, but increasing paid employment is not one of them.

Second, *remove undue barriers to employment.* In many developing countries, employment protection laws are in place restricting dismissals of workers. While the workers covered by the legislation are in fact likely to enjoy more secure employment, there is also an unintended side effect: employers may be reluctant to hire workers in the first place, knowing that they cannot be dismissed in the event of a business downturn or unsatisfactory job performance. In India, where this phenomenon has been studied most carefully, employment protection laws have been found to have resulted in lower employment and higher poverty (Fallon and Lucas, 1993; Besley and Burgess, 2004; Ahsan and Pagés, 2009).

Third, *increase employees' skills and productive abilities to the extent that skill deficiencies are causing job vacancies to go unfilled.* Note the qualifier: to the extent that skill deficiencies are causing job vacancies to go unfilled. If employers are not hiring for other reasons and if the additional skilled people join a pool of others holding out for "suitable" jobs, additional education and training may make labor market conditions worse. In Africa, when school enrollments expanded, paid employment was found to grow by nearly the same amount in just two countries, Botswana and Zimbabwe. In the other countries studied, the number of newly-educated individuals entering the labor force was between four and twenty-nine times larger than the growth of paid employment (Bennell, 1996; Pritchett, 2001).

Another set of questions arises: in those circumstances in which skills and productive abilities should be increased, what is the best way to go about doing it? One study has classified youth education policies according to what has been proven successful (examples are enacting compulsory schooling laws in Venezuela and offering conditional cash transfers in Mexico, what has been judged promising but unproven (examples are teaching practical thinking and behavioral skills in South Africa and offering part-time schooling in Argentina and Russia), and what has been judged unlikely to be successful (examples are doing early tracking and selection in Tanzania and Thailand and instituting teacher incentives based on test scores in Chile, Kenya, and Mexico); see World Bank (2007(a)) for more information.

Turning from schools to post-schooling training, Mexico has a System of Training Workers (known by its Spanish acronym, SICAT). The in-service training component of SICAT provides for employers to offer training in skills they need. Among the areas in which training has been offered are air-conditioner repairing and lathe operating, which are not necessarily the skills that would have been chosen by Ministry officials in Mexico City. An evaluation study found that for most groups in the labor market, SICAT graduates did better than comparable individuals who did not undergo such training (Calderón-Madrid and Trejo, 2001).

A fourth policy action to increase paid employment is to *create jobs for the poor*. Examples of such so-called "workfare" programs are Argentina's Program for Heads of Households, Bangladesh's Food for Work Program, and India's National Rural Employment Guarantee Act (NREGA). Of these, NREGA is the most ambitious, both in the sense that India is the world's second most populous country and in the sense that the program has now been expanded to serve the poor in every district of the country.

NREGA guarantees to each rural household at least one hundred days of wage employment per year. In order to appeal to the poor and only the poor, the wage is set low enough so that the poor but not others will want to join. NREGA has had some noteworthy positive effects including reduction in distress out-migration, improved food security, employment with dignity, greater economic empowerment of women workers, and sustainable asset creation. But it has also had some major problems, foremost among which are that NREGA households are getting only forty-three days of work rather than the one hundred guaranteed to them and the existence of "operational deficiencies," of which the most serious is non-payment of wages to persons who have performed work. The government of India is well aware of these problems and is working actively to overcome them. For more on NREGA, see Mehrotra (2008), NCEUS (2009), and Indian Society of Labour Economics (2009).

General lessons have been drawn on how to design workfare schemes (Ravallion, 2009). Low-wage work should be guaranteed. The work should be proposed by bona fide community groups in poor areas. The government should contribute to non-wage costs only if the community putting up the proposal is in a designated poor area. The project wage rate should be no higher than the market wage rate for unskilled labor in a normal year. There should be little or no administrative discretion in access to the program.

Before leaving the topic of increasing paid employment, let me mention one thing which I think in general should <u>not</u> be done, and that is to improve labor market information systems such as online information centers, public employment services, job banks, and the like. Such services are well-suited for situations in which employers want workers, workers want jobs, but the employers and workers cannot find one another – what labor economists call "frictional unemployment". But in my experience, unemployment in developing countries is rarely frictional. Rather, the reason for unemployment is deficient demand in the labor market. Labor market information systems address the wrong problem and so are not deserving of scarce public resources.

<u>Increasing self-employment earnings</u>

As we saw in Section I, in the countries in which the world's poor are concentrated, the great majority of working people are self-employed. A number of interventions have had positive effects in raising self-employment earnings:

First, *designing products to help raise the productivity of the self-employed* (Cooper-Hewitt, 2007; Polak, 2008). Organizations with names like International Development Enterprises, KickStart, Fuel from the Fields, One Laptop per Child, and D-Rev: Design for the Other 90% have done this. Among the products they have come up with are: a WorldBike designed especially for transporting cargo; a mobile water purification tool called LifeStraws that enables people to suck water directly through a filter, thereby preventing water-borne diseases; a rolling water system called Q Drum that enables large quantities of water to be rolled from placed to place rather than carried on one's head or back; and a pot-in-pot cooling system with wet sand inserted between the two layers, enabling tomatoes to last for twenty-one days rather than two or three.

Second, *adopting a positive policy stance toward the self-employed and avoiding hassling them.* In the major cities of South Africa, the city councils have budgeted substantial sums on employing and equipping metro police officers to stop "illegal, unlicensed street trading." What makes them "illegal" is that very few permits are issued so that the vast majority of traders have to operate without them. This kind of official hostility is worse than needless; it is anti-development. If the city councils were to think of poverty reduction as a top priority, recognize that most of the poor people living in their jurisdictions have no choice but to earn their livelihoods from self-employment, and adopt a more positive or at least a less negative policy stance toward the self-employed, the urban poor would have a better chance of earning their way out of poverty. The informal economy should be nurtured, not repressed.

Third, *providing the poor in agriculture with more to work with.* The constraints facing developing country farmers are many and include lack of land, water, other inputs, knowledge of best practice, access to product markets, protection against risk, and access to financial services. Here are some measures that have been taken to overcome them.

Pioneered in Madagascar and extended elsewhere, a System of Rice Intensification (SRI) enables more rice to be grown with fewer inputs. How? Planting very young seedlings (8-12 days old) rather than more mature seedlings (3-4 weeks old). Planting seedlings singly rather than in clumps of three or four. Planting fewer seedlings more widely spaced. Keeping the fields moist but never flooded. Doing several weedings rather than one. Adding compost to improve the soil quality. By following these simple steps, rice yields have been raised by 50 to 100 percent compared with traditional flooded paddies while using 40 percent less water and 50 percent less fertilizer at a 20 percent lower production cost. (CIIFAD, n.d.).

Lack of water is often a problem for rural farmers. Turkey has responded by creating the Southeast Anatolia Project, known by its Turkish acronym GAP. GAP is an integrated rural development project encompassing investments in agriculture, industry, transportation, education, health, and rural and urban infrastructure. Throughout that part of the country, one sees fertile fields and barren fields side by side, differentiated by their access to irrigation or lack thereof. Alas, only 15% of the planned investments in irrigation have been made to date. Government recognizes full well that its targets for crop diversification and development of agro-based industry cannot possibly be achieved until the remaining investments are made.

Space permits one more example. The Bill and Melinda Gates Foundation has highlighted agricultural development as one of its priority areas, thereby making massive resources available provided that it can be shown that the interventions proposed are actually effective. With funding from the Gates Foundation, the International Food Policy Research Institute examined more than 250 possible interventions and concluded that 20 were “proven successes” (Spielman and Pandya-Lorch, 2009). What were they? Among them: The Green Revolution in Asia. Improved maize in sub-Saharan Africa. Pearl millet and sorghum in arid lands. Connecting the milk grid in India. Land tenure reform in Vietnam. Such evidence-based policy formulation is increasingly the norm these days.

Fourth, *facilitating supplemental off-farm wage-employment and self-employment.* Even among farm households, it is the norm to have more than one activity (Banerjee and Duflo, 2007). These off-farm activities can be stimulated by a variety of means. One is to overcome the disadvantage of location by investing in “hard infrastructure” such as roads and electrification as well as “soft infrastructure” such as banking systems and market information systems. Another is to invest in general education and specific skills. A third is by providing greater access to credit and financial savings, on which more below.

An instructive contrast in this regard is presented by the experiences of Taiwan and South Korea. Although the two economies had many development policies in common, they differed in one important respect: Taiwan chose a geographically decentralized development strategy, while Korea relied on two growth poles (Seoul and Pusan). Both economies grew rapidly, but Taiwan followed a much more egalitarian path than did South Korea

Fifth, *making capital available to the poor*. The poor lack six kinds of capital: human capital, business capital, infrastructure, natural capital, public institutional capital, and knowledge capital (Sachs, 2005). Yet, capital does not flow from rich to poor countries for reasons having to do with low credit-worthiness of small borrowers, adverse selection, moral hazard, and lumpy transactions costs. The result is that the poor have only limited opportunities to raise the capital they need to be able to make profitable investments that might help lift them out of poverty.

Fortunately for the poor, new microfinance institutions are being developed (Armendáriz and Morduch, 2005; Collins, Morduch, Rutherford, and Ruthven, 2009). These include credit unions, village banks, microbanks, and group lending. A heated debate rages about whether to try to reach the poor through not-for-profit or for-profit institutions (Bruck, 2006; Malkin, 2008).

The best known of the not-for-profit microfinance institutions is Bangladesh's Grameen Bank, which was awarded the 2006 Nobel Peace Prize along with its founder, Dr. Muhammed Yunus. The Grameen Bank works on the following model. Five borrowers, usually all women, form a group which may borrow a small sum of money, perhaps U.S. $100, collateral-free at relatively low interest rates, usually on the order of 12-17% per year. The bank makes loans to group members sequentially, extending a loan to a second group member once a previous loan has been repaid. Once all group members have borrowed and repaid, the group becomes eligible for new, larger loans. Knowing this, group members have an incentive to choose other reliable persons to join their group and also to engage in self-enforcement, keeping opportunistic defaults to a minimum. The Grameen Bank model has been carried all over the world, even to New York City where Grameen America operates. More than 150 million such loans are made each year.

As for for-profit lending, we find organizations such as Compartamos in Mexico, which makes small loans to the poor at interest rates starting at 6% per month. Moreover, Compartamos loans carry a group liability clause, so that the members of a group are collectively responsible for repaying the group's loans each week for the term of the loan. Despite the high interest rates charged, the default rate on these loans is just 2%.

Defenders of for-profit lending interpret the low default rate on loans from organizations such as Compartamos as evidence that the poor have great needs for capital and many good uses to which they can put it. On the other hand, critics of for-profit lending contend that money can be made in other ways, not through very high interest charges on the poor. Despite their disagreements, where both sides agree is that the poor need savings accounts, insurance, access to credit, and other financial services. Microfinance is fulfilling that need.

Sixth, *building skills and business know-how.* Among the many organizations involved in developing business know-how are: the ILO's Workers Activities Programme

(ACTRAV); Coca-Cola Sabco; Goldman Sachs' "10,000 Women" initiative; India's Self-Employed Women's Association (SEWA); a government-operated training scheme for the self-employed in Côte d'Ivoire (PAFPA); and the Foundation for International Community Assistance in Peru.

Seventh, another approach to small enterprise development is *microfranchising* (Fairbourne, Gibson, and Dyer, 2007). Microfranchising brings together microfranchisors (entrepreneurs who wish to expand their businesses) and microfranchisees (people who seek to operate their own self-employment activities but may not have the business know-how). The Grameen Bank's Village Phone program and similar programs operated by the Grameen Foundation in Rwanda and elsewhere are run on this model. In the case of the village phone ladies (nearly all of them are women), a franchisee is provided a loan enabling her to buy a cell phone business in a box. She buys not only the phone but also instructions on how to operate the phone, charge customers for minutes, and so on. Other microfranchising businesses include VisionSpring, which makes available low cost eye exams and affordable reading glasses, and Honey Care Africa, which sets up beekeepers with hives, loans, training, extension services, and a guaranteed market for their honey at fair trade prices.

IV. Concluding Remarks: Suggestions for Future Research

In the two core sections of this chapter, I have tried to highlight what we know about how the world's poor work and what policy interventions are most promising. In this concluding section, I briefly highlight some priority areas for future research.

The first is the need for empirically-grounded theoretical labor market models that can be used in the formulation of policy. Examples of such models that have proven insightful in the past are those of Harris and Todaro (1970) and Banerjee and Newman (1993). While there is some value in developing single-sector models and representative agent models, it would be more helpful to have multi-sector models in which labor markets are segmented, incorporating the key features of labor markets in India, China, South Africa, or wherever.

The second is the need for in-depth empirical analysis on which particular policy interventions matter or do not matter. We can gain such knowledge from statistical and econometric studies, from experimental studies, or from a mix of the two. What we need are more studies that tell us specifically what has made a positive difference and what has not – for example, that student performance and hence workers' skills can be raised by improving teacher quality but not by reducing class sizes. What we do not need as much are more studies that say that those individuals/households/workers/students with more of characteristic X have such-and-such higher value of outcome variable Y in country Z.

The third is the need for sector-level and market-level analysis. For example, studies were cited in Section III showing that in Africa when more students were educated, paid employment typically did not increase correspondingly. This kind of market-level analysis is more valuable than knowing that in those countries, the newly-educated individuals earned more, worked in better job categories, or were more likely to be employed at all than new entrants to the labor force without those educational qualifications.

And fourth and finally, we need more careful social cost-benefit analysis kinds of thinking. Using explicit social welfare criteria. Comparing benefits with costs, not just saying "it would be good for these particular poor people if . . ." Taking account of opportunity costs as well as direct costs. Working with social benefits and costs, not private benefits and costs. Analyzing marginals, not averages. Doing general equilibrium analysis, not partial equilibrium or micro level analysis. Let us try to draw policy prescriptions when our knowledge permits us to but be humble enough to acknowledge when our judgments are driven by hunches rather than hard facts.

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