INCLUSIVE GROWTH

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The Global Challenges of Social Inequality and Financial Inclusion

BY

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Howard is a highly cited scholar, with fellowship awards from the US Academy of Management, the British Academy of Management, the Strategic Management Society, the Academy of Social Sciences, and the Institute of Directors. He was also awarded the Richard Whipp Lifetime Achievement Award of the British Academy of Management in 2013, and the Strategic Leadership Award from the Association of Collegiate Schools of Business International (AACSB) in 2014. He is a companion of the Association of Business Schools in the UK, and former chair of the board of the Graduate Management Admissions Council (GMAC), AACSB, the Association of Business Schools (CABS), and the Global Foundation of Management Education (GFME). He is also an honorary life member and a former board member and vice president for Business Schools of the European Foundation of Management Development (EFMD). He served as president of the Strategic Management Society and has held visiting and permanent academic posts at the Australian Graduate School of Management (AGSM); London Business School; Edinburgh University; Questrom School of Business, Boston University; Sloan School of Management, MIT; Kellogg School of Management, Northwestern University; University of Southern California (USC); European Institute for the Advanced Studies in Management, Brussels; HEC Montréal and the University of British Columbia in Canada. He has had Deanships/ Senior Administrative positions at London Business School, AGSM, the University of Illinois at Urbana-Champaign, Warwick Business School, and Singapore Management University. He is also the recipient of several honorary degrees.

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He is a Canadian who spent 25 years working in Europe, sub-Saharan Africa, the Middle East, North Africa, and Asia Pacific before returning to Canada in 2011.

Yuwa studied philosophy, political science, history, and economics at Trent University, and pursued post-graduate studies at the University of British Columbia and Simon Fraser University in Canada, where he received his PhD. He lives on Salt Spring Island, off the West Coast of Canada, with his wife and their cat, where he gardens enthusiastically.

Preface and Introduction

Among large global public companies, Mastercard has been a pioneer in advocating and advancing inclusive growth and financial inclusion in the 200 + countries and territories in which it operates. In 2006, it created the Mastercard Foundation to fund visionary partners working on catalyzing deep social and economic transformation to empower the poor for self-sustaining development across the world, with a specific focus on sub-Sahara Africa. In 2013, it created the Mastercard Center for Inclusive Growth with its signature theory of change built around democratizing productivity, which supports a global network of research partners and scholars to work on cutting edge research on inclusive growth.

Among the research partners of the Mastercard Center was the Singapore Management University (SMU), which funded a Social and Financial Inclusion Research Program that ran from 2015 to 2018, led by Professor Howard Thomas, who was also appointed the Mastercard Chair Professor of Social and Financial Inclusion.

The SMU/Mastercard research program was structured with several clearly defined objectives that included a series of research projects on inclusive growth and financial inclusion involving faculty members and research students with a geographical focus on ASEAN (the Association of South East Asian Nations), though not exclusively; and two annual SMU/Mastercard Research Forums with the twin aims of SMU acting as a "hub" to bring together practitioners and academics to discuss and share research ideas; and in turn, developing the research capacity of young researchers (also with the help of the Lien Center at SMU). More importantly, the Mastercard Chair, Professor Howard Thomas, had not only reviewed and managed the research projects but has also promoted the development of a series of case studies in the area of social and financial inclusion. Eight case studies have currently been concluded (Cambodian Water Project, SCVD; Fullerton Financial Holdings (FFH) in Myanmar; Cardpe in India; Yangon Bakehouse in Myanmar; SureCash in Bangladesh; Juntos Global; Veriown in India; and Great Women in the Philippines). A few others such as iCare in Vietnam are in the writing stage. In addition, the Chair has been asked by Mastercard to co-author a readable and thought-provoking volume on social and financial inclusion utilizing the research findings and lessons learned from the case studies (with Yuwa Hedrick-Wong – Chief Global Economist, Mastercard, NY). This publication is sponsored both by Mastercard and the European Foundation for Management Development (EFMD), an acknowledged thought leader in global management education.

Strong research linkages have also been built between the SMU/Mastercard Program and the Susilo Institute for Ethics in the Global Economy at the Questrom School of Business at Boston University in the United States, as well

as the Enterprise Academy and Ethics Think Tank at the Gordon Institute for Business Science (GIBS), University of Pretoria, South Africa, during the course of the SMU research. These linkages will serve as a foundation for future collaboration between these institutions to develop further research on inclusive growth.

Broad Rationale for the Book

Recently, there has been an upsurge of debate and writing about income inequality and its relationship to concepts of inclusive growth and indeed capitalism itself. For example, Caulkin (2017, p. 9) in a provocative article entitled "Inclusive Growth and Prosperity – For Whom?" stated that: "nearly 10 years after the global financial crisis, much of the world remains mired in the last paradigm, which has delivered the opposite of inclusion - inequality, insecurity, and the feeling of being excluded from global and technological advance - and hence, Trump, Brexit and the rise of nationalism and populism."

He also reflected (Ibid.) that: "in 2017 growth is stalling, productivity is static, innovation rates are falling and new business formation is modest." He quotes (Ibid., p. 10) Professor Gerald Davis (University of Michigan) who has characterized the conflicts between corporate objectives and job creation as: "the shifts from outsourcing to uberization have been driven by the corporate imperative to create shareholder value. Under current conditions creating shareholder value and creating jobs is clearly incompatible."

There is a growing sense that the "last paradigm," ostensibly the current model of capitalism, which has failed to deliver better living standards for significant segments of the society while creating much greater corporate power, requires modification and change. The well documented widening gap between the top 1% and the rest is compelling a deep rethink of the efficacy and relevance of the capitalist market economy in generating widely shared growth and prosperity.

The intellectual case for a reevaluation of capitalism is, for example, persuasively and engagingly articulated by Professor Mariana Mazzucato (2013, 2018) of University College London (UCL). She argues that in the market economy, the current balance between those who create value and those who extract value is not appropriate, given the evidence by Piketty (2014) and others. She notes that classical economists such as Adam Smith, David Ricardo, and Karl Marx had always drawn a distinction between value creation and value extraction in their works in the tradition of political economy.

However, this analytical tradition has been by and large ignored in the mainstream contemporary economic framework. Instead, led by Fama (1970), a winner of the Nobel prize in economics, the price mechanism was upgraded to a central role in determining how value is created and distributed in the market economy, especially in the financial and capital markets. Corresponding to this shift in intellectual paradigm has been an increase in the power of financial institutions in extracting growing shares of the value-added in financial transactions,

with some of the excesses clearly exposed during and after the 2007/08 global financial crisis.

The global financial crisis, however, also served as a powerful catalyst in accelerating the rethink of the capitalist market economy. In the last decade, we have seen a productive proliferation of new ideas and theoretical constructs aiming to broaden the intellectual paradigm economics thinking: take for instance Lo's (2017) ground-breaking work in integrating evolution, psychology, and human behavior in understanding the financial and capital markets. And, increasingly, many of these new ideas are converging on understanding how a more inclusive capitalist market can be constructed and made to work for the vast majority instead of the few.

It is important to recognize that promoting inclusive capitalism has also been a strategic objective of the European Foundation for Management Development (EFMD). For example, a report on inclusive capitalism (2016) undertaken by Said Business School with EFMD sponsorship, developed five dimensions of inclusive capitalism from interviews with 40+ leaders of non-governmental organizations. The five dimensions were "economic inclusion, human development, social inclusion, environmental sustainability, and political inclusion," which reflect a comprehensive formulation of inclusive growth (Said Business School, University of Oxford, 2016). Similarly, we conceptualize inclusive growth as a process of democratizing productivity. This means extending basic rights for all to access and participate in the vital networks of services and know-how that are the essential enablers of increasing productivity in modern economies. We discuss the concept fully in Chapter 1 of the book. For us, our explanation of the process of inclusive growth is the critical, and most important, contribution of our work.

The importance of an inclusive form of capitalism was also highlighted by Sam Palmisano, former CEO of IBM, in his prophetic articles published in the journal, Foreign Affairs (Palmisano, 2006, 2016), which were quoted in studies on globalization by Ghemawat (2017) and Wladawsky-Berger (2017). In the 2006 article, Palmisano noted that "the alternative to global integration is not appealing. Left unaddressed, discontent with globalization will only grow. People might ultimately choose to elect governments that impose strict regulations on trade or labor, perhaps of a highly protectionist sort. Worse, they might gravitate toward more extreme forms of nationalism, xenophobia, or anti-modernism" raising issues "that are too big and too interconnected for business alone or government alone to solve." Sadly, some of Palmisano's (2006) warnings have indeed come to pass.

In his follow-up article in 2016, Palmisano notes his concern about the unwelcome evolution of political and economic developments over the previous decade, pointing out that: "today the world stands at a crossroads [...] a rising chorus of nationalism echoes across developed countries; it calls for tighter borders and restrictions on immigration. Global trade negotiations have essentially ceased, and regional trade deals face strong headwinds of opposition [...] although political forces seem to be trying to separate people, technology is

digitally connecting and integrating them in everything from business to entertainment to commerce to social sharing and commentary to scientific endeavors."

He concludes with a heartfelt plea for stronger leadership and partnership between business and government in the future, "the key now is for enlightened leaders to develop and continually modernize models for business and government. If they don't we will see an increase in intolerance and tensions. If they do, I'm confident that the challenges of today and tomorrow can be overcome in ways that deliver greater civility, more employment, higher incomes, and greater prosperity for people throughout the world."

We agree wholeheartedly with such sentiments. Indeed, in a recent column, Hedrick-Wong (Forbes, July 6, 2018), warns against the folly of isolationism, nationalism (e.g. America first) and trade wars: "running a trade surplus in the US is theoretically possible, but the consequences would be prohibitively expensive imports of any kind; impoverishing American households and debilitating American businesses. Not exactly the right way to make America great again. Retreating into economic isolationism would produce a similar outcome [...] winning a trade war means losing, big time."

Unlike many others, we take an optimistic and positivist perspective on the importance and efficacy of inclusive growth in democratizing productivity globally. Consequently, our book outline of seven chapters is a journey from enabling models of government and business to strategies for creating both financial and social inclusion and entrepreneurism as mechanisms for sustainable and inclusive growth.

Book Outline and Content

At the outset it is important to explain the logic, structure, and design for the book. We believe that interpreting, understanding, and implementing inclusive growth policies is essential in reducing the widening gap between the wealthy and poor both in Western developed as well as developing economies. Accordingly, the book starts by explaining the enabling models and basic principles which underlie inclusive growth and then looks at key issues and problems that must be addressed, and resolved in order to achieve inclusive growth through democratizing productivity. The following is the rationale for each of the chapters.

Chapter 1

Enabling Models of Inclusive Growth from Financial Inclusion to Democratizing Productivity

We conceptualize inclusive growth as a process of democratizing productivity. In essence, inclusive growth means extending basic rights for all to access and participate in the vital networks of services and know-how that are the indispensable enablers of increasing productivity in modern economic production.

This requires access to basic inputs (e.g. electricity, health, and education); enabling inputs (e.g., ICT networks, financial services, and property rights), and complementary assets (e.g., social capital, professional networks, knowledge, and skill networks).

Chapter 2
What Is 'Financial Inclusion'?

This chapter focuses on the inability of the 2 billion or more underbanked (and micro, small, and medium enterprises (MSMEs)) which are mainly at the bottom or base of the pyramid (BOP) to access formal financial services. We discuss in detail the meaning of financial inclusion, using a multi-dimensional definition involving access, availability, and usage as the essential elements (as in the Indian Jan Dan Aadhaar model). We then assess how to measure financial inclusion and identify the contextual, social, and economic factors which impede inclusion. Understanding these factors allows for the examination of how the widespread adoption of mobile telephones in emerging economies can be exploited in combination with other advances in technology, particularly digitization, in order to improve financial inclusion. We conclude the chapter with an examination of Veriown, a case study of technology and mobile phone adoption in India, which demonstrates how the enabling models of infrastructure and technology can together achieve better financial inclusion. Note that this case study was written as part of the SMU Mastercard program.

Chapter 3
How Digital Finance and Fintech Can Improve Financial Inclusion

Following the financial inclusion discussion in Chapter 2, we suggest that digital products and financial services have clear advantages in terms of the cost of provision and the ease of usage for digital payments and loans. Therefore, we examine in detail the reasons for the success of the M-Pesa digital payments program in Kenya and describe its distinctive impact on the financial ecosystem in Kenya. We draw further lessons from similar digital payments interventions in India (EKO Financial and Cardpe) and Bangladesh (bKash and SureCash). We also examine an empirical research study of Fintech start-ups undertaken at SMU in order to identify the success factors of such start-ups, including prior financial industry experience of the founders, customer centricity, partnerships/collaborations with financial and business institutions, and interoperability.

Chapter 4
What Is Social Inclusion and How Financial and Social Inclusion Are Inextricably Linked

It is clear that those who are financially excluded are also socially excluded. Some of the key barriers, apart from poverty, are the ability to prove identity,

establish credibility and trust with financial institutions, and gaining financial knowledge for those at the BOP; especially in terms of their capability to use mobile technology and mobile financial wallets. We discuss the well-known Aadhaar identity project, which has provided a biometric identity for virtually all the residents of India, and hence enabled access and account availability to be granted for the majority of Indian citizens. We also discuss efforts to increase usage of accounts at the BOP by examining the use of behavioral and text messaging approaches to "nudge" those at the BOP to use their accounts. This discussion focuses around the Juntos Global case study written as an outgrowth of the SMU/Mastercard program. We finally examine another SMU/Mastercard program case, that of Fullerton Financial Holdings (FFH), which outlines the processes by which FFH launched their microfinance banking services in Myanmar. They used approaches based on a combination of digital finance and social networks and groups – mainly of women, to build a strong and viable financial services platform in Myanmar. We contrast FFH with the relative failure to quickly scale up the BPI Globe BanKo MFI launch in the Philippines.

Chapter 5
Pathways to Inclusive Growth: Social Capital and the Bottom of the Pyramid

The FFH case in Chapter 4 provides a very useful transition for exploring the role of social networks and social capital in financial inclusion. In particular, after defining the meaning of social capital, this chapter explores how social capital and social networks can be developed through training and other interventions using protocols developed by the World Bank. This social capital development process is the subject of a research study carried out at SMU in the context of fishing and farming communities in rural, and extremely poor, areas of the Philippines, in Northern Samar. Indeed, these communities bonded and linked very closely following training so that, for example, joint investments in farming and fishing technology, were introduced to improve productivity and income growth. Work on improving the quality of their business loans is continuing. We also discuss a further example based upon an SMU case in Cambodia of a water purification project, which demonstrates the linkages between villagers, social entrepreneurs, and water filtration companies in order to improve local water quality.

Chapter 6
The Role of Social Enterprises and Entrepreneurship in Driving Inclusive Growth

Here we examine the meaning and definition of a social enterprise and its dual goals of achieving both financial and social impact. Social impact investing is also a growth area which involves companies and non-profit organizations such as AVPN and ACCION in the Asian context. We discuss not only the role of social enterprises in enhancing inclusive growth, but also review alternative

approaches to financing these enterprises using both voluntary organizations and capital markets as partners. We emphasize the issues of the growth of social enterprises by discussing two case studies. First, evolution and sustainable growth of Yangon Bakehouse, another SMU case study, in Myanmar, where currently no legal definition for the constitution of a social enterprise organization exists. Second, iCare Benefits which sought to assist low income retail consumers in Vietnam as a for-profit social enterprise.

Chapter 7
The Role of Women Entrepreneurs in Inclusive Growth

One very important finding that emerged from our work in Asia is that women are particularly important in their role as group anchors, and are often the key element of social network bonding. For example, this is a feature identified in the microfinance situation of FFH in Myanmar. Yangon Bakehouse's key founders were women and their baking partners were all poor women who were trained by them and then financially included because they provided poor employees with a bank account and financial training as part of their employment. In essence, this chapter examines the research evidence of the role of gender, and particularly women, in social enterprises. It amplifies that evidence with a further SMU case study of the successful evolution of the Great Women social enterprise in the Philippines, where the three key founders were all women.

Postscript and Future Directions

The book catalogues a multi-year journey exploring inclusive growth through the lenses of research projects and living case studies primarily from the SMU/Mastercard program. Finally, we also review the future directions and pathways to take this work forward, for example, with Howard Thomas's ongoing association with the research efforts of the Susilo Institute at Boston University and others.

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The book would not have been possible without the further collaboration, help, and support from a number of key people and sources. We offer thanks and gratitude to the following people and organizations.

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Then we are extremely grateful to the many colleagues at SMU who embraced the concept of the program and together ensured that we had a strong research team environment. They are in a number of categories: senior management, faculty and research colleagues, case writers and editors, and members of the entrepreneurship and wider business community.

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modern China, and Aurobindo work on financial literacy have both been influential in tandem with their counsel and enthusiasm about research in the field of inclusive growth. Chon Phung and Miguel have also produced excellent doctoral theses. Miguel's (2017) work was on the success of Fintech start-ups and is novel and influential. He is currently a fellow at the Cambridge Centre for Alternative Finance at the Cambridge Judge Business School, University of Cambridge. Chon Phung's work on purposely developing capital to improve social enterprises is also path-breaking. He is continuing his passionate and enthusiastic research work as a research fellow at SMU in a program led by Professor Reddi Kotha. It is also important to recognize the academic insight offered by colleagues such as Jeremy Goh, Stephen Harney, Michelle Lee, Saumya Sindhwani, and Rick Smith from the Lee Kong Chian School of Business.

Third, many thanks are due to Howard's colleagues in the Center for Management Practice and Asian Case Studies Center at SMU for their professionalism and help in developing the range of case studies on inclusive growth listed in the book's appendix. In particular, Phil Zerrillo and Havovi Joshi provided direction and focus for this effort. The excellent work of case writers including Sheetal Bhardwaj, Lipika Bhattacharya, Lakshmi Appasamy, and C. W. Chan is also acknowledged. We would also offer a vote of thanks to those entrepreneurs who not only allowed us to write cases involving their enterprises but also contributed significantly to our seminars, they include Kelly Macdonald (Yangon Bakehouse), Jeannie Javelosa (Great Women), Steve Johanns (Veriown), and Jennifer Tan and Anindo Mukherjee (FFH). At these seminars they were joined not just by academics but by professionals in the field such as Suman Bery (India), Matteo Chiampo (CGAP), Lesley Goh (Microsoft and now World Bank, Washington, DC), and Yogavelli Nambiar (Allan Gray Orbis Foundation, Cape Town, South Africa). There are also many other external businesses and social entrepreneurs who attended our seminars and thus created an interdisciplinary perspective on the inclusive growth field (note that summaries of the seminars are available in the appendix). We thank them all for their valuable participation and teamwork.

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Salt Island, Vancouver, CA

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Chapter 1

Enabling Models of Inclusive Growth from Financial Inclusion to Democratizing Productivity

Introduction

The Puzzle of Economic Growth: The Widening Gap between Richer and Poorer Countries

During World War II, a group of Allied airmen who were shot down captured and imprisoned in a Nazi Prisoner of War camp, engineered an ingenious break-out; an event that inspired the 1963 film *The Great Escape.* It is also the title of a 2013 book by the economics Nobel Laureate Angus Deaton about another extraordinary escape: the decline in global poverty across the world over the last half century.

The full title of Deaton's book is *The Great Escape: Health, Wealth, and the Origins of Inequality* (Deaton, 2015). It meticulously documents the economic and social progress made with an abundance of data at both the micro- and macro-levels.

In addition to focusing on standard economic measures Deaton combines data on health with income to create a more holistic perspective; an approach that enables him to assess more rigorously the illusive concept of well-being. The book encapsulates the virtues of vision, rigor, and creativity that Deaton has consistently displayed in his scholarship with the compelling conclusion that the achievement in poverty reduction in the past half century is real and historically unprecedented.

This is corroborated by the progress made in achieving the United Nations Millennium Goal of cutting the 1990 poverty rate in half by 2015. As it turned out, the world achieved this target in 2010, five years ahead of schedule. According to data by the World Bank, nearly 1.1 billion people have been moved out of extreme poverty (defined as living on less than $1.90 a day) since 1990. China in particular was responsible for a significant element of this by lifting almost 400 million out of poverty. In 2013, 767 million people lived on less than $1.90 a day, down from 1.85 billion in 1990 (World Bank Group, 2018).

And yet, in the midst of so much progress, the world remains extremely divided between the rich and the poor with a wide disparity in the "wealth of nations." For example, in 2015 Switzerland had the highest *per capita* GDP in the world at $80,802, followed by Norway at $74,342, and the United States at

$56,049. In sharp contrast, Burundi had the lowest *per capita* GDP at $268. The Central African Republic was the second lowest at $325, and Niger the third lowest at $361. In other words, the richest country is 301 times richer than the poorest country on a GDP *per capita* basis.

Africa accounts for 15 of the 16 countries with the lowest GDP *per capita* in the world (Afghanistan is the only non-African country in this group) (IMF WEO Data, 2018). And the gap between the richest and poorest countries has continued to widen at the same time that hundreds of millions of people were escaping poverty.

An even more disheartening picture emerges through the lens of "wealth account," which is a more comprehensive measure than GDP. While GDP is a flow concept, summing up how much is produced, consumed, and invested each year, the wealth account estimates the sum of productive assets in a country.

Four key types of capital are included in the estimate: produced capital (e.g., physical infrastructure, machinery, and tools); financial capital (e.g., net foreign assets); human capital (estimated as the present value of the future earnings of the labor force); and natural capital (the sum of values of natural resources).

While GDP growth fluctuates – often wildly during financial crises – the wealth account of a country is a more stable measure of its growth and development prospects, especially when estimated on a *per capita* basis.

The latest estimates of wealth *per capita*, which cover 141 countries over the period 1995–2014, unveil a deeply divided world (Lange, Wodon, & Carey, 2018). There is a significant overlap between countries with the lowest GDP *per capita* and the lowest wealth *per capita*. In fact, Burundi, which has the lowest GDP *per capita*, has also seen its wealth *per capita* shrink the most among the countries measured during the period. Other sub-Saharan African countries such as Democratic Republic of Congo, Nigeria, Zimbabwe, and Cote d'lvoire also experienced declining wealth *per capita*. Note that outside of Africa, notably Portugal, Spain, and Greece also experienced shrinkage in wealth *per capita* due to their extraordinarily high unemployment in the aftermath of the Eurozone Crisis.

The fact is that much of the progress documented in Deaton's *The Great Escape* over the past 50 years can be attributed to a single country – China.

Deaton has pointedly observed that we do not yet have all the answers as to how and why so many are left behind, and why the gap between the richest and the poorest is still widening. Deaton's work shows that advancing inclusive growth remains the foremost challenge of our time.

To advance inclusive growth, we need to address the puzzle of a simultaneous increase in disparity and a decline in poverty. Why are so many people in the world steadily getting ahead while others are being left farther and farther behind? Why do market forces seem to be working well in some places but not so well elsewhere? And why are different countries in the same region (and indeed different regions in the same countries) experiencing dramatically diverse trajectories in economic growth and poverty reduction, often in spite of similar macroeconomic policies, institutions, and regulatory regimes?

This economic growth puzzle has compelled a deep reevaluation of many conventional theories and approaches. And, in so doing, it has stimulated a

rethinking of fundamental constructs of economic growth itself. Expert advice on accelerating economic growth over the last 50 years has run the gamut from macro policy prescriptions such as the IMF's structural adjustment programs to industrial policy for nurturing infant industries and more grassroots-oriented microfinance and direct assistance to the poor plus an emphasis on investment in education and health. The weak results of 50 years of effort have been aptly described by William Easterly, an American economist specializing in economic development, as "the elusive quest for growth" (Easterly, 2002).

Economic Complexity, Productivity, and Economic Growth

At the heart of the puzzle is the challenge of understanding productivity. The standard economic models traditionally treated productivity as somehow "external" to the economic system, something that just happens as a result of technological changes. Before long, however, even the most pig-headed economists came to realize that sound economic analysis is needed to account for technology and productivity. What evolved next is the so-called endogenous growth models that explicitly incorporate technological progress as part of the economic system. There are two main variants:

The first is to tie the rate of technological progress to certain macroeconomic conditions, such as investment in human capital, research and development expenditures, and indicators related to macroeconomic stability and so on.

A second variant focuses on entrepreneurial behavior and conditions under which market competition is intense, which can lead to further creative destruction. While representing a major improvement over their predecessors, the endogenous growth models remain inadequate, being very top-down and they can take us only so far in decoding the dynamics of productivity growth.

In the past decade, advances in a new field of research known as economic complexity, led by Ricardo Hausmann and his team at the Center for International Development at Harvard University in the US, has made it possible to understand better how technology and productivity interact and drive economic development.

The research on economic complexity highlights a key feature in today's economic process – the need for economic agents, be they individuals, firms, or even countries, to collaborate in order to be productive. Such collaboration typically takes the form of being connected to a range of vital networks that are powerful enablers for raising productivity. The fact is that modern economic production requires a very large set of complementary inputs (Figure 1.1).

At the most basic level, we need to be connected to networks that supply us with clean water and power, and affordable transportation networks that move us efficiently and affordably before we can even participate meaningfully in the economy.

Then there are the critical networks for accessing information and for obtaining important services such as health, education, banking, and finance. There are also the more intangible, but no less critical, social, and professional networks for accessing skills and the know-how that resides in people's minds. How

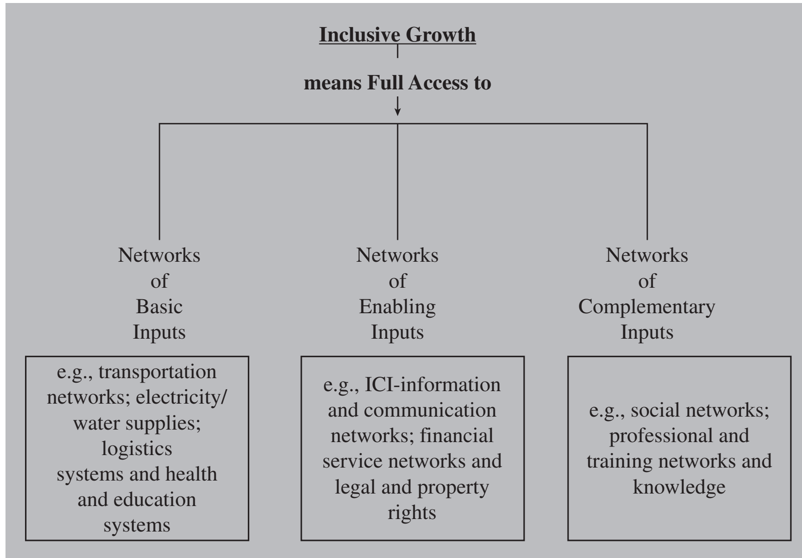

Figure 1.1. Inclusive Growth, Access and Eliminating Barriers to Inclusion. *Source:* Hedrick-Wong and Thomas (2018).

well an economic agent is connected to these vital networks determines fundamentally how productive it can be.

These networks can also be understood as the conduits through which knowledge is transmitted and shared. Depending on the nature of that knowledge, the network characteristics themselves will also differ as will conditions affecting access to these networks.

We can think of knowledge in three different dimensions: embodied knowledge in the form of tools; codified knowledge in the form of information, blueprints, recipes, and manuals; and tacit knowledge, which takes the form of collective know-how (Figure 1.2).

This decomposition of knowledge allows us to examine systematically how, in regard to each of these dimensions at the grass roots level, individuals are able or unable to access the knowledge they need in order to reach their full productive potential (Hausman, Hidalgo, & Bustos, 2013; Hidalgo, 2015). Such an approach in turn opens up a whole new way of thinking about inclusive growth.

In the dimension of embodied knowledge, which includes all tools, machinery, and physical infrastructure, it is easy to see how many people in poor countries are simply not able to access these networks. Simply, there may not be enough of them or they may even be non-existent. For example, in the Sahel region in Africa, rural women spend on average about three hours a day just to fetch enough water for their families to use for the day because their homes are not connected to any form of reliable water supply. They typically have to walk long distances to a source of water and then physically carry the water home.

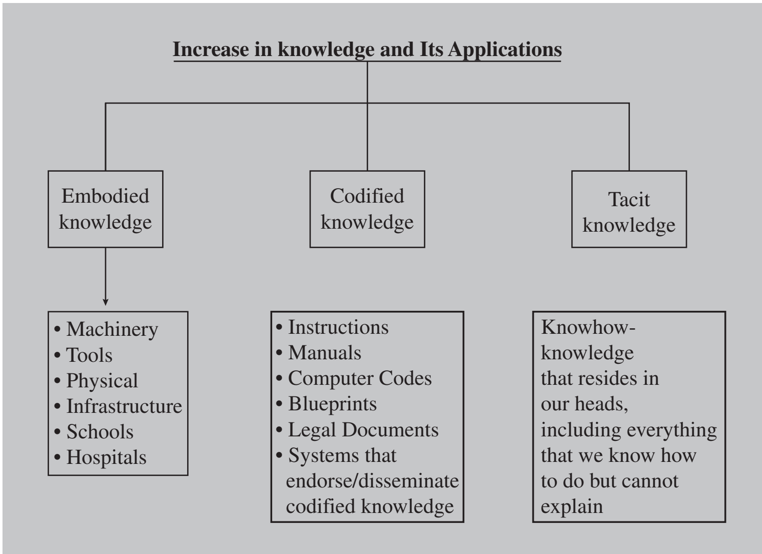

Figure 1.2. Dimensions of Knowledge. *Source:* Hedrick-Wong and Thomas (2018).

It's not hard to imagine how much productivity is being reduced daily for these rural women.

A lot of the networks of physical infrastructure are also interdependent: without roads, it is difficult to connect a village to electricity (even allowing for sufficient electricity supply, which is typically not the case) and without electricity all sorts of labor-saving devices and tools will not work. The exclusion from accessing better tools and more efficient infrastructure is a primary reason that the poor are kept at a very low level of productivity. In other words, they are stuck in a poverty trap. A good example is available from Lim's (2018) PhD research in which he stresses that the lack of access to basic farming and fishing tools is the main cause of poverty in rural communities in Northern Samar in the Philippines.

In the dimension of codified knowledge, which includes essential services such as finance, health care, and public services that are made possible by having effective institutions, many networks for service delivery typically have very high fixed costs and low variable costs. For example, in financial services based on the conventional banking business model, a relatively high fixed cost is incurred in serving a new customer. And the poor being poor, they are unlikely to generate sufficient business volumes to justify the high fixed cost incurred in serving them. So, they are excluded.

Imagine a talented young entrepreneur from a poor rural background in Uganda who has started a very promising small business. His or her customer base is growing rapidly and merits expansion. But lacking family connections and without any significant collateral, the entrepreneur cannot get qualified for

any business loans. This exclusion from the network of financial services is why productivity is stuck at a level far below the true potential. One further example of this is the way iCare Benefits, a profit and purpose-driven social enterprise, has enabled the "official or non-casual" workforce in Vietnam to gain access to "no interest" credit to enable women to buy consumer durables in households like refrigerators, washing machines, and smart phones to free up their time to participate in the labor force and use their time more productively.

The third dimension – know-how – is even more problematic. Know-how is everything that we know how to do but cannot explain. Skiing is a know-how. We learn how to ski by skiing not by studying the physics of skiing. A ski instructor cannot download his/her skills directly to a student skier. Consequently, the diffusion of collective know-how is far more difficult than the diffusion of embodied and codified knowledge. Yet more sophisticated and higher value-added economic activities typically require many more inputs in terms of know-how. Lack of access to know-how is a serious constraint of productivity growth and economic development.

Know-how has two properties that make it especially tricky. First, it resides only in people's brains, not in books of computer codes, so it cannot be downloaded from the Internet. It is a capacity to perform a task that does not involve explicit comprehension. We learn about various know-hows through a long process of imitation – sometimes we work with experienced people and repeat what they do and sometimes we learn from our own mistakes. Second, the growth of know-how in a society is not based mainly on each person knowing more but instead on each person knowing different things. To a large extent, knowledge grows via networks of complementary inputs through increased diversity and by connecting people who know different things.

In modern economic production, the more complicated the task, the more important is the dimension of know-how relative to embodied and codified knowledge. Exclusion from accessing networks of complementary inputs in the form of know-how is therefore particularly detrimental to productivity. Because the networks of complementary inputs in the dimensions of tacit knowledge are made up of people, not machinery or electricity supply, discrimination on the basis of gender, class, caste, region, dialect, religion, and so on can play a big role in suppressing productivity.

From this perspective, the poor are poor precisely because they are stuck in low-productivity activities. In poor countries, workers, micro-entrepreneurs, businesses, and even entire industries are often shackled to low-productivity operations due to the absence of many of the critical conditions that would have enabled workers to learn new skills and get better jobs, micro-entrepreneurs to thrive, small businesses to expand, and bigger firms to finance acquisition of productive assets and to access new and promising markets and customers.

To appreciate the detrimental effects of being excluded from accessing networks of knowledge and complementary inputs, imagine one of the best brain surgeons in the world being put to work in a village clinic in sub-Sahara Africa. In this rural setting, she or he has to try to function without a high-tech operating theater or an intensive care unit with advanced medical devices and teams of

professional staff. He or she is alone and unsupported by diagnostic laboratory services and associated specialists.

Under such circumstances, the very best that this brain surgeon can do is to perform routine tasks much like a general practitioner, dispensing basic medicine to patients but very likely not even that. In other words, the productivity is dramatically reduced if this person is confined to working alone, disconnected from all the vital networks that a brain surgeon needs to function effectively.

This thought experiment is supported by empirical research. For example, household surveys from 35 countries show that returns to working experience vary hugely across countries, with poor countries having much flatter age-earnings profile (Lagakos, Molls, Porzio, Qian, & Schollnian, 2012). This suggests that in spite of gaining more experience and getting better at what they do, experienced workers in poor countries are less able to move onto more productive jobs with better pay. In other words, the huge potential of raising productivity from deploying the more experienced and skilled workers in positions where they can be more productive is left untapped in poor countries. Obviously, many factors are at work but there is little doubt that labor market rigidity, poor transportation, and lack of social and economic inclusion is very much at the crux of the problem.

A parallel situation can be found at the level of the firm. In the US, for example, firms get much bigger as they age; firms that are more than 35 years old have eight times the employment of firms in the same sector that are less than five years old. Older firms have survived the test of competition and evolved; in other words, they are much more productive. And as they expand their employment, they are also creating opportunities for more workers to function at higher levels of productivity.

In contrast, firms that are over 35 years old in Mexico have only twice the employment of firms that are less than five years old; in India, there is virtually no difference in employment between the older and younger firms (Hsieh & Klenow, 2014). Again, evidence points to the lack of social and economic inclusion as the "smoking gun." This is also corroborated by research evidence that shows lack of access to financial services in general, and credit in particular, is a major reason for loss in productivity (Midrigan & Xu, 2014; Moli, 2014). The findings of the National Economic Development Authority (NEDA) in the Philippines further emphasized that the long-standing problems of poor farmers to improve their livelihood were due to very limited access to credit, hampering their access to basic tools (Lim, 2018).

Inclusive Growth and Democratizing Productivity

Whether it is poor infrastructure, labor market rigidity, monopolistic practices, restricted access to finance, collusion of vested interests, or stifling regulations (most likely some combinations of them), it is clear that innovative micro-entrepreneurs and successful firms alike in many poor countries are prevented

from expanding, which reduces their potential growth of productive employment, thereby leading to lower productivity in the overall economy.

Through the lens of economic complexity, we can now re-interpret poverty as people being trapped in low-productivity activities due to a lack of access to any number of the vital networks that are powerful enablers for raising productivity. We can also address the puzzle of why there has been a simultaneous increase in income disparity and reduction in poverty.

The dramatic reduction in poverty that the world has seen in the last half century came about because hundreds of millions of people who used to live in poverty were connected to many of the vital networks that enabled them to raise their productivity. China is a prime example where rapid improvement in infrastructure, the movement of tens of millions of migrant workers from rural areas to cities, and massive influx of know-how and the often mandatory knowledge transfer, that arrived with foreign direct investment created endless opportunities for poor peasants to connect to such networks, which then dramatically increased their productivity.

At the same time, however, many countries, and segments of population within countries, continue to fail to access many of these vital networks so poor people are stuck in low-productivity traps. As a result, the distance between the richest and the poorest has continued to grow despite a massive reduction in poverty.

From this perspective, inclusive growth is all about overcoming barriers of exclusion. Some exclusion is due to the nature of the network itself. For example, as mentioned above, there is a high fixed cost per customer in providing banking and financial services using conventional banking business models and low-income people are excluded because they cannot generate sufficient business volumes to justify the fixed cost involved. This fixed cost, however, could be lowered and made variable, through the increasing adoption of Fintech solutions.

However, many social and institutional networks for connecting people and combining know-how have evolved historically, predating the modern economy, and ancient prejudices embedded in these networks could seriously constrain segments of the population from full participation. Gender bias that is rooted in traditions and cultural practices is one such form of exclusion. And there are many others.

In this context, we can conceptualize inclusive growth as a process of democratizing productivity. Just as citizens in a democracy have a set of participatory rights in choosing their leaders and setting parameters for public policies so inclusive growth means extending basic rights for all to access and participate in the vital networks of infrastructure, services, and know-how. And in order to democratize productivity, we may need to work with governments under certain conditions but amplify market forces in other contexts.

In fact, governments and markets need to function as complements in order for inclusive growth to succeed. Government regulations are needed to create standards, protect property rights, and enforce the rule of law so that markets can operate efficiently. And governments play a major role in the production and protection of what is referred to as public goods: infrastructure, health, education, safety of consumers, and the environment. The bottom line is that markets and governments are complements in inclusive growth, not opposing substitutes.