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# Macroeconomic Policies and Poverty

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## ***1. Introduction***

Macro-economic performance is of critical importance in determining levels of poverty since the growth of the economy is among the most important influences over both the private and social incomes of the poor. Poverty can, of course, fall in the context of stagnant macro-performance, if the share of income of the poor is rising (or conversely), but sharp changes in income distribution are unusual and difficult to attain. Hence the importance of macro-policies. The aim of this paper, therefore, is to identify macro-policies that are likely to be poverty-reducing.

The dominance of the International Financial Institutions over the macro-policies of many poor countries makes analysis of the poverty consequences of the policies they advocate of particular relevance, and considerable effort has been devoted to this. However, although much of this work has been empirical, the conclusions depend heavily on the assumptions underlying the methodologies – in particular on how the counterfactual is estimated. Consequently, unambiguous conclusions are rare.<sup>1</sup> Moreover, in some ways a good deal of this work is beside the point since the conditions of the poor *have not been improving in a satisfactory way in most countries affected by these macro-policies*. Poverty rose in the “adjusting regions” (Africa and Latin America) in the 1980s and was stationary or fell very slowly during the somewhat less stagnationary decade of the 1990s. The Millennium targets are unlikely to be met in important areas of the world (UNDP 2003). Underlying the weak and uneven achievements on poverty are unsatisfactory changes in the underlying macro-conditions most relevant to the determination of poverty – the growth rate, employment, income distribution and social incomes – none of which have been performing well in large parts of the developing world. From the mid-1980s, the World Bank supported a variety of social-safety nets to counter some of the adverse or inadequate impacts of the macro-policy package on the poor. By now it is quite apparent that these have not been particularly effective, for a variety of reasons.

Consequently, irrespective of whether the macro-policy package of the IFIs improves or worsens the conditions of the poor on average compared with some counterfactual, the

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<sup>1</sup> See Stewart (1995) and Gunter (2002) for reviews of a number of studies.

record – in terms of actual changes to the conditions of the poor – has been weak. Acknowledgement of this, indeed, is one factor behind the ‘comprehensive development strategy’ of the World Bank and the Poverty Reduction Strategy Papers (PRSPs) which are required from poor countries before gaining HIPC debt relief or access to the concessional finance windows of the World Bank (IDA) and the IMF (Poverty Reduction Growth Facility).

Rather than exploring yet again the overall impact of existing policy-packages on the poor for the median developing country, compared with some assumed ‘non-adjusting’ situation, this paper, therefore, will aim to identify policies that *are likely to improve the actual conditions of the poor in the range of conditions to be found in poor countries*. In order to do this, the paper will draw on theoretical analysis of the various macro-policy instruments and relevant aspects of the literature assessing such instruments. The objective will be to produce a rather simple guide to policies likely to improve the conditions of the poor. These policies will not be confined to macro-policies but must also include meso-policies (i.e. those policies which determine the distribution of resources, in a given macro-situation).

## ***2. The policy objective depends on the definition of poverty***

There is a great deal of controversy about defining poverty, with views on how best to do so ranging from a simplistic headcount approach adopting a monetary poverty line (e.g. \$1 a day), to capability poverty, participatory approaches and those that identify poverty with social exclusion (see Ruggeri-Laderchi et al., 2003). The definition of poverty is important because the appropriate policy approach depends upon it. A monetary approach to the definition of poverty implies that poverty can be tackled through monetary means – notably raising the monetary incomes of the poor, while capability poverty requires a much broader approach – tackling lack of education, health, or other basic capabilities. For this, money income is an important factor, but the public sector has a central role. Other approaches to poverty definition focus on how the poor themselves

view their situation (a participatory approach), or on social relations (social exclusion approach).

In this paper a reduction in capability poverty is taken as the overriding objective, since capabilities represents people's ability to lead fulfilling lives through what they can do or be. Poverty in capabilities occurs when basic capabilities are absent, such as the capabilities of being well-nourished, educated up to some minimum level, and being healthy. Money income is instrumental for this, rather than the objective. But as it is an important instrument, for brevity I shall work with a dual objective – achieving adequate basic capabilities and the money income necessary for this. The range of basic capabilities has not been definitively determined. Here I shall stick to health, education and nutrition – which invariably form a central part of any list of basic capabilities.

Taking this dual approach to defining poverty, poverty can then be seen as the outcome of (a) the rate of growth of GDP per capita; (b) how that growth (or lack of it) translates into private incomes of the poor; and (c) how it translates into social incomes of the poor, which underpin basic capabilities. In other words, it is a matter of growth and distribution, where distribution encompasses the level and distribution of social incomes as well as monetary incomes.

### ***3. An overview of the main policy instruments and their impact on poverty***

Macro-policy instruments can be divided into those affecting the level of demand (or absorption), and those affecting the deployment of resources between domestic and external uses (or switching instruments). In practice some instruments (such as devaluation) can affect both absorption and switching. Within each category, there are a range of alternative instruments, which can have different impacts on poverty. In the first category are monetary and fiscal policies. Monetary policy instruments include limits on credit expansion and the money supply; while fiscal policies include restraints on public expenditure and tax rises. Exchange rate adjustments, price decontrol and wage restraint form part of the switching policies. In addition, both IMF and WB policy packages include a variety of reforms designed to enhance long run efficiency (sometimes called 'supply-side' reforms) – for example, financial reforms, trade liberalisation, privatisation,

governance reform. Although both institutions include all three types of policy, the IMF takes primary responsibility for the short-term macro-policies, while the WB assumes major responsibility for supply-side reforms.

IFI macroeconomic programmes typically contain policies to reduce demand. As Table 1 shows, restraint on credit expansion has been a feature of most IMF programmes from the 1970s. Direct restraint on public expenditure featured in two thirds of the programmes in the late 1980s, a quarter of standby programmes in the late 1990s and a higher proportion (45%) of Poverty Reduction Growth Fund (PRGF) programmes. Reduction of the budget deficit as a proportion of GDP appears in 30% of standbys and nearly half of PRGF programmes, 1999-2001. While tax reform is a common feature, only 3% of PRGF contained tax increases. In the late 1980s nearly all programmes contained exchange rate reform; perhaps because this had been achieved with many countries adopting flexible exchange rate policies, far fewer showed this condition in the late 1990s. In fact on the basis of the evidence presented here, it seems that there has been a reduction in the proportion of programmes with switching policies. As far as longer term structural policies are concerned, trade liberalisation appeared in 30% of standby programmes and 19% of PRGF, financial reforms appeared in three quarters of the programmes, and privatisation in 42% of the standbys and 71% of the PRGFs; and capital account liberalisation in nearly a fifth of IMF programmes where data are available (late 1988-92). A third of the standbys and a quarter of the PRGFs had specific conditions relating to the protection of the poor. In 2001 the IMF decided to streamline its conditions and place more focus on what it described as the 'Fund' core areas: fiscal, financial and exchange rate policies' however, some of the 'dropped' conditions seem to have been taken up by the World Bank ( IMF 2001. )

Data for reforms contained in the WB's Country Assistance Strategy (CAS) documents indicate the division of labour with the IMF.<sup>2</sup> Significantly fewer programmes have particular macro disabsorption policies, though over 40% require reduced budget deficits. A much larger number of programmes involve sectoral restructuring (71%); a high

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<sup>2</sup> Whilst the CAS puts forward the WB's assistance strategy for a country and is not a programme, as such, it provides an indication of the reforms that the WB is recommending, particularly by showing what actions would lead the WB to lend more. The CAS typically shows three different lending scenarios (the base, low and high cases) with the conditions attached to each of them.

proportion include privatisation; and measures for the protection of the poor account for a significantly larger number of programmes than in the case of the IMF. Analysis of PRSPs, which are in principle prepared by the countries but in practice have a heavy dose of World Bank and IMF influence, indicates a high rate of disabsorption policies, exchange rate reform and trade liberalisation, as well as sectoral restructuring and privatisation. The PRSPs all include measures to protect the poor.

**Table 1: Content of World Bank and IMF Programmes**

	IMF 1969-78	IMF 1988-92	IMF 1999-01		WB 1998-2000	WB/IMF, 2002-3
	All types		standbys (36)	PRGF* (31)	Country assistance strategy papers, (17)	27 PRSPs**
limit on credit expansion	94.3	81.3	88.9	100	5.9	88.9
restraint on public expenditure	na	66.7	25	45.2	17.7	81.5 <sup>a</sup>
tax reforms	56.2	na	17	64.5	29.4	81.5 <sup>b</sup>
tax increases	na	52.4	na	3	na	na
deficit reduction	40	66.7	30	48.4	41.2	na
exchange rate reform inc. deval.	na	97.9	16.7	na	na	66.7
price changes	11.4	75	22.2	9.7	na	na
wage guidelines	5.7	25	5.6	na	na	18.5
sectoral restructuring	na	35.4	25	61.3	70.6	74.1
financial reforms	na	na	66.7	67.7	64.7	77.8
trade liberalisation	50	18.8	13.9	22.6	25.3	81.5 <sup>b</sup>
capital account liberalisation	na	18.8	na	3	na	na
privatisation	na	na	41.7	70.8	58.8	81.5
<i>protection of the poor</i>	10	na	33.3	25.8	58.8	100

\*Poverty Reduction Growth Facility; \*\* Poverty Reduction Strategy Papers.

Source: IMF, 1986; World Bank, 1992; IMF, 2001; Dreher, 2002; Stewart and Wang, 2003.

a. Fiscal constraint

b. Tax and customs reform

As well as macro-policies, meso-policies are important for poverty reduction since they affect the distribution of resources for a given macro situation, for example, the distribution of public expenditure between sectors, the incidence of taxation by income group etc. Among WB supported policies, those oriented towards sectoral restructuring and public expenditure planning are relevant here, as well as policies specifically aimed at protecting the poor, such as Social Funds. These policies can be very important in helping determine how any particular set of macro-policies affect the poor and will also be discussed below.

### ***Absorption/disabsorption.***

Table 1 shows how universal disabsorption policies are in IFI programmes. Yet policies which reduce demand invariably have a short-term negative impact on formal sector employment and/or real wages, and normally on informal sector income earning opportunities. For example, in the first half of the 1980s, when almost all adjustment efforts were focussed on disabsorption, industrial employment in Sub Saharan Africa stagnated, falling sharply in proportion to the growing labour force; real formal sector wages fell by over 30% in nine SubSaharan African countries, and by between 20 and 30% in another nine countries. Similarly, in Latin America, there was a marked rise in unemployment and a fall in real wages (most acute for those on minimum wages) over the 1980s – ranging from 15 to 45% in eight countries - and a fall in the share of wages in national income. While there was a compensating expansion in informal sector employment and self-employment as a proportion of the labour force in both regions, country studies show that there was not a parallel expansion in *incomes* from informal activities. Similar developments occurred in East and SE Asia after the 1997 financial crisis – in which, again, most of the policies followed in the immediate aftermath of the crisis, following the requirements of the IFIs, were deflationary. Unemployment rates doubled in Thailand, and increased more than three-fold in S.Korea in the year and a half following the crisis, with Indonesia worse hit. It is estimated that as much as 10% of the workforce in Thailand, S.Korea and Indonesia lost jobs. There were also sharp reductions in real wages, averaging 10% in S.Korea and 40% in Indonesia. Even though the poorest people are generally not employed in the formal sector they are adversely

affected by knock-on effects – by depressed opportunities in the informal sector, for example, as the newly unemployed seek support there and by worsening markets as a result of the reduced purchasing power coming from the formal sector.

Disabsorption policies also frequently involve cuts in social services. Even if the poor are not the main consumers of social services, they will also suffer from cuts, and these cuts expressed as a proportion of their original incomes are generally heavier than those of richer groups. For example, in Indonesia, following the financial crisis, use of health services by children fell on average by nearly a quarter between 1997 and 1999, partly due to the worsening facilities, and partly because people could not afford fees. In Sub-Saharan Africa in the 1980s, there were quite sharp cuts in real expenditure per person in both health and education, social spending falling from 26 to 20% of government expenditure, and from 5.9 to 5.3% of GDP (World Bank 1996). In the education sector, there were quite widespread falling enrolment rates and rising drop-outs, again due to a combination of deteriorating services and falling incomes which made it difficult for families to send children to school. In Latin America, in contrast, although social spending dropped from 24 to 19% of government expenditure, it increased from 7.1 to 7.8% of GDP (World Bank 1996).

Public expenditure cuts almost invariably fall disproportionately on public investment with adverse impact on employment, the level of private investment and its productivity. (Cornia et al., 1986; Hicks, 1991, 1994). This affects the medium term growth rate adversely. For Latin America, one estimate suggests that the growth rate in several countries was 1% p.a. lower as a result of infrastructural cuts. (Calderón et al. 2002).

Some disabsorption may be unavoidable if there is limited external financing, and external imbalance, with total domestic expenditure exceeding what can be supplied from domestic production and the imports that can be financed out of exports and long-term capital inflows. Reducing aggregate demand may then be needed to improve the external balance as it reduces demand for imports and releases resources for exports as domestic consumption falls. In a very flexible economy – if the deflationary policies are accompanied by switching policies – domestic disabsorption need not result in much rise in unemployment, as the resources previously employed to supply domestic demand can



be switched to supplying exports. However, where the economy is relatively inflexible, and resources cannot be readily switched from domestic consumption to exports, as in many developing countries, then disabsorption will be accompanied by a rise in unemployment. This is more likely the smaller the element of switching policies in the adjustment package. In addition, it is often argued that reduced budget deficits may be desirable for the poor themselves, because budget deficits lead to inflation and inflation reduces growth, while it is held that the costs of inflation fall disproportionately on the poor. From a theoretical point of view, all three of these statements can be questioned, while empirically, there is ambiguous and weak evidence for each one of these claims

The connection between budget deficits and the inflation rate is not an automatic one as it depends on what causes the inflation, and whether the budget deficit is financed from borrowing or by an increase in the money supply and its impact on monetary demand. Structuralists argue that strategic bottlenecks are a major factor behind inflation, while, in highly unionised economies, competitive wage claims can also cause inflation. However, even if such factors are the fundamental sources of inflation, very tight monetary policy may stop the inflation, albeit generally at a high cost in terms of lost output and high unemployment. This was indicated by the way that the extremely high inflation rates experienced by most Latin American countries in the 1960s and 1970s, and widely attributed to structural bottlenecks and/or to efforts by particular groups to increase their share of national income, were mostly reduced to quite moderate levels by the much stricter monetary policies followed in the 1980s.

The empirical evidence is inconclusive: according to Salch (2003, p 22), "it is fraught with contradictory results." For the U.S., Vicrey finds that "deficits do not in themselves produce inflation, nor does a balanced budget assure a stable price level." For developing countries, on the basis of data for 1960-1990, Islam (2003) similarly concludes "concerns about lack of fiscal prudence in the developing world may be exaggerated" (p. 19). Of nine cross-country regressions covering developing countries, only one finds a statistically significant link (Catao and Terrones 2001), one finds a link when inflation is over 100% (Fisher 2000) and eight find no evidence of a statistically significant link.<sup>3</sup> Investigation of particular countries over time produces mixed results. A connection

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<sup>3</sup> The seven are: King and Plosser, 1985; Leviatan and Piterman, 1986; Serban, 2002; ; Montiel, 1989; Dornbusch et al, 1990; Odedokun, 1995 ; islam (2003).

between budget deficits and inflation is reported for Peru by Choudhary and Parai (1991); for Turkey by Mettun (1995, 1998) and Kivilcim (1995); and for SubSaharan Africa by Ghura (1995). At the same time, lack of a strong connection is reported for Turkey by Sonmez (1994) and Ozätay (1996); for Ghana by Sowa (1994); and for Brazil and Mexico by Koluri and Giannarose (1997). Islam (2003) divides countries into 'good', 'intermediate' and 'bad' performers and compares macro variables in each. He finds that inflation rate for 'intermediate' performers is a bit above 'good' performers, but no meaningful difference in the fiscal position of the two groups. "As expected, the 'bad performers' are characterized by relatively high rates of inflation, but even here, the recorded fiscal deficit is not significantly worse than other groups" (p. 14).

As far as the growth/inflation connection is concerned, theory can be interpreted both ways. On the one hand, it can be argued that policies which boost absorption encourage both investment and innovation; and that inflation reduces real interests and therefore does so too. Against this it is argued that inflation may reduce the returns on savings deposits as real interest rates decline, and consequently affects the supply of investible funds negatively, while it increases uncertainty, and this reduces the demand for investible funds, so investment falls and consequently so does growth.

The conclusions of much econometric investigation suggest that high inflation rates are associated with worse economic growth, but at moderate rates there seems to be little impact. Simple correlation across countries shows a weak connection between growth and inflation, and sometimes even a positive one (Karras 1993; Stanners 1993; McCandless and Weber 1995; Temple 2000). Time series evidence – which generally shows a negative relationship between inflation and growth - presents problems as the data pick up reactions to inflation as well as inflation itself and there is also a question about the direction of causality (also true of cross-country regressions). The conclusions of a number of studies using pooled time series and cross-section data are that high inflation rates are associated with lower growth, but below a critical threshold there is no such relationship. (Templar, 2000) In Barro's 1995 investigation of 100 countries, from 1960-1990, statistically significant effects only appear at inflation rates above 50%. Bruno and Easterly find no relationship between inflation and growth below rates of 40%. They also find "no lasting damage to growth from discrete high inflation crises as

countries tend to recover back towards their pre-crisis growth rate” (p 146). Khan and Senhadji (2000) of the IMF Research Department suggest a threshold as low as 7 to 11% for developing countries.<sup>4</sup>

Country experience shows that high inflation can be consistent with good economic growth – notably exemplified by Brazil from 1965 to 1980. The growth rate over this period was over 5% p.a. and the inflation rate was over 30% p.a. In this case comprehensive indexation reduced the uncertainty creating effects of inflation. Colombia and Turkey too have experienced good growth at times of quite high inflation (Corden 1991). Low inflation can also accompany good growth (e.g. Taiwan), but equally, like high inflation, it may be associated with low or even negative growth (e.g. Cote D’Ivoire in the 1980s; India in the 1960s and 1970s). From this evidence it is difficult to argue that inflation is a major obstacle to growth. Moreover, the investigations do not consider the costs (for investment, growth and poverty) of reducing inflation.

The second argument for controlling inflation is that it falls disproportionately on the poor. Inflation is a ‘cruel tax’ according to Easterly and Fischer (2001). The main argument supporting this view is that the poor find it more difficult to protect themselves against inflation than the rich. Whether this is so or not must depend on the nature of poverty in the particular society, and the assets open to poor people. In purely subsistence economies, for example, the poor would be unaffected by inflation. In cash economies, it depends on whether inflation affects their incomes differently from their expenditures, and on the nature of their assets. To the extent that the poor have more debt than others, they would gain from inflation if their debt is fixed in nominal terms. Assets of the poor vary – in many African countries, a major asset is cattle which might be expected to retain its real value with inflation; in India, gold and jewellery form an important element in such assets as the poor have, the value of which might also move with inflation

The empirical evidence on whether the poor suffer disproportionately from inflation is again fairly weak. A number of studies have investigated the relationship between inflation and poverty; and others have looked at the relationship between inflation and income distribution. The balance of the evidence is that inflation worsens poverty/income

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<sup>4</sup> Some studies continue to find a negative relationship between growth and inflation – see e.g. Ghosh and Philips, 1998; Gylfason and Herbertson, 1996.

distribution, but the results are sensitive to the definition of inflation and to the inclusion of outliers, while quite a few studies find no relationship.

*Inflation and poverty:* Epaulard (2003) shows that with very high inflation (above 80% p.a.), there is a higher elasticity of poverty to economic downturn, but no such relationship at more moderate rates of inflation. Agenor (2002) and Islam (2003) find no significant relationship between poverty and inflation in low and middle-income countries, although others (e.g. Agenor (1998) and Ravallion and Chen (1998)) find that higher inflation increases poverty and Dhatt and Ravallion (1996) find that Indian states with higher inflation have higher poverty. The results are, however, sensitive to the precise measure of inflation adopted, and to the inclusion or exclusion of outliers. Cardoso (1992) finds that inflation does not impact adversely on those who are poorest in Latin America because of negligible cash holdings, but that higher inflation is associated with lower real wages in Latin American countries. A negative association with real wages is also found by Rama and Artecona (1999). Lustig and McLeod (1997) find inflation is statistically insignificant as a determinant of poverty. But when the minimum wage variable is dropped from their equation, inflation does have a significant effect on poverty. They conclude that “Together these results suggest that inflation affects poverty by reducing minimum or unskilled wages.” (p. 75). Some have investigated people’s aversion to inflation and how this is distributed across income groups. Using polling data from 38 countries, Easterly and Fischer (2001) suggest that the poor are more likely to mention inflation as a top concern than the rich (which is hardly surprising since prices may not even be noticed by very rich people), although this is less marked in developing countries. In the World Bank’s extensive consultations on what it means to be poor and how the poor perceive their situation (*Voices of the Poor*) inflation did not emerge as significant priority, while in that study, as well as other participatory exercises, employment emerged as one of the most important priorities among the poor.<sup>5</sup>

*Inflation and income distribution.* IMF research (Bules 1998) shows that very high inflation worsens inequality according to cross-section data for 75 countries, but, in parallel to the growth effects, less clear -cut results appear at lower inflation rates. In two other broad cross-sectional studies, Sarel (1997) finds no significant impact of inflation

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<sup>5</sup> See Narayan-Parker et al., 2000.

on income distribution. Chu et. al. (2000) , find inflation does not affect income distribution in the long-run . A study of Turkey found that income distribution worsened with accelerating inflation, yet improved with steady inflation (He 1999). Bulir and Gulde (1995) find that inflation variability affects income distribution – but not in a consistent direction. Many high inflation countries show little or no change in income distribution – for example, the distribution of income in Brazil in 1976 and 1996 was remarkably similar. World Bank (2000) concludes that the relationship differs across countries. The evidence on inflation and income distribution looks mainly at the relationship between some definition of inflation and primary income distribution.<sup>6</sup> Yet in the few progressive tax systems, inflation is likely to increase the relative tax burden of the rich, and to raise revenue as a proportion of GDP. The first effect will tend to improve after tax income distribution, while the second may permit lesser reliance on expenditure cuts which impact adversely on the poor.

The conclusion from this brief review of the evidence is that high (40% plus) inflation rates may be damaging to growth and to poverty. But at lower inflation rates the evidence on the inflation/poverty connection is not strong enough to justify disabsorption policies which have heavy costs for lower income groups, in the short-term at least. As noted earlier, these costs are of two kinds: first, through depressed employment opportunities; higher unemployment in the formal sector directly adversely affects those working in the sector, who are typically in the lower half of the income distribution, but are not normally in the bottom 25%; and indirectly it affects those working in the informal and agricultural sector, who are typically poorer than wage earners in the formal sector, as the newly unemployed add to their numbers, and markets are depressed. The second way deflation affects the poor adversely is through cuts in public expenditure. But it is quite often argued that cuts in government expenditure, even social expenditure, will not impinge much on the poor because the distribution of public expenditure is biased towards upper income groups. This is an important issue, since if it has bearing on what the appropriate policies are if the poor are to be protected during adjustment.

*Public expenditure and the poor.* People often argue that public expenditure in developing countries is regressive because most studies show that the proportion of the

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<sup>6</sup> Where income distribution is derived from household surveys, some income may be after tax; where it is based on consumption expenditure, it will exclude income tax but not consumption taxes.

benefits from public expenditure that accrue to the poor are smaller, in relation to their share of population, than the proportion that accrues to upper income groups. For example, Castro-real et al. (1999) found that the richest fifth of the population in a number of African countries received twice or more the share of education benefits compared with the share received by the poorest fifth of the population. Yet to conclude from this that the poor do not benefit from public expenditure is completely wrong. Compared with their original (pre-tax, pre-benefit) income, the poor generally receive much more than the rich. For example, in the Cote D'Ivoire in 1995, the ratio of education benefits of the top quintile to the bottom quintile was 2.7, but the ratio of their original incomes was 6.2. Assuming incidence of taxation proportional to income, for any additional taxation in Cote D'Ivoire which financed extra educational expenditure, the ratio of extra benefits to extra taxes would be 80% for the richest quintile and 229% for the poorest quintile. In other words, the increase in expenditure financed out of general taxation would be favourable to the poor. Almost all investigations of the distributional incidence of both health and educational expenditure in developing countries show that they are progressive as defined above, though often not well-targeted (defined as occurring if the absolute benefits to the poor exceed those to upper income groups). (Chu et al, 2000). There are fewer studies of the distribution of government expenditure as a whole, but Chu et al conclude that most expenditures are progressive. The assumption of taxation as broadly proportional to income is borne out by most studies of tax incidence. A survey of 36 tax incidence studies concluded that in 19 cases, the tax system was progressive (with the share of tax as a proportion of income rising as incomes rise), in 7 it was proportional and in just 7 regressive (taking a larger share of lower incomes) (Chu, Davoodi and Gupta, 2000).

There are three important conclusions from this discussion in terms of pro-poor policies. First, since disabsorption policies are likely to be adverse for the poor in the short-run, it is important to reduce their magnitude as far as possible. The extent to which this is possible will depend on the possibilities of foreign borrowing, including finance available from the IFIs and debt adjustments, as greater external borrowing allows for more gradual adjustment, which may then be achieved by greater use of switching policies and less use of disabsorption. Hence, secondly, it is important to maximise the availability of external finance especially in rather inflexible economies where immediate switching of

resources from domestic use into foreign exchange earning is not likely to be possible. Thirdly, to the extent that a country does rely on deflationary policies, their adverse impact on the poor may be lessened by putting the emphasis on tax rises rather than expenditure cuts. The discussion above suggests that a rise in public expenditure will be good for the poor and a cut bad, if the expenditure is distributed in the same way as public expenditure as a whole, and if the expenditure is financed by taxation. The same is likely to be true if the expenditure is financed by inflation, given that the incidence of inflation appears to be broadly neutral.

***b. Switching policies.*** As argued above, a key factor determining the impact of macro-policies on the poor is how far the adjustment process depends on disabsorption as against switching resources. In general the more that adjustment is obtained by switching domestic resources into exports or import substitution and the less the reliance on disemploying domestic resources via deflation, the better the impact on the poor. An associated factor is the speed of adjustment aimed for. A slower pace of adjustment will generally be better for the poor because it provides time for switching to occur. Major switching policies include changes in the exchange rate, tariffs and other import restrictions, and export subsidies of various kinds. Such switching policies appear to form an element of about two-thirds of IFI programmes, below the almost 100% incidence of disabsorption policies.

The extent of switching possible is partly dependent on the nature of the economy. In particular, primary product exporters with small and inefficient industrial sectors may be unable to adjust through export expansion because of low-supply elasticities, particularly in the short-run; and for them it may be an ineffective strategy because of worsening terms of trade, partly caused by the simultaneous output expansion of a number of adjusting countries; moreover, they may be unable to increase import substitution because their industrial sectors cannot produce the type of output needed. Hence such countries may be forced to rely largely on a combination of external assistance and disabsorption. Unless external assistance is generous, such economies are likely to suffer rising poverty during adjustment. Unfortunately, these are the poorest economies (though not the countries with the most poor people because of the huge size of China and India which have high potential industrial sectors).

Economies with large and flexible industrial sectors can, with appropriate policies, achieve export-led growth. For them switching policies can generate output and employment expansion after quite a small period. (for example, S.Korea, which rapidly recovered from crises in the early 1980s and in the late 1990s). But successful switching of this kind requires a high rate of investment. Hence it is important that the short-term policies followed don't deter investment. There is an instructive contrast between macro-policies that have been successful in supporting the restructuring needed for switching -- for example in Asian economies generally, and East Asia in particular -- and those that have not, as in much of Latin America. In Latin America, in the 1980s exchange rates were generally overvalued and there was less vigorous export promotion, while investment rates were far lower (Sachs 1985). In the late 1970s, in Latin America there was an exchange rate appreciation just before the debt crisis, when exchange rates depreciated significantly in Asia. Private investment rates have been lower in Latin America than Asia over several decades. In 1997, the overall investment rate in East Asia and the Pacific was 34%; in South Asia 24% and in Latin America 20% (down from 24% in 1980). Lower private investment was partly due to a lower rate of government investment (15% of GDP in E. Asia; 9% in South Asia; and 4% in Latin America); and to generally higher interest rates, as a result of the anti-inflationary monetary policies. In Latin America in over half the major economies, infrastructural cuts accounted for more than half of fiscal adjustment. (Calderón et al., 2002). One estimate suggests that one fifth of the growth differential between East Asia and Latin America, 1997-2000 was due to differences in the investment rate (De Gregoria and Lee, 2003).

The impact of switching policies on growth thus vary with the nature of the economy and other policies being adopted. This is borne out by empirical evidence on the relationship between greater openness and growth. Some empirical assessments have concluded that greater openness leads to faster growth, the best known probably being Sachs and Warner (1995). The methodology of this and other studies, however, has been effectively criticised by Rodriguez and Rodrik (1999), particularly in relation to the measure of openness. One vital set of questions is exactly how much openness and to what? For example, a cross-section study by Rodrik (1999) of the relationship between capital market liberalisation in developing countries, 1975-1989, and per capita GDP growth



rate found no relationship. However, there is strong evidence of a positive correlation between growth in exports and output, and consensus that very high levels of protection are adverse for growth (Hallward-Driemeier, Iarossi and Sokoloff, 2002).

Switching policies have a differing impact on income distribution (and hence incomes of the poor) according to the nature of the economy. The classic expectation (Stolper-Samuelson) is that developing economies are labour-intensive in their export sector so labour (and its share) tend to gain with switching as employment increases. But in a Stolper-Samuelson framework mineral-rich economies are likely to see a worsening income distribution with a change in the internal terms of trade in their favour. The situation for agricultural product exporters is ambiguous. On the one hand, exchange rate changes are likely to improve the rural/urban terms of trade. Since the incidence of poverty is generally higher in the rural areas than the urban, and the absolute numbers in poverty are also greater in the rural areas throughout Africa and in much of Latin America. Hence one would expect improved rural terms of trade should on balance help the poor, although the urban poor have suffered particularly in much of Africa. But the distribution of earnings from export crops are generally unequal; in some (plantation) economies, most of the gains go to landowners; where the crops are produced by smallholders, the distributional consequences are more even, though even then it is invariably the richer households which get most of the gains, and the poorest households are excluded. For example, in Madagascar, farmers below the poverty line suffered from rising rice prices, while the more affluent farmers gained; in both Ghana and Cote D'Ivoire, too the richer peasants gained by improved cocoa prices. (Barrett and Dorosh, 1994; Kanbur, 1990; Boateng et al. 1992). Pryor (1990) estimates that agro-export led growth in Malawi in the 1970s was accompanied by a doubling of the gini coefficient among smallholder households.

Moreover, the Stolper-Samuelson framework rests on a number of restrictive assumptions, including absence of significant economies of scale, full employment and competitive pricing. In import-substituting economies with mark-up pricing, sharp cuts in real wages can accompany devaluation (Krugman and Taylor, 1978; Taylor 1983), especially if accompanied by dismantling of minimum wages and weakening of the trade

unions. Where wage cuts are not offset by expansion in employment, income distribution worsens (as exemplified by Latin America in the 1980s).

Empirical work on the relationship between trade liberalisation and income distribution gives mixed results. The evidence suggests a negative impact on income distribution in Latin America, mainly due to a widening of wage differentials between skilled and unskilled workers (Berry, 1999; Morley, 2000; Ghiara, 1999; Mazumdar and Agnoli (nd); Felicano, 2001; Beyer et al, 1999). However, trade liberalisation has been found to be equalising in some Asian countries (Qadir et al, 2000; Fischer, 2001; Been Lon and Hsu, 2001). Cross-country regressions produce differing results; some find no significant relationship (e.g. Sarel 1997; Higgins and Williamson 1999; Behrman et al, 2000); some that the relationship varies with the nature of the economy -- for example, Barro (2000) finds that openness raises inequality in countries with per capita income below a certain income threshold (about \$13,000 (1985 prices) ) and lowers it at incomes above that threshold. Spilimbergo, London and Szekeley (1999) find that contrary to the predictions of Stolper-Samuelson, greater openness reduces inequality in capital abundant countries, and raises it in skill abundant economies, though the results depend on the precise indicator used for openness.

The impact of trade liberalisation on poverty depends partly on its impact on income distribution and partly on its impact on growth. Given the conflicting findings on how openness affects both growth and income distribution, it is not surprising that there are also ambiguous results on this. For example, Lundberg and Squire, 2003, find that trade openness reduces the incomes of the poor; Using a different measure of openness and different estimation techniques, Foster and Szekeley find it improves the incomes of the poor as does Qadir et al, for Pakistan; a number of investigators find no evidence of any impact once the impact on growth has been incorporated (Roemer and Gugerty 1997; Ghura et al. 2000; Bannister and Thuge 2001; Dollar and Kray 2001; Epaulard 2003). The quantitative empirical work is generally concerned with assessing the impact of greater openness and less government intervention in trade. However, this is not the only way of pursuing switching policies. It is possible to promote exports without a significant reduction in import protection, which is, broadly, the policy that S. Korea followed in the 1970s and 1980s. (Amsden, 1989).

At this stage, we can conclude that the switching policies do not have strong impact on growth, income distribution or poverty *in general*, but it seems that a negative impact is mostly observed in Latin America and a more positive impact in Asia, while there is inadequate econometric evidence to say much about Africa. However, in the African case, the deindustrialisation impact of greater openness does seem to be established (see e.g. Shafaeddin 1995), while the expansion of traditional exports have mostly been accompanied by (and partly caused by) worsening terms of trade. It therefore seems likely that the switching policies adopted have had a negative impact on growth and on incomes of the urban poor.

From a policy perspective, different policies are needed in order to protect the poor according to the nature of the economy:

- In mineral rich countries, it is desirable to tax mineral revenue and promote employment-intensive activities with the proceeds (or transfer the proceeds to the poor in other ways). Alternatively, a dual exchange rate might be adopted so as to promote non-mineral exports, without generating big gains for mineral producers.
- In peasant economies, the boost to the rural economy from a more competitive exchange rate is likely to help the poor generally, although special measures may be needed to reach the poorest. However, it is essential for such economies to diversify their production and exports, and this requires developing their industry, as well as processing and services. For this, some initial industrial protection (or promotion) could be helpful. This can best be carried out at a regional level, rather than that of individual countries whose economies (particularly in Africa) are mostly too small for efficient production.
- In economies with a significant industrial sector, there is a need to promote investment to support the switching policies, so as to generate employment growth in export industries.

*c. Capital account policies* In principle, changes in the capital account can affect the level of demand and the exchange rate (i.e., both absorption and switching). To date

capital account liberalisation has only been an aspect of a small proportion of adjustment programmes, though it was becoming a standard feature up to the Asian financial crisis of 1997. The impact of capital account liberalisation is primarily relevant to the more advanced developing countries – since private capital is rarely attracted in significant amounts to the least developed economies. If capital account liberalisation leads to an inflow of foreign capital, then domestic disabsorption can be reduced; and if it finances investment, then growth may be promoted. Hence it would seem that it should be good for the poor.

But it is not so simple as this. First, Dutch disease type effects can lead to an appreciation of the exchange rate discouraging exports. Secondly, if the inflow takes the form of short-term capital, it is unlikely to finance growth-promoting investment, and may support property development and speculation, as appears to have occurred in South East Asia in the 1990s. Thirdly, large inflows increase the economy's vulnerability to large outflows, which can be such as to generate a crisis of confidence, requiring stringent measures (such as massive deflation; sharp devaluation; large rises in interest rates) to end the crisis. When this happens the poverty-worsening impact is likely to outweigh any prior positive impact. Developments in Mexico in 1994 and 1998; and in East and SE Asia in 1997 are examples. Fourthly, unrestricted international capital flows tend to be concentrated in middle income and/or high growth countries, and rarely lead to substantial additional resources for the poorest countries. Moreover, additional capital inflows rarely reach small or micro enterprises and are unlikely to benefit the poor directly.

A review of evidence concluded: 'the existence of growth benefits for developing countries – of both short term flows and FDI – has simply not been established' (OXFAM 2001, p32). Nonetheless, Morley's investigation of the impact of reforms in Latin America found that capital account opening benefited the poor (Morley 2000), though Behrman et al. (2000) and Cobham (2003) report an increased wage dispersion, a conclusion echoed by Taylor (2000) for a broader group of countries. Controlled capital inflows (with an emphasis on foreign direct investment) may avoid some of the risks (especially of sudden outflows) of capital inflows and may be growth-promoting, as seems to have occurred in Chile, Singapore and China. If such inflows are to benefit the

poor directly, it will be necessary to establish schemes to help direct funds to small and micro enterprises. (See also Griffith-Jones in this volume).

*d. Meso-policies.* In any macro-context there exists a range of policies with distributional impacts which affect how the macro-situation translates into poverty. These policies are particularly important in the context of deflationary and poverty-promoting adjustment policies. In contexts in which disabsorption is unavoidable because of imbalances in the external accounts and inadequate finance to cover deficits, identifying meso-policies which protect the poor may be the only pro-poor policies possible. It is important to emphasise that the same macro-achievements can be accompanied by very different consequences for the poor, partly stemming from the meso-policies adopted.

Meso-policies influencing poverty include those affecting the distribution of assets; the incidence of taxation and expenditure; user charges and subsidies; income transfers; minimum wages; employment schemes; and other types of protection such as Social Funds and insurance schemes. Here I will briefly review some examples of relevant policies in each category.

#### *Distribution of assets.*

- *Privatization* is the one form of asset distribution which is a common feature of adjustment programmes. Although its distributional impact depends on the precise design of the scheme, in general privatization programmes have generally been unequalising, leading to greater inequality in asset ownership and income from assets, and sometimes, also, in the services provided. Following a wide-ranging review Nellis and Birdsall (2002) conclude that “at least initially and on average” privatization increased income inequality throughout the developing world, with a slight increase in Latin America, and a very large jump in transition economies. However, Behrman et al (2000) report that in Latin America privatization narrowed wage differentials.
- *Land reform* Land reform policies could make a major contribution to helping the poor, especially in agrarian societies. Yet it is rarely included in the reform package. There is evidence that inequality in land ownership is a major source of

aggregate inequality, while land reform has contributed significantly to improved income distribution. For example, Bourguignon and Morrisson (1990) estimate that 17% of income inequality is accounted for by inequality in land distribution; while education has been estimated to account for from 10-20% of observed inequality. Moreover, Carter (1999) shows that concentration of land ownership is associated with concentration of income over long subsequent periods, even in countries where the economic relevance of agriculture has diminished. More egalitarian land distribution not only contributes to more equality in income distribution directly, but also indirectly by increasing the employment intensity of output in both agriculture and non-agriculture, and strengthening domestic linkages (i.e., the demands that agriculture generates for non-agriculture; and the demands that the formal sector generates for the products of the informal sector (Ranis and Stewart, 1987, 1993). More equal distribution of land also raises output<sup>7</sup>. Land reform has been very effective in some countries (e.g. Taiwan and Korea, and also Egypt in the 1960s), but political obstacles are often severe. In quite a number of countries, reforms have been only partially implemented. Yet even then they have still mostly achieved substantial land redistribution (Powelson, 1984; Lipton 1993) and the more limited reforms have led to some improvements in rural income distribution (El-Ghonemy, 1990; Besley and Burgess, 1998).

- *Credit policies.* The distribution of credit affects the accumulation and distribution of assets. In general, formal sector credit tends to be biased against the low-income because of their lack of collateral, while informal sources are extremely expensive. Surveys of the informal sector generally report that less than 1% have access to formal sector credit (see, e.g., Anderson, 1982; surveys quoted in IADB, 1999). The self-employed and employees of micro-enterprises are generally among the lower-income groups - e.g. in Latin America it is estimated these enterprises account for 30-40% of low-income earners. In principle, reforms of domestic credit markets towards lesser government intervention (reduced 'financial repression') are intended to achieve a more equal distribution

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<sup>7</sup> Deininger and Squire, 1997, show that a difference of one standard deviation in the initial Gini coefficient for land is associated with income gains of 0.5% for the population as a whole, with gains of 1% for the poorest 20% and 0.9% for the poorest 40%. See also Birdsall and Londoño 1997; Deininger and Olinto 1999.

of credit, but given imperfect and asymmetrical information, in practice little is achieved unless lending mechanisms are also reformed. New lending mechanisms (e.g., the group lending procedures of the Grameen Bank) can help to redirect credit to the low-income. However, while such schemes do help the poor (and often women, especially) in some important respects, even the most extensive (for example, the many schemes in Bangladesh and Bolivia) have not been sufficient to make a significant impact on poverty. This is partly because they do not always achieve extensive coverage of the poorest, and partly because the strict repayment requirements and high interest rates mean that they rarely lead to a substantial increase in income (Zeller et al, 2000). Another approach to credit reform, which can be complementary with the particular schemes, is to reserve a certain proportion of bank lending for low-income borrowers (or small borrowers). This has been tried, for example, in India and Indonesia. In both cases, the requirement has facilitated the finance of useful initiatives – for example, the Self-Employed Women’s Association (SEWA) in India; and the Badan Rakyat, the Badan Kredit Kecman (BKK) and the Kredit Usaha Rakyat Keail (KURK) lending institutions in Indonesia.

- *Human capital.* According to Thompson (1998), ‘the unequal distribution of education opportunities is often a more important determinant of the skewed income distribution than is the skewed access to land.’ . On the basis of cross-country analysis Bourguignon and Morrison (1990) estimate that a one percent increase in the percentage of the labour force that has at least secondary education increases the share of income received by the bottom 40 percent by 6 percent and the bottom 60 percent by 15 percent (Bourguignon & Morrison, 1990). A study of Latin America in the 1980s found that about a quarter of inequality among workers’ incomes was due to differences in educational levels (Psacharopoulos et al., 1996). Education benefits the rural as well as the urban population - educated farmers are more likely to adopt new technologies and obtain higher returns on land (shown by studies in Korea, Malaysia and Thailand.) Chou and Lau (1987) show that in Thailand one additional year of schooling adds about 2.5% to farm output. Even in the informal sector, there seem to be high returns to education. Returns were estimated to be as high as 33% for women self employed in the

retail textile sector in Peru, and to be 14% for post-primary educated men in the service sector (World Bank, 1990).

Educational access and expenditure is often distributed very unevenly. Adult literacy varies from over 80% in E. Asia to as little as 13% in Niger, and is less than half in Pakistan. Zambia spent nearly a quarter of its educational budget on tertiary education, with an estimated enrolment rate of 2% in 1980, while Bangladesh spent 8% with an enrolment rate of 3% and Korea also spent 8% with a much greater enrolment rate of 48%. Extending educational access, therefore, can be a critically important policy for long-run improvement in the position of the poor. This is best achieved by increasing total expenditures on education but correcting any imbalance in the distribution of educational expenditures can also help. Yet very often adjustment policies are associated with cuts in government expenditure on education. (Cornia et al, 1986; Hicks, 1991). Sustaining expenditure levels alone, however, is not sufficient in countries where there is much (and especially worsening) poverty, since families may not send their children to school because of heavy out of pocket expenses, which go well beyond fees and include materials, transport costs, uniforms and the opportunity costs of the children not working. Policies are needed to address such issues, such as the successful food for education programme adopted in Bangladesh.

*Policies towards minimum wages and Trade Unions.* The adjustment policies have tended to reduce or even eliminate minimum wages as part of the move towards market determination of prices, and increasing country's competitiveness, and to weaken trade unions. In both Africa and Latin America there was a near universal decline in real minimum wages in the 1990s compared with the 1980s (van der Hoeven, 2000; Saget 2001). It is sometimes argued that this should help the poor since (a) those receiving minimum wages are generally not among the poorest; and (b) there should be compensating expansion of employment which should help the poor. This conclusion has been challenged theoretically – as the argument depends on the existence of a perfect market. Moreover, most empirical evidence contradicts such conclusions. The level of poverty is almost universally found to be inversely related to the level of the minimum wage, while studies find only a small negative, no or even a positive impact on



employment (Rama, 1995; Lustig and McLeod, 1997; Saget 2001). A significant proportion of the rising inequality in Latin America in the 1980s has been attributed to the fall in the minimum wage (Neumark et al., 1998). According to some evidence formal and informal wages move together, despite expectations to the contrary (World Bank, 1990; Maloney 1996; ).

One objective of many liberalising governments has been to weaken trade unions, in the interests of 'flexible labour markets'. In Latin America, in particular, trade unions were severely weakened over the 1980s, partly because of the economic climate and in some cases because of political and legislative changes. There is evidence that such weakening of trade unions has contributed to reduced real wages and has been unequalising in Latin America generally; it is held partly responsible for the rising dispersion in wages (Calvo, 2001; Cortez, 2001; Fairris, 2003). However, Brazil seems to be an exception (Carneiro and Henley 1998). In South Africa, trade unions and wage councils have also had an equalising impact on wage dispersion (Butcher and Rouse, 2001).

In the light of this evidence, policies to sustain real minimum wages, and in some cases increase them by a modest amount, might help contain any rise in poverty during adjustment. It should also be recognised that weakening trade unions is likely to worsen real wages and inequality. However, clearly any policies to sustain minimum wages and to support trade unions would clearly be more effective in relation to poverty the more comprehensive the coverage of both, particularly if they extend to rural as well as urban areas. The moderately poor are likely to be positively affected by such measures, but not the extreme poor, for whom other measures are needed.

*Taxes and government expenditure.* For any given distribution of primary incomes, secondary income distribution can be improved through the tax and expenditure system.

*Tax reform.* As noted earlier, most tax systems in developing countries do little to alter the distribution, though there are exceptions, with example of both progressive (e.g., Costa Rica) and regressive (e.g., Guatemala) tax systems. Tax reform forms an important element of many adjustment programmes. Reforms generally have been (a) towards greater reliance on indirect taxes; (b) to replace excise duties by a uniform value-added

tax; (c) towards a reduction of the progressivity of income taxes; and (d) towards reduced corporation tax rates. The distributional implications of these changes depend on the details of the tax changes – for example a value-added tax can be progressive if items mainly consumed by the poor are excluded. In a study of India, Ahmed and Stern (1987) found that replacing a number of direct and indirect taxes by a uniform value-added tax would increase the burden on the poorest and reduce that on the richest households. But in Uganda, replacement of export taxes on coffee by a value-added tax with exemption of many goods consumed by the poor was found to be pro-poor. In each country tax reforms need to be assessed for their net distributional implications. In general, pro-poor tax reform is likely to include reliance on progressive income taxes and corporation taxes; land taxes; and value-added taxation with exemption for items consumed by the poor. In general, if all food expenditure is excluded, a value-added tax becomes a progressive tax.

User charges have also been widely introduced, often as part of adjustment packages, including for health and education. Such charges raise rather little revenue, but do deter the poor from using these services. Even when the poor are exempt, the exemption systems tend to be administratively cumbersome, and many who merit exemption do not receive it. Given the problems in ensuring exemption for those below the poverty line, and the way in which charges can deter usage, user charges on basic services should be avoided altogether, and revenue raised through the general tax system.

*Government expenditure:*

1. *Health and education.* Government expenditure is generally broadly progressive as noted earlier – i.e., the poor benefit more than in proportion to the taxes they pay compared with richer groups. But in almost every context, government expenditure can be made more pro-poor. In general, expenditure on the social sectors is more pro-poor than general government expenditure (Chu et al., 2000). Moreover, social sector expenditure can be made more progressive by focussing more on the provision of basic services. For capability poverty, especially, it is important to raise expenditure on basic health and education, and not cut it as often happens during adjustment. Since expenditure on basic health and basic education accounts for only a fraction (5% or less) of total government expenditure, it is possible to raise expenditure on these services quite significantly, with only a small fall in the rest of government expenditure. Essentially,

there are three ratios which determine how much of GDP is spent on basic services - the expenditure ratio ( $G/Y$ ), social allocation ratio ( $S/G$ ), and priority ratio  $P_s/S$  (proportion of government expenditure going to promote basic capabilities). The aim should be to sustain, and in many contexts increase,  $P_s/Y$ . This can be achieved by raising one (or more) of the three ratios. Which ratio should be raised depends on which are high (or low) to start with. For example, Indonesia has a low tax and expenditure ratio, and relatively high social allocation and priority ratios so the appropriate policy in order to raise the expenditure on basic services is to raise the tax and expenditure ratio. In contrast, Pakistan has a very poor social allocation ratio (spending so much on the military) and here the appropriate policy would be to improve the social allocation ratio.

The evidence suggests that female education (and the female share of income) is a particularly important element determining families' health, education and nutrition.<sup>8</sup> Moreover, it seems to exert a positive independent impact on growth and on poverty reduction (see, Udry et al. 1995, Dollar and Gatti 1999, and Klasen 1999). Recent research suggests that raising the education of mothers in Egypt, and of one female per household in Mozambique, would reduce poverty by 34% and 23% respectively (Datt and Joliffe, 1998; Datt et al., 1999). Consequently, policies to reduce capability poverty also need to take into account the gender distribution of educational access and income distribution.

2. *Government transfers*. These include pensions and other state benefits, such as unemployment or disability benefits, which, in principle, can be substantial. Transfers are large and generally redistributive in many developed countries. But they are typically small, with less clear distributional implications, in developing countries because benefits are often mainly confined to the relatively privileged formal sector workers. In Latin America such systems have been shown to be regressive in some cases (Mesa-Largo, 1983), although in Costa Rica near universal coverage meant that most people were protected during the crisis of the 1980s (van der Hoeven..). Similarly, small universal old-age pensions have played an important role in protecting households as a whole

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<sup>8</sup> For general evidence, see Bruce (1989), McKee (1989), Downing (1990), and Strauss and Beegle (1996). For evidence for Bangladesh, see Pitt et al. (2003); for Indonesia, Mellington and Cameron (1999), and Panjaitab et al. (1999); for Sub Sahran Africa, Jiggins (1989); for Cote D'Ivoire, Hoddinott and Haddad (1995); for Jamaica, Handa (1994); and for Dominican Republic, Lorge Rogers (1996).

during drought in Namibia (Næraa et al., 1993). When appropriately designed pensions can be highly redistributive (e.g. means-tested widows' pensions and disability pensions introduced in Tamil Nadu). (see Guhan, 1992; Dreze and Chen, 1995; Dréze and Sen, 1991).

3. *Food subsidies.* Many countries offered universal food subsidies in the 1960s and 1970s. Even though these generally mainly reached urban consumers they were redistributive, helping the urban poor. However, they were much criticised as being excessively expensive, since they were received by many above the poverty line. Consequently, adjustment packages in the 1980s and 1990s typically replaced such universal subsidies by targeted subsidies. However, targeting generally diminishes the value and coverage of the subsidy received by the poor, first because in the process of excluding those above the poverty line, many of the poor are invariably also excluded; secondly, once targeted to the poor they lose their political constituency and their real value is rapidly eroded (see summary of evidence in Cornia and Stewart, 1995). This occurred in Colombia, Sri Lanka, and Jamaica for example.

Food subsidies are an effective way of protecting the urban poor. While they need to be universal to avoid the problems just mentioned, selecting only basic staples for subsidy can greatly reduce the proportion of the subsidy received by those above the poverty line. The problem of ensuring that the whole group in need receives the benefit applies to any means tested item, including user charge exemptions and means-tested pensions, discussed above. In each case, it is preferable to provide universal benefits/subsidies and raise revenue to compensate in other ways (e.g., through taxes on petroleum).

4. *Employment schemes.* Several countries have introduced emergency employment schemes, some *ex ante* ready to meet crises, and others put in place after the crisis has erupted. *Ex ante* schemes are mostly drought related, introduced in situations where drought is a regular event - e.g. Maharashtra in India and Botswana - and have been extremely effective in covering most of the able-bodied in need, while excluding those on higher incomes who are not prepared to do the low-paid work necessary to qualify. Chile, however, introduced highly effective employment schemes in the early 1980s, aimed to protect the poor against the unemployment arising from severe stabilisation and

adjustment policies; at one stage the schemes covered 13% of the workforce and prevented severe destitution (Raczynski, 1987). Other schemes have been less effective: for example, food for work schemes planned to assist in drought relief in Namibia were very slow in getting off the ground. In general successful schemes are open-ended (employing as many as come forward), offer low subsistence wages, and are *ex ante*. They, of course, fail to reach those who cannot work, and thus need to be supplemented by pensions or other forms of support for those in this category.

5. *Social Funds*. In the 1990s, the World Bank sponsored a number of 'social funds' (SF) to compensate the poor during adjustment. SFs basically consist of funds (of determinate size) to be spent on a variety of types of project - in most cases 'demand-determined' (i.e. given out in response to project proposals put forward by communities, and/or individuals), but sometimes 'supply-determined', i.e., determined by the agency, often dedicated to health or education projects. SFs have basically failed in offsetting the social costs of adjustment, as shown by a large number of assessments (Stewart and van der Geest 1995; Reddy 1998; Cornia 1999; Tendler 1999). In the first place, they are almost invariably put in place *after* the crisis has occurred so that there is a considerable period before any protection is offered - e.g. Ghana's PAMSCAD<sup>9</sup> only began to have any significant effect in the later 1980s, although the worst of the crisis was 1983-5; secondly, they are poorly targeted, failing to reach many of the poorest, partly because they are demand-determined, and the worst off lack the initiative to put forward proposals - for example, Bolivia's scheme, which was one of the most extensive, barely covered rural areas or women; thirdly, their total coverage is generally only a fraction of those in need - less than 1% in many cases (Stewart and van der Geest 1995). This is mainly because of the limited funding put aside for most SFs - amounting to less than 1% of GDP (Cornia 1999).<sup>10</sup> Positive assessments of SFs tend to emphasise the fact that some of the poor have benefited, and pay little attention to the fact that the majority have not (see White 2002). Despite the many adverse assessments, some by the World Bank itself, SFs

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<sup>9</sup> Programme for the Mitigation of the Social Costs of Adjustment.

<sup>10</sup> It has been claimed that the Indonesian case, the SFs amount to much more, 10% of GDP, but this is basically the deficit tolerated to avoid huge social costs and does not feed into a specific fund. However, it is one highly unusual example of use of macro-policies to protect the poor.

continued for some time to be the main way in which the IFIs propose to deal with 'social costs'. Tendler (1999) has commented on this irony, explaining it by the pervasive power of a prevalent 'narratives' even when confronted with clearly contradictory evidence. However, since the late 1990s, it appears that social funds are being replaced by the more comprehensive policy packages reflected in PRSPs (see below).

6. *Poverty Reduction Strategy Papers (PRSPs)*. These are the latest World Bank instrument for protecting the poor. They are intended to achieve two objectives: to identify mechanisms for improving the position of the poor during adjustment and development; and to do so in a participatory way that increases country 'ownership' of the schemes. They are intended to be drawn up by a wide range of actors, including governments (donors and recipients), NGOs (international and domestic), and representatives of the private sector and communities. The limited experience with PRSPs so far would suggest that they have achieved little in the way of increasing ownership/empowerment over programme design by national governments or civil society, though the process is still at an early stage. The reason is that very little time is given for the consultations; a rather random and unrepresentative set of institutions are consulted, often led by international NGOs; and major areas of policy-making (notably macro-policy) are effectively kept outside the process. In practice, the policy content of PRSPs are almost identical with normal adjustment policies so are unlikely to make major additional impact on poverty reduction. (Stewart and Wang, 2003).

#### ***4. Conclusion***

In general growth is likely to be good for the poor, or put more negatively, stagnation is almost certain to be bad, so macro-policies need to promote growth where possible. The poor will benefit especially if the growth is of a type to generate sustained expansion in jobs. The evidence does not show that inflation and budget deficits, except at very high levels, hurt the poor disproportionately.

Macro-policies which are likely to be growth-promoting are those that avoid substantial disabsorption through rising taxation, and cuts in government expenditure, and involve policies that sustain investment. While we do not know exactly how to promote investment, we do know that infrastructural investment should be promoted, excessive interest rates avoided, and uncertainty reduced. Less disabsorption will be possible the more the availability of external finance, the more gradual the adjustment process, and the more reliance can be made on switching policies. Where some disabsorption is needed, reliance on tax increases rather than expenditure cuts is likely to be more pro-poor.

The possibilities of relatively painless switching from domestic to external use of resources varies according to the economy. Economies highly dependent on primary products for exports and with small undeveloped industrial sectors are in a particularly weak position to generate sustained growth via the normal switching policies. External financing is especially needed in such economies, so that the adjustment can be gradual and investment sustained – as well as to compensate for worsening terms of trade.

Capital account liberalisation is unlikely to help the poor much, especially in low-income economies. Moreover, the financial crises that can result, and the ensuing stringent deflationary policies which fall heavily on the poor, are costly consequences of capital account liberalisation. Therefore continued controls of some sort over the capital account seem desirable from the perspective of poverty.

Compared with this set of policies, the macro-policies that are involved in most IFI programmes tend to put too much reliance on disabsorption, to emphasise expenditure cuts rather than revenue increases, and to take an undifferentiated attitude to opening the economy. The regions that have followed their policies most closely (Africa and Latin America) have had the weakest economic performance. The majority of assessments of such programmes suggest a neutral or small positive growth impact, when comparing them with similar countries without programmes, or according to some counterfactual generated by a computable general equilibrium model. This paper has not followed this type of assessment, partly because the results are so dependent on the methodology adopted. But more importantly because the absolute performance of the programmes has

been so poor, that it seems more fruitful to focus on policies which might achieve more rather than whether the actual programmes had some small positive impact.

Given a weak macro-performance, it remains important also to consider meso-policies, or how to achieve better conditions for the poor with a given macro-situation. The review of meso-policies in this paper suggests that land reform, progressive taxation, a shift in government expenditure towards human development priorities, employment schemes, food subsidies and transfers to the poor, support for minimum wages and trade unions are all likely to improve the situation of the poor. Of these, adjustment programmes include policies to reorient public expenditure, but not the other policies – and indeed, they have dismantled or reduced food subsidies, minimum wages and progressive taxation in some cases. Privatisation and user charges (a feature of some adjustment programmes) are likely to worsen the position of the poor. And credit schemes, Social Funds and PRSPs (general features of adjustment programmes) are marginally positive for the poor but will not make any significant difference to their situation.

Capability poverty is especially affected by government expenditure towards health and education, and food subsidies. Of course, the other elements which reduce monetary poverty will also contribute to improving the capabilities of the poor.

The pro-poor macro and meso policies identified above have been successfully adopted in quite a number of countries. But the most redistributive policies usually face severe internal political obstacles; while they, and the policies that involve a retreat from the unadulterated market, may also face opposition from the international agencies.

Finally, it must be emphasised that a one size fits all policy package is not appropriate. The appropriate policy package depends on the nature of poverty in the country, the nature of the economy, and external opportunities.



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