CHAPTER 7

Helping Poor Households Deal Better with Economic Crises

GIVEN THE FINDINGS IN CHAPTER 5 ON HOW HOUSEHOLDS RESPOND TO ECONOMIC CRISES, designing minimalistic and effective interventions to help households—especially poor families—deal better with crises is not easy. While more investigation is needed to confirm the findings of panel studies in Argentina, Brazil, El Salvador, and Mexico, what we found appears to suggest three fundamental points.

- First, the poor, like the rest of the population, are reluctant to take actions that are not in their own long-term interest—such as withdrawing children from school during short or moderate downturns. But they have to draw down their assets like everyone else and—since reserve labor is a primary asset of such households—greater labor force participation of secondary workers (mainly women) in the household is observed. Since this takes time away from household production, these changes are likely to affect the quality of education and health.
- Second, steeper or longer downturns do have negative effects even on education enrollment and basic healthcare decisions. For example, children may be withdrawn from school or attendance reduced, and the incidence of child labor increases. That is, both quantity and quality of schooling and healthcare are reduced: as shocks become more serious, "good coping" appears to give way to "bad coping" as assets are exhausted.
- Third, the poor do gain from economic growth episodes—in fact, good times appear to be more beneficial for the poor than the non-poor.

These findings should influence policy choices of any government concerned with sustainable poverty reduction. Governments should not be reluctant to carry out growth-enhancing liberalization and reform that may mean somewhat greater volatility during the transition, because while short downturns may not hurt the poor much, increased growth helps the poor a lot. Further, the findings suggest that macroeconomic policies should be oriented not to avoid downturns at all costs, but to prevent them from becoming long or deep. In addition, the quality of social programs used by the poor should be smoothed over the cycle—protecting the quantity and quality of public education and health services used by the poor is critical in both long and short downturns.

While the first two findings involve government actions that are treated in Chapter 4 (macroeconomic, financial sector, and capital markets policies) and Chapter 6 (labor policy), the third—spending on social services—is the focus of this chapter. Protecting the quality of selected social services that the poor need during economic crises is a difficult task for even a determined government. This generally involves maintaining the level of spending per poor person during economic downturns, which is doubly challenging because the fiscal envelope shrinks at the same time that the number of poor increases. This is where the appeal of programs that are well targeted to the poor is highest: even if governments cannot maintain social spending per poor person at their normal levels, the adverse effects of the downturn may be reduced if a subset of this spending that is used mainly by the poor is maintained or even increased.

This chapter examines whether governments in Latin America have maintained social spending over the economic cycle, distinguishing as much as possible between "general" social spending and its more targeted components. Two studies of cyclical fluctuations in government spending in Latin American countries commissioned for this report form the core of this section, but the section also uses more detailed examinations of public education in Chile, and health insurance in Argentina, Brazil, Chile, and Colombia. We briefly study the characteristics of five poverty-targeted programs in Brazil, Honduras, Mexico, and Nicaragua that aim to reduce current and future poverty by giving cash transfers conditioned on health and education decisions by recipient households. Given the concerns that the poor may reduce education and health investments when their income falls, these are considered prime candidates for the type of programs that should be protected or even expanded during economic downturns. However, their suitability as an effective instrument for countering cyclical fluctuations in income and human capital investments is not self-evident from either their design or their track record. We evaluate whether they can in fact serve this function well, and propose some policy lessons based on our findings in the light of evidence on how households respond, bringing in political economy considerations.

Briefly, what we find for governments contrasts with our findings in Chapter 5 on how households respond to economic risk. While poor households in LAC tend not to rely on "bad coping" over the economic cycle, for example, by sharply cutting investments in the education of their children during downturns, governments in the region do behave in ways that are shortsighted by sharply increasing spending when times are good, and decreasing critical investments such as in education and health when times are bad. This report provides some conjectures as why this may be so, and suggests policies that can help make government behavior conform to the principles of effective insurance.

Before we discuss how governments in the region have tried to help the poor deal with economic shocks, it is useful to briefly discuss what sound insurance principles would require of governments. Figure 7.1 presents an ideal scenario where the targeted social spending per poor person increases steadily or *acyclically* at the long-term rate of growth of per capita income (which is subject to *cyclical* fluctuations). This implies, however, that the share of targeted spending to total government spending or GDP must be strongly *anticyclical*. Maintaining a noncyclical pattern of targeted social spending is a tall order for even the most pro-poor and determined government, but it may be a good measure against which governments can judge their own performance. This chapter will show that gov-

FIGURE 7.1
Targeted Social Spending Over the Economic Cycle

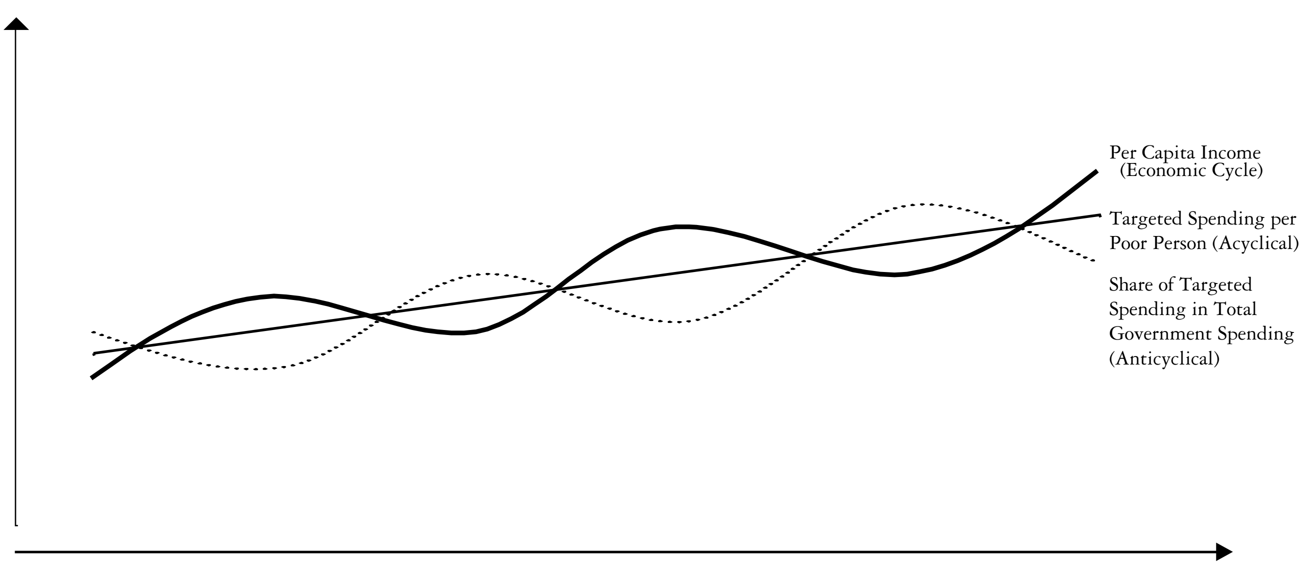

TABLE 7.1
Targeted Public Spending per Poor Person in Argentina and Mexico, 1994–96

	ARGENTINA						MEXICO				
	REAL PER CAPITA GDP (1994 = 100)	SHARE OF TARGETED SOCIAL SPENDING IN GDP (%)	POVERTY RATE (%)	NUMBER OF POOR PEOPLE (MILLION)	TARGETED SPENDING PER POOR PERSON (1994=100)		REAL PER CAPITA GDP (1994 = 100)	SHARE OF TARGETED SOCIAL SPENDING IN GDP (%)	POVERTY RATE (%)	NUMBER OF POOR PEOPLE (MILLION)	TARGETED SPENDING PER POOR PERSON (1994=100)
Level						Level					
1994	100	1.24	21.6	7.5	100	1994	100	1.36	46.95	42.04	100
1995	94.68	1.21	27.2	9.6	63.12	1996	95.07	1.23	60.93	56.51	67.30
Change						Change					
1994–95	-5.32%				-27.88%	1994–96	-4.93%				-23.70%

Source: Hicks and Wodon (2000).

ernments in the region have found it hard both to keep targeted spending per poor person from falling during bad economic times, and to keep it from rising "too fast" during good times.

Social Spending Over Economic Cycles

For social spending that is targeted toward the poor to reduce the losses incurred by them because of an economic downturn (that is, for it to act as a complement to self-insurance and a substitute for missing market insurance), governments should design social spending to be countercyclical. In fact, we generally observe the opposite in Latin America. Table 7.1 summarizes the findings for both Argentina and Mexico during the 1994–96 recession in these two countries. As one might expect, the natural effect of the recession is to lower GDP per capita and to increase the headcount poverty ratio, as was observed in both cases. To increase social spending per poor person, the government should have therefore considerably increased its share of GDP in targeted spending. Instead, that share fell in both countries. The result was that targeted spending per poor person declined by about 28 percent in Argentina and 24 percent in Mexico (Hicks and Wodon 1999) during the economic crisis.

We also recognize that the pattern observed by Hicks and Wodon (1999) is almost certainly not the result of ignorance on the part of governments. There are obviously some factors—both economic and political constraints—that prevent them from following policies that are so obviously in the interests of their citizens. In a paper commissioned for this report, Wodon and others (2000) analyze more closely how social spending by government varies over the economic cycle. Of special concern is how public spending that is targeted to the poor is affected by expansions and recessions (see Box 7.1). Another commissioned paper, by Snyder and Yackovlev (2000), examines these factors for the U S. and for Latin American countries within a political economy framework.

How Do Governments Vary Spending Over the Economic Cycle?

In this section, we first summarize the findings for seven LAC countries regarding how the elasticity to growth of targeted spending for the poor behaves during booms and busts. The countries are Argentina, Chile, Costa Rica, the Dominican Republic, Honduras, Mexico, and Panama. They were chosen because data available were more reliable for them than for other LAC economies. The data cover the 1980s and 1990s, generally between 1981 and 1997–98.

The data are not refined enough to test whether governments are "pro-poor" in the sense required by Wodon and others (2000) (see Box 7.2). Assuming that social spending (for example, on education and health) is more pro-poor than nonsocial spending, testing whether governments have been pro-poor can then be done using social spending as a proxy for targeted spending. The *share* of social spending in total spending is found to increase during booms, and is not reduced during busts (see Table 7.2). This suggests that these governments are "prosocial," that is, they make special efforts to protect social expenditures.

This should help to protect the poor during a crisis, but it is not enough. Despite efforts by government to main-

BOX 7.1

How Do Pro-Poor Governments Vary Spending Over the Economic Cycle?

According to Wodon and others (2000), governments are "pro-poor" if the growth elasticity of targeted public spending is at least 1 during booms, and smaller than 1 during recessions. This asymmetry between booms and busts is tested empirically using panel data on public expenditures for seven Latin American countries. The results suggest that governments are pro-poor, or at least tend to vary social spending over the cycle to conform to this rule. But this is not enough to protect the poor during a recession. The reason is that during a downturn, the economy (and government spending) contracts at the same time that the number of poor increases.

To more formally understand why, denote the total targeted spending for the poor by the government by SP, the headcount index of poverty by H, and the size of the total population by N, so that the targeted public spending per poor person is $SP/(H*N)$. This can be expressed as a function of three parameters: (a) the targeted budgetary spending as a share of GDP, denoted by SP/GDP; (b) the level of GDP per capita, denoted by GDP/N; and (c) the inverse of the headcount index of poverty, denoted by $1/H$:

$$\frac{SP}{H*N} = \frac{SP}{GDP}\ \frac{GDP}{N}\ \frac{1}{H}$$

To assess how growth affects how much targeted public spending reaches each poor person, this can be transformed to yield:

$$\frac{\Delta Log(\frac{SP}{H*N})}{\Delta Log(\frac{GDP}{N})} = 1 + \frac{\Delta Log(\frac{SP}{GDP})}{\Delta Log(\frac{GDP}{N})} - \frac{\Delta Log(H)}{\Delta Log(\frac{GDP}{N})}$$

That is, the growth elasticity of targeted spending per poor person is *1* plus the growth elasticity of the share of targeted spending in per capita *GDP*, minus the growth elasticity of poverty.

To increase targeted spending per poor person during a crisis, the left-hand side of the equation should be negative. Wodon and others (2000) estimate the elasticity of poverty reduction to growth to be minus 1, that is, a 1 percent increase in per capita GDP reduces the number of poor by 1 percent. To maintain targeted public spending per poor person constant, therefore, the growth elasticity of the share of targeted spending in GDP must be less than -2. This is a difficult task for any government. For the seven Latin American countries studied, the observed elasticity during recessions is not statistically different from zero, so that a 1 percentage point negative growth *reduces* targeted social spending per poor person by 2 percentage points.

tain targeted and social spending constant *as a share of total spending* during a crisis, a 1 percentage point decrease in GDP still reduces targeted public spending *per poor person* by about 2 percentage points during a recession. Half of this impact (1 percentage point) is due to the reduction in GDP, which leads to reduced total spending even when the share of targeted spending in GDP remains constant. The other half is due to the increase in the number of poor people due to the economic contraction.[1]

Another test of the pro-poor tendency of governments is to see how they spend during times when budgets are not as tight, for example, during economic expansions. For these seven countries, the elasticity of social spending to GDP growth is found to be larger than 2. Thus, in the most general terms, governments expand spending on social programs twice as fast as overall budgets during periods of economic growth.

The Importance of Political Factors

The procyclicality of social spending in Latin America is also confirmed by Snyder and Yackovlev (2000) using data over roughly the same period as that analyzed by Wodon and others (2000), but for 19 countries in the LAC region. While they do not distinguish between targeted and general social spending, they examine the influence of political factors as well as economic cycles. One of their main findings is that while both authoritarian and democratic governments behave similarly during recessions (cutting social spending per capita), the behavior during good times appears to be more pro-poor under democracy (see Box 7.3 and Table 7.3). They also find that the relatively nontargeted parts of social spending (for example, higher education) tend to be more procyclical than those that help the poor more (primary and secondary education), which is encouraging.

BOX 7.2

Data Sources and Classification into Targeted and Social Spending

Although Wodon and others (2000) carefully construct the data using both the General Financial Statistics of the International Monetary Fund and country-level data provided by governments, social spending information is more reliable than data for targeted spending. Targeted spending is not strictly comparable between countries because while some countries classify certain programs as targeted, others may classify similar programs as social, but not targeted. Social spending is more reliable because it includes all targeted expenditures as well as spending for education and health (plus a few small items).

Argentina

Annual GDP and budgetary data for 1980–97 are from the Ministry of the Economy. Apart from information on total spending, the Ministry provides consistent series for social spending (education, health, water and sanitation, social assistance, labor, housing, and other services for urban areas excluding those expenditures allocated in the social security budget). Within social spending, the data identify targeted spending as consisting of spending for housing and urban development, social assistance, and labor. This includes *Trabajar*, the public works program discussed in Chapter 6. The data include spending at federal, provincial, and municipal levels. Health excludes health expenditures allocated in the social security budget.

Honduras

The data are from the Ministry of Finance and are not available in published form. The expenditures are for the central government (but the level of decentralization is low in Honduras). Targeted expenditures exclude the expenditures for the social investment fund, but include all other expenditures directed specifically at the poor. Programs included in targeted expenditures are PRAF II (a demand-side program targeted according to malnutrition rates and providing cash stipends for nutrition and school enrollment—see following section), some general subsidies, and expenditures for a number of smaller programs.

Mexico

The data are for the federal government only but, since the decentralization process in Mexico started only in 1998, this is not of major concern. Social spending consists of spending for education, health and social security, labor, regional development, water, environment, and social assistance. Targeted spending is the sum of social assistance and spending for labor, which includes programs such as *Empleo Temporal* (public works in rural areas) and *Probecat* (job training in urban areas), mentioned earlier. Health spending includes social security expenditures, so that health as a share of social expenditures is overstated.

Chile, Costa Rica, the Dominican Republic, and Panama

The expenditure data for these four countries are from the IMF's Government Financial Statistics, combining the series for consolidated central government, state or provincial governments, and local government where available. When data on transfer payments from the central government to other levels of government are available, these were added to the consolidated expenditures in education, health, and targeted spending. Targeted spending was calculated by subtracting social security spending from "Social Security and Welfare" expenditures. This yields an approximate measure of spending that is targeted because countries do, for example, grant noncontributory pensions targeted at the poor. These countries were selected because of data quality considerations.

Overall, the results suggest that governments do make efforts to protect the poor—or at least to protect social expenditures during crises—and that they increase these expenditures faster than economic growth during periods of expansions. Unfortunately, the findings also indicate that their efforts during contractions are not enough—spending per poor person falls despite their efforts. And equally worrisome is that government behavior in expansions may be pro-poor but shortsighted—democratic governments expand too fast, perhaps responding to strong political pressures to "make up" for their inadequacies during recessions. The finding in Chapter 5 that the poor

TABLE 7.2

Elasticities of Spending to Growth, by Type of Spending

ELASTICITY WITH RESPECT TO GROWTH OF	TARGETED SPENDING	NONTARGETED SPENDING	EDUCATION SPENDING	HEALTH SPENDING
Targeted spending/GDP				
Overall	0.75*	0.31	0.35	0.24
In expansions	1.06*	0.55*	0.43*	0.55*
In contractions	0.44	0.07	0.27	-0.04
Total spending/GDP				
In expansions	-0.08	-0.08	-0.02	-0.07
In contractions	0.04	0.04	0.23	0.18
Social/total spending				
In expansions	0.69*	0.69*	0.74*	0.75*
In contractions	0.07	0.07	0.13	0.08
Targeted/social spending				
In expansions	0.46	-0.06	-0.29	-0.14
In contractions	0.32	-0.05	-0.09	-0.30*

* Denotes significant at 10 percent level of significance or better. Otherwise the coefficient should be interpreted as zero elasticity.
Note: These are elasticities of shares. A zero growth elasticity of the ratio of total spending to GDP implies that spending increases in proportion to GDP.
Source: Wodon and others (2000).

register strong income gains during growth episodes also means that governments help them most when they least need the help.

The Quality of Social Services Over the Cycle

These findings suggest that the quality of social services consumed by the poor should be even more procyclical

BOX 7.3

Social Spending Over Economic and Political Cycles in Latin America

Snyder and Yackovlev (2000) conduct cross-section, time-series (panel) regressions for 19 Latin American countries from 1980–96, for eight spending variables (total social spending—consisting of social security, education, health, and housing—and education spending at primary, secondary, and tertiary levels). The independent variables are growth of GDP (current and lagged), government deficit (lagged), regime type, and governing party "ideology." The main results are:

- The income elasticity of overall per capita social spending with respect to GDP is clearly positive, but less than 1.
- For the four broad categories, education, health, housing, and social security, they find that the income elasticity of spending on education and health is about 1; the elasticity is also 1 for housing, but it is imprecisely estimated. Interestingly, for social security—which is probably less targeted than public education and health care—the elasticity is not statistically different from zero—that is, per capita social security spending is not procyclical.
- Breaking down education spending into three broad categories—primary, secondary, and higher education—Snyder and Yackovlev (2000) find income elasticities of about 1 for primary and secondary education, but a noticeably higher elasticity of about 1.5 for higher education spending, which is the least targeted of these categories.
- Authoritarian and democratic regimes appear to respond similarly to economic crises. Both cut social spending per capita, and about equally. But there is a large difference by regime type on spending changes during expansions: greater increases in spending take place under democratic rule. Social spending increases only when there is both democratic rule and a nonshrinking economy.
- There appears to be little effect of the executive branch's "ideology" or populist leanings.

TABLE 7.3

Changes in Latin American Social Protection Spending, 1970–95

(Broad Spending Categories)

	DEPENDENT VARIABLE = PERCENT CHANGE IN PER CAPITA SPENDING		
	TOTAL SPENDING	4 BROAD CATEGORIES	4 BROAD CATEGORIES
%Δ in per capita GDP	.73*	—	—
%Δ in per capita GDP × social security	—	.24	.25
%Δ in per capita GDP × education	—	.90***	—
%Δ in per capita GDP × health	—	.97***	—
%Δ in per capita GDP × housing	—	1.60*	—
%Δ in per capita GDP × not soc. sec.	—	—	1.07*
Lagged deficit	-.01*	-.01*	-.01*
New democratic regime	.05***	.09**	.08**
Old democratic regime	.04	.06	.06
# of observations	226	835	835

* = Significant at the .10 level.
** = Significant at the .05 level.
*** = Significant at the .01 level.
Note: Country-specific, fixed effects included in all specifications.
Source: Snyder and Yackovlev (2000).

than social spending because government spending on social services such as education and healthcare is cut at the same time that private capacity to pay for them declines. But there are mechanisms specific to education and healthcare that may offset some of these effects. In education, for example, governments may reallocate spending from higher education toward primary and secondary education during downturns—the previous section discusses some evidence that suggests this. In healthcare, the reforms in countries that have strengthened health insurance for those employed, as well as others, may provide some relief during economic cycles.

There is no systematic evidence on this question of how quality of social services varies with aggregate economic shocks. Two studies commissioned for this report, Mizala and Romaguera (2000) and Jack (2000), address this issue for public education and health, respectively, but the results should be regarded as preliminary. Mizala and Romaguera (2000) approach the question by studying changes in the quality of educational outcomes in Chile in the mid-1990s. They find that the quality of educational services, using two standardized school achievement test scores as proxies, behaves procyclically.[2] There are two possible explanations. First, a downturn reduces private incomes for the wealthier households, thus reducing the demand for places in fee-charging private schools that traditionally have displayed higher educational attainment. Second, decreased educational spending affects schools, teacher incentives, and other inputs generally, but also forces cuts in targeted programs intended to benefit disadvantaged students.

While the issue of cyclical fluctuations in education quality requires much more study, it appears that during a downturn there is a negative effect on the quality of education for the middle and upper-middle classes, who generally send their children to private subsidized and unsubsidized schools. For poor children things may be even worse: they use public schools which may be even more vulnerable to expenditure cuts, and they benefit from special public programs that are threatened as well. The only group whose education quality may be unaffected by cyclical fluctuations is the wealthy. Economic volatility may thus, through its effects on government spending, make it harder to narrow the educational gap between the rich and poor.

This is especially unfortunate because education has been found to be related to the ability of workers and families to withstand aggregate shocks (see Chapter 5). Many countries in the region have chosen to not redistribute assets such as land, focusing instead on improving the distribution of human capital assets such as education through aggressive public education initiatives for the poor. This is in all likelihood the most sensible policy, but the rewards will be seen only after some time. Violent cycles in public education spending and the quality of education services push the rewards from public-education-as-redistribution policies even further into the future. Programs such as Mexico's *Progresa* and Brazil's *Bolsa Escola*—if used as instruments to reduce this cyclicality in education quality—have the attractive feature that they can reduce the amplitude of these quality swings for poor families. The usefulness of these programs is evaluated in some detail in the next section.

In Latin America, the regulatory role of governments is becoming more complex, especially in two areas: the regulation of financial markets, and the regulation and public provision of health services. A critical review of the recent experiences with health insurance reform in Argentina, Brazil, Chile, and Colombia can be found in Jack (2000). The study finds that the traditional approach of public health systems in LAC attempted to provide free universal coverage, motivated more by a concern for equity than for the efficiency of the insurance arrangements available to households. This was, in turn, caused by the highly unequal income distributions prevalent throughout most of the region.

During the 1980s and 1990s a number of governments in the region, including the four studied by Jack (2000), sought to improve the efficiency of public health provision by relying on or mimicking private insurance mechanisms, albeit to varying degrees. In some cases, like that of the *obras sociales* in Argentina, this was achieved by reforming the focus of existing institutions. In others, entirely new institutions were created, such as Chile's Instituciones de Salud Previsional (ISAPRE).

Because health insurance and health care are almost always integrated, the task of reducing the exposure of individuals to health risks is intimately connected to the organization of health care delivery and financing mechanisms. Colombia's health insurance reform appears to have been explicitly market-augmenting: the reform aimed at ensuring that those who could pay for coverage—employees in formal sector jobs—were guaranteed access to quality healthcare, while those from whom contributions are harder to collect—the unemployed, the self-employed and the poor—were guaranteed access to services as well, but of modest quality. The performance of such "dual-voucher" systems during aggregate shocks should be studied in greater detail. However, with evidence that health system coverage for the poor increased from 5 percent to almost 50 percent because of the reform, the new system is almost certainly better for helping those affected adversely by aggregate fluctuations (see Box 7.4). This does not rule out cyclical fluctuations in quality as the relatively high quality unsubsidized subsystem contracts and the subsidized subsystem expands during downturns, and vice versa during upturns.

BOX 7.4

Colombia's Healthcare Reform

Colombia's health sector reforms initiated in the early 1990s represent one of the most ambitious policy interventions undertaken in Latin America. Before the reforms, Colombia had a centralized, budget-financed, and poorly organized public health delivery system, and many informal sector workers and their families were uninsured. The general goal of the Colombian reforms was to ensure a basic level of coverage for all individuals, that could be improved upon for those willing and able to pay more.

Although no formal voucher scheme exists, the scheme is equivalent to a two-level voucher system. Effectively, members of one group of families (those with workers in the formal sector) receive a voucher for insurance that covers a wide range of services at high quality, while all others (many of whom are poor) receive a voucher for a less generous package of insurance. Members in the first group are said to be in the "contributory regime," and those in the second are referred to as participating in the "subsidized regime."

The tax base consists of a payroll tax plus general revenues. Participants in the contributory regime are required to pay a 12 percent payroll tax to help finance health care. This tax is earmarked for health services provision. Participants in the subsidized regime also contribute, but these contributions are means-tested.

There has been a marked increase in formal coverage of the population, particularly among lower-income groups. Overall, the proportion of individuals with insurance more than doubled during this period from 24 percent to 57 percent, with the largest proportionate gains among the poor—the lowest quintile group's coverage rate rose from about 5 percent to 45 percent.

On the whole, health insurance functions in LAC are still covered by a dichotomous system. On the one hand, most countries now have a private or quasi-private market for actual insurance policies, with explicit premiums, coverage rules and deductibles, which gives access to varying degrees of reasonably high-quality services. On the other, there remains almost everywhere a large public or publicly subsidized provider of health services, such as

Brazil's Sistema Unico de Saude (SUS) or Chile's FONASA, which is quantity-rationed and provides low-quality care. Reform of these health systems must continue in most countries. Given the complexity of health insurance markets, governments throughout the region would be well advised to invest in a greater understanding of the main design and regulatory principles that need to be set in place.

Targeted Spending During Booms and Busts

Many countries in the region have steadily moved from using general subsidies (especially for food and fuel) as the major instrument of support to poorer households, to programs aimed at providing income transfers to the poor. Facing administrative difficulties in keeping these programs focused on the poor, some countries have tried to make the programs more self-targeting, for example, by using low-wage work as the targeting device (as in public works programs in Argentina, Brazil, and Chile). While LAC followed countries such as India in these second-generation programs, the region has led the world in what can be considered the third generation of antipoverty programs "targeted conditional transfers," which make means-tested cash transfers, but make them conditional on "socially desirable behavior" of recipients. The five programs reviewed in this chapter belong to this class of targeted programs that provide social assistance to poor families with children, on the condition that these families invest in their education and health (Sedlacek, Ilahi, and Gustafsson-Wright 2000).

TABLE 7.4

Main Characteristics of Targeted Conditional Transfers

INDICATOR	PROGRESA (MEXICO)	PRAF-II (HONDURAS)	RED (NICARAGUA)	BOLSA ESCOLA (BRAZIL)	PETI (BRAZIL)
Implementing Agency	Federal	National	National	Municipal/State	Federal
Objectives					
Education enrollment increase	Yes	Yes	Yes	Yes	
Health and nutrition improvement	Yes	Yes	Yes	Yes	
Child labor reduction	Yes	Yes	Yes	Yes	
Poverty alleviation					
Supply-side support	Yes	Yes	Yes	No	Yes
Current coverage	2.3 million families (1997)	Under preparation	Under preparation	200,000 families (1995)	131,000 children (1996)
Size of monthly education grant	US$10 per person	US$5 per person	US$9.3 per person	US$32–$65 per family	US$12 per person
Geographical targeting level	National	National	National	Municipal	National
Beneficiary selection criteria	Income means-tested	None	Under preparation	Income means-tested and score	Income means-tested
Targeting outcome	Low leakage, but high undercoverage			Low leakage, but high undercoverage	
Outcomes					
- Improvements in education	Yes: enrollment increases			Yes: lower dropout, promotion increases	No evaluation
- Better health and nutrition	Yes				
- Child Labor	Mixed			Mixed	
Suitability for expansion in crisis					
- Intensive (more for old covered)	Yes	Yes	Yes	Yes	Yes
- Extensive (new participants)	Difficult	Difficult	Difficult	Difficult	Difficult

Source: Sedlacek, Ilahi, and Gustafsson-Wright (2000).

BOX 7.5

Mexico's *Progresa* Program: Works Well, But Would it Do as Well in Crises?

Progresa gives cash grants to poor families in rural areas on the condition that their children attend school and visit health centers regularly. The stated objective of the program is to reduce current and future poverty, the latter by increasing investments in children's human capital. This demand-side intervention is also accompanied by sizable supply-side support in the form of increases in teacher salaries and the supply of medicines. *Progresa* began in 1997 and today covers 2.6 million rural families—about one-tenth of all families in Mexico—at a cost of $800 million, or 0.2 percent of GDP. Three questions are of primary concern for this report: Does the program target well? Does the program improve child school and health outcomes? And can the program be altered to serve the purpose of a social safety net in a world with risk? Evaluations of the program being carried out by the International Food Policy Research Institute (IFPRI) in collaboration with *Progresa* can provide answers to these questions.

Targeting

Progresa was found to be the most effective of the targeted programs in Mexico—both in terms of selecting poor localities and selecting poor households within them. *Progresa* is not effective, however, when it comes to distinguishing between localities in the middle of the scale. As *Progresa* expands into less-poor communities, selection error is higher. It also did not do well in selecting moderately poor households. Thus, as *Progresa* expands into less marginal communities, leakages are likely to compound at both the locality and the household level (Skoufias, Davis, and Behrman 1999).

Education and Health Outcomes

Systematic evaluations of *Progresa* have revealed significant impacts on education and health. Enrollment rates of children in households in *Progresa* localities are higher compared to the enrollment rates of children in similar households in non-*Progresa* localities (Schultz 2000). The increases in enrollments were largest in the grades in which enrollments were lowest—between completing elementary school (grade 6) and starting junior secondary school. These effects imply, for example, that a 16-year-old completed on average 1.1 more years of schooling than a poor child in a community without *Progresa*. The internal rate of return on *Progresa* grants is 9.2 percent. The program also improved health indicators (Gertler 2000). Clinic visits in *Progresa* localities were 18 percent higher than in non-*Progresa* areas, the number of pregnant women making their first visit in the first trimester increased by about 8 percent, and prenatal care visits increased by 5 percent. Participation lowers the probability of illness by 22 percent among children aged 0 to 2.

Suitability in Crises

While the targeting and outcomes are encouraging, *Progresa's* design suggests that its ability to serve as an instrument of social insurance might be limited. It is useful here to distinguish between the program's ability to expand *intensively* and its ability to expand *extensively*. It would do better in the former—that is, it might be relatively simple to increase the amount of benefit distributed to households already in the program during periods of economic crises so as to continue providing the incentive to beneficiary families to keep their children in school. However, any attempt to expand the program extensively—that is, to include households that experience transitory income or employment shocks—would require changing selection methods and criteria. In addition, any major expansion would also necessitate defining exit rules—that is, how families that "improve" after a positive shock will be dropped from the rolls. Otherwise, the program will not be financially sustainable over the long run.

Source: Emmanuel Skoufias, International Food Policy Research Institute, and Leader of the *Progresa* Evaluation Project.

Table 7.4 summarizes the principal features. Broadly speaking, these programs have three objectives: the alleviation of poverty; improvements in educational attainment, health, and nutrition (and hence a subsequent reduction in long-term poverty); and the reduction of child labor (explicit in some of the programs such as Brazil's Programa de Erradicacão do Trabalho Infantil (PETI), and implicit in others such as Mexico's *Progresa*, Honduras' PRAF II, and Brazil's *Bolsa Escola*. The programs are demand-side interventions, with some supply-side support. The largest of these programs is *Progresa*, which covers more than 2 million households (or about 10 percent of total households in Mexico).

Regarding their effects on poverty, human capital, and child labor, rigorous evaluations are scarce, but the programs appear to work well. *Progresa* has been systematically studied, though, and appears to have improved education, health, and nutrition (see Box 7.5). The programs have low leakage to the non-poor. However, there is also considerable undercoverage of the eligible poor both because the programs are relatively new and expansion has been cautious, and because of the inevitable fiscal constraints facing some of the programs such as *Bolsa Escola*.

Because eligibility requires having school-age children, the programs will exclude some of the poor even if all eligible families are covered. This makes it relevant to ask if it is the behavioral condition that leads to the observed gains, or if this is the effect of the income transfer making the household somewhat better off. In determining this, however, both administrative and political economy considerations are important. First, the additional conditionality may somewhat paradoxically lead to lower administrative costs: the programs anchor the monitoring system in established schools and clinics, and therefore circumvent the need for completely new administrative arrangements. Second, this conditionality may be key to their political popularity, and may make them resilient to cuts even when budgets are being cut.

For the purposes of this report, however, the critical question is how well the programs can serve as a safety net over the economic cycle. They come up somewhat short in this regard. The programs do not cover families that are non-poor in good times, but who fall into poverty during a recession. Thus, while the amount of the cash transfer to those already covered can be increased quickly when incomes fall (thus being responsive on what can be called the "intensive margin of poverty"), the programs cannot by their design cater to the transient poor (and hence are unsuited on the "extensive margin of poverty").

In the terminology of Chapter 3, these targeted conditional transfer programs may therefore be more effective in augmenting *self-protection*—decreasing household vulnerability to risk in the long run—than in providing *market-type insurance* during crises for all or many of those people who fall into poverty. As the next section proposes, however, these programs may have the attributes that make transfer programs resilient to cuts over the economic cycle. Political economy considerations may overturn their purely economic drawbacks.

Designing Economic Policy Under Political Constraints

In examining the role of governments in assisting their citizens in dealing with economic risks, we found three findings of note. First, social spending by LAC governments is generally highly procyclical: even when the share of social spending in total budget outlays rises during bad times, total spending shrinks and headcount poverty increases, so that social spending per poor person is procyclical. Second, the spending—which includes most expenditure on social insurance and safety net programs—is often poorly targeted. Third, the quality of social services—especially education—also behaves procyclically. These are not desirable characteristics of policies for facilitating comprehensive insurance by individuals and families.

Insurance principles require that governments transfer resources from good times to bad—"saving" during good times, and "dissaving" during bad, or borrowing during bad times and repaying loans during expansions. It is clear that this is not what has happened over the last two decades in Latin America. Whether governments are prevented from doing so by political and economic factors is important to understand. What is clear is that governments seem to treat changes over the economic cycle as permanent—being shortsighted when times are good, and engaging in "bad coping" when times are bad by cutting down on critical investments such as education and health. That is, *governments respond to economic shocks uncannily like the stereotyped responses that poor households allegedly display.* Ironically, in Chapter 5 we found that the poor actually do *not* behave as stereotyped—in bad times that appear to be temporary, (that is, short or mild recessions), the poor draw upon assets such as reserve labor, and do not sharply cut investments in health and education.

The factors that make governments poor practitioners of the most basic insurance rules are worthy of closer study. In proposing policies, this section makes some summary observations on this subject. There are four major policy implications that follow from the analysis of how households respond to economic volatility (in Chapter 5) and what governments in the region have done to help.

The Long-Term Goal of Social Policy Must be to Improve the Distribution of Assets

First, since assets are crucial to enable households to self-protect and self-insure against shocks, a better distribution of assets should reduce *ex post* variations and thus improve welfare. Our findings provide additional support to the already traditional emphasis on more and better education: in addition to the impact it has on income levels, education appears to reduce the vulnerability to shocks and enable both rural and urban workers to cope better with them.

Targeted Programs Should be Permanent and Better Protected During Crises

Second, the temporal profile of social spending—especially on targeted programs—needs considerable realignment. Targeted social spending accounts for small shares of GDP, but the programs it makes possible can make such a large difference to poor people affected by a negative shock that governments should make an effort to protect them from the great budgetary pressures which arise during recessions, and to design them as much as possible to be automatically countercyclical. Unemployment insurance programs, public works guarantees, and poverty-targeted human development programs can all be designed to have this property. Other budget items that deserve attention during recessions are those which relate to the quality of selected social services, such as the salaries of teachers and primary healthcare workers, and the maintenance budgets of the facilities with which they work.

Keeping Increases in Social Spending Moderate in Good Times is Important Too

Third, while the evidence is not definitive, there is enough to suggest that it may be as important not to increase social spending during good times as rapidly as countries have, as it is to protect it during bad times. The empirical evidence for LAC summarized in this chapter indicates that despite efforts to restrict cuts in social spending, targeted and general social spending per poor person are reduced during recessions by 2 percentage points for each percentage point decrease in per capita GDP. There are two reasons for the failure of targeted public spending to protect the poor. First, when GDP falls, even if targeted spending remains constant as a share of GDP, there will be less money available to distribute to the poor through targeted programs. Second, when GDP falls, poverty increases, which means that targeted spending for the poor must be distributed to a larger number of poor people. These two factors combined make targeted spending for the poor highly procyclical, which leads to a lack of protection during hard times. The same is true for social spending. Our results suggest that additional efforts should be made to create effective countercyclical programs and safety nets to protect the poor during crises.

With governments cutting targeted spending per poor person during economic crises, the finding that during expansions targeted spending per poor person increases by more than 2 percentage points for every percentage point increase in per capita GDP may seem like good news. However, for several reasons, this finding is not as encouraging as it seems. There is evidence that the income of the poor grows rapidly—generally even faster than that of the nonpoor—during growth episodes so that, as a rule, they need government transfers the least in these times. In addition, rapid increases during good times make the subsequent cuts in spending during bad times seem much worse, and may be politically destabilizing. Moderation in spending during good times lowers the risk of large reductions in spending during crises—especially if accompanied by transferring resources from good times to bad.

International Financial Institutions Can Help Overcome Political Constraints to Insurance

Fourth, for democratic governments, the pressures to spend during economic recovery can be ignored only by risking loss of political power. Because economic and political cycles seldom coincide, it is equally difficult to ensure that the savings during good times are spent only for the right things (social services and targeted programs) at the right time (during economic crises)—the record of such self-insurance efforts by governments, such as fiscal stabilization funds, is patchy at best.

Under these political constraints, governments that have taken appropriate self-protection measures through comprehensive reforms should adopt strategies that involve a good measure of market insurance. Recall from

Chapter 3 that at the margin, rarer losses are better insured through market insurance than self-insurance, and Chapter 4 applied these principles at the level of the country. In the absence of a well-developed market for insuring against aggregate risk, the strategy that suggests itself is for governments to borrow during bad times to prop up social spending and repay during good times. The problem, of course, is that the private market for countercyclical finance is also thin or nonexistent. Governments that have carried out comprehensive economic reforms deserve access to countercyclical finance from multilateral financial institutions. For governments that have yet to carry out the required economic reforms—and face a high likelihood of crises—the appropriate mechanisms for transferring resources would be of a more self-insurance nature. Recall from Chapters 3 and 4 that more frequent risks may be better insured against through self-insurance than through market-type insurance. Setting up programs that build up reserves during good times which are strictly earmarked to be spent only for these purposes during bad times may be the main viable option for such governments until they carry out comprehensive economic reforms.

Conclusion

The foregoing policy recommendations aim either to better enable households to self-insure and self-protect, or to improve the government's role in assisting them. When all is said and done, however, these are necessary steps largely because insurance markets are either missing or seriously imperfect. Ultimately, risk is best dealt with through a combination of market insurance, self-insurance, and self-protection. Policymakers should recognize this, and note especially that the market for insurance with pooling of risk is highly prone to failure. The best solution will usually be to correct and complement the market, rather than to replace it. Intelligent regulation is essential for this, be it in labor markets, financial markets, or health services.

Following the comprehensive framework outlined in Chapter 3 for understanding household behavior in the face of risk, the absence of insurance markets would generally make households worse off. Governments may be able to improve matters through public action (see Gill and Ilahi 2000). This can be of three types:

- First, the provision of or subsidy to activities used by households to generate *self-protection*, but the production of which is characterized by positive externalities. The presence of these provides an efficiency-based reason for government subsidy or direct provision. An additional equity-related rationale may arise if these activities, in addition to contributing to self-protection, also increase lifetime earnings. Education and health care qualify under this heading and, in practice, most "social spending" finances these services.
- Second, the provision of *market-type insurance* for risks where markets may be missing or underdeveloped, and some scope for risk-pooling exists. Unemployment insurance and public works guarantees are typical examples. Public health services, either in the form of direct provision or of cash subsidies to users or suppliers of private services, are another important category of social insurance against idiosyncratic risks which may be unrelated to aggregate income risks.
- Third, regulation of private insurers helps to extend insurance to many who would be excluded without such rules. Additionally, other forms of regulation—notably prudential regulation of financial intermediaries—may reduce aggregate risk in an economy and provide safer instruments of *self-insurance* to individuals. Financial and capital market sector strengthening may be the most seriously underemphasized instrument of social policy.

In practice, almost every example of governmental action that successfully fulfills one of these three roles will also to some extent fulfill one or both of the others. In addition, many social insurance policies will also perform social assistance (that is, redistribution from richer to poorer households).

Many countries in the region have improved the poverty impact of social spending through reform over the last decade, for example, by replacing generalized subsidies with programs specifically designed to help the poor. Evidence on government spending over the cycle for several countries is consistent with the view that LAC governments are sincere about protecting social spending during downturns: spending on education, health, housing, and social security generally does not fall by as much as GDP. However, social spending *per poor person* does fall—roughly equally because of the reduced overall budget and the increased number of poor people during economic contractions.

Social spending—while being generally pro-poor—directly benefits the nonpoor as well. Spending on more

BOX 7.6

Social Programs, Entitlements, and Countercyclicality in the U.S.

Since the New Deal launched by President Franklin Roosevelt in the 1930s, the U.S. has had many of the programs being considered in LAC. Some of the U.S. experience may be relevant for countries in the region. Snyder and Yackovlev (2000) provide a quantitative analysis of social spending in the U.S. during 1962–98, using detailed spending series and controlling for both political and economic factors. Some of their results are:

- Overall, spending on social protection is quite countercyclical in the U.S. The analysis deals only with ongoing programs, though it appears that extending the analysis to new programs will make the spending appear somewhat more procyclical.
- The most countercyclical program, by far, is unemployment insurance (see Chapter 6). Social security is also relatively countercyclical. These programs are distinguishable from others in having a strong "entitlement" factor: because people see them as something they have specifically contributed to, they are difficult for politicians to alter over the cycle.
- Targeted and nontargeted programs appear to be equally countercyclical. Programs can be quite well targeted and still be resilient over both economic and political cycles—that is, it is not true that programs must help both the poor and nonpoor to attain resilience in a democracy. Avoiding overt "welfare" labels, keeping eligibility flexible so that the transient poor also can benefit from the program (for example, food stamps), and aiming to help poor children rather than adults can keep support for the programs high among even the nonpoor.
- Programs that are targeted at (poor) places appear to fare worse than nationwide programs targeted at the poor.
- Which party is in control of Congress clearly matters—all social protection programs grow faster under Democratic control. However, party control matters even more for targeted programs.

tightly targeted programs for the poor does appear to suffer more during crises. Governments could do better to protect these programs from cuts. Experience in the region and in the U.S. shows that a successful strategy requires explicitly accounting for political economy factors that make programs resilient to both political and economic changes (see Box 7.6). Such factors may include deliberately building in some features that have been associated with longer-lived government interventions, such as designing and marketing them as countrywide programs aimed at the poor, rather than programs targeted at particular parts of the country.

There is room for improving the design of targeted programs, however, especially how they relate to the economic cycle. While meeting many of the goals they were designed to accomplish in various settings (for example, both rural and urban), targeted conditional transfer (TCT) programs such as Mexico's *Progresa* and Brazil's *Bolsa Escola* do not seem to be especially well suited to assist those vulnerable to poverty with cash assistance in economic downturns. Through their innovative links with human capital accumulation, TCT programs may be better suited than earlier interventions to address structural poverty concerns, and even to counter the cyclical swings in quality of education and healthcare services. They look even better when political economy factors are explicitly considered—the programs appear to have increasingly broad political support, which is rather rare for transfer programs. More conventional instruments such as public works programs—when designed well—may be better safety nets, but have not enjoyed the same degree of popular support in the region. Based on these considerations, targeted conditional transfer programs should be viewed as a strong contender for forming the third leg of a comprehensive and permanent safety net—the first two being social security for the elderly and disabled, and income support for the unemployed in both the formal and informal sectors.

In conclusion, governments in the region do appear to have behaved in a pro-poor manner in the most general terms, especially since the rise of democracy in the last two decades. While authoritarian and democratic regimes in LAC appear to have responded similarly to economic crises—both cut social spending sharply and about equally—greater increases in spending take place under democratic rule. However, this is also where governments run the greatest danger of adding policy risk to economic risk. Well-intentioned governments or those under political pressure to sharply increase spending on social programs during growth episodes, only to have to reduce spending in the next contraction, both raise risk and sow the seeds of social discontent.

The obvious solution for governments is to rely less on ex post coping and more on ex ante insurance—that is, move resources from good states to bad. This report takes the view that the reason why governments have not been doing this is neither ignorance nor indifference, but lies in an interplay of political and economic factors. Self-insurance at the country level (for example, through fiscal stabilization funds) is a difficult option for democratic governments: saving during good times runs the risk of being punished by the electorate, and the funds may be used up by more short-sighted successors. There are two viable options. The first is to create a sense of entitlement among the electorate for programs that have a genuine insurance component, such as that displayed by unemployment insurance and social security in the U.S. The second is access to financial markets in a manner that serves the purpose of market insurance: governments can borrow during bad times and repay during good times. The main problem in this regard is that private markets for such instruments do not exist: short-term capital usually flows *out* of countries during economic downturns, to return only in good times.

Discipline on the part of both governments and international financial institutions can help countries deal better with aggregate economic volatility. Countries that institute effective self-protection (that is, through comprehensive economic reforms) and self-insurance (that is, through well-designed and efficiently run social programs) should be rewarded with credit at reasonable terms. These loans should be repaid during good times. Lending by these institutions should therefore be both strongly countercyclical so that it serves as insurance, and discriminating so that it encourages self-protection by governments.

Notes

1. Wodon and others (2000) find that this is roughly proportional: a 1 percent fall in per capita GDP leads to a 1 percent rise in headcount poverty.

2. As measured by the SIMCE Mathematics, Spanish, and General Knowledge tests, taken at the fourth and eighth grades in all Chilean schools.