The 1980s: shocks, responses, and the poor

Many countries experienced macroeconomic difficulties in the 1980s as the debt crisis and international recession brought structural weaknesses into the open. But when structural adjustment issues came to the fore, little attention was paid to the effects on the poor. Macroeconomic issues seemed more pressing, and many expected that there would be a rapid transition to new growth paths. As the decade continued, it became clear that macroeconomic recovery and structural change were slow in coming. Evidence of declines in incomes and cutbacks in social services began to mount. Many observers called attention to the situation, but it was UNICEF that first brought the issue into the center of the debate on the design and effects of adjustment. By the end of the decade the issue had become important for all agencies, and it is now reviewed in all adjustment programs financed by the World Bank. As UNICEF advocated, attention is focused both on how adjustment policies affect the poor and on the specific measures that can be taken to cushion the short-term costs.

Short-run policy and household welfare

The starting point for adjustment is macroeconomic disequilibrium. Whether the causes are external or internal, the usual symptoms are an unsustainable current account deficit, internal financial problems—often linked to high inflation—and slow growth. Adjustment has two objectives: reducing the demand for imports and domestic goods to stabilize economic conditions and restructuring the economy to reach a higher growth path. Many policies, notably exchange rate and fiscal measures, can have both demand-reducing and restructuring effects. For example, changes in public spending can involve both generalized cuts and deliberate shifts in composition, either to squeeze demand in a particular way or to support economic restructuring.

This chapter is concerned with the effects on the poor of demand-reducing and restructuring policies. Since restructuring calls for a more efficient use of labor, it is fully consistent with the policies advocated in this Report for the long-run reduction of poverty. In Indonesia restructuring policies mainly focused on the industrial sector, whereas in Tanzania the emphasis was on agriculture. But in both cases the changes will help the poor over the medium to long term by promoting the demand for labor.

The short-run effects of adjustment, however, can create difficulties, for two reasons. First, the process of economic restructuring is often sluggish and uneven. Firms and labor markets take time to adjust, and in the meantime economies can suffer higher unemployment or underemployment and labor incomes may decline. Second, demand-reducing measures may be unavoidable, and these are likely to hurt the consumption of the poor and the nonpoor alike. The need for cuts in public spending can lead to a particularly sharp short-run conflict with two essential parts of the strategy advocated in this Report—delivering social services and providing transfers and safety nets.

Changes in the economy affect poor households through two main channels: markets, which determine private incomes and the cost of consumption, and public services. Developments in agricultural and labor markets are the main determinants

Box 7.1 Macroeconomic adjustment, household responses, and the role of women: the experience of an urban community in Ecuador

Studies of the impact of economywide events on households are surprisingly rare. One such study was based on fieldwork in a low-income section of Guayaquil, Ecuador's largest city, between 1978 and 1988. That was a period of boom and bust in the economy, driven partly by changes in the international oil market.

In 1978 the prospects for Indio Guayas, a rapidly expanding community largely made up of households in low-wage employment, looked good. A decade later real wages had fallen by up to one-half, the prices of some foods had soared, and local public health and education services, which had expanded rapidly in the boom of 1978–82, had been cut.

Recession and adjustment had widespread effects. Most men were still working full-time, but at lower wages. In response to falling incomes, the proportion of women working rose from 40 to 52 percent between 1978 and 1988. Many women had reentered the labor force despite having young children at home, and others devoted more hours each day to paid work. Household composition was changing, with married sons or daughters staying in the homes of their parents. Eating habits changed: households consumed much less milk, fish, eggs, and fresh fruit, shifted from potatoes to plátanos, and in some cases cut out meals—first supper, then breakfast. A survey of children at a local health center in 1988 found that 80 percent were suffering from malnutrition.

In this community, as in many others, women have to balance several roles. In addition to earning income, many women spent more time on community activities, notably to arrange NGO services to replace declining public services. This put greater pressure on their role in the family—only rarely have men taken on more household tasks. For women with young children, going out to work created even more difficulties. There is evidence that more women are taking control of their fertility; in 1988 more than 40 percent had undergone surgical sterilization. Teenage daughters were often a help to mothers, but at the cost of schooling and adequate parental attention. There was concern in the community about teenage boys who were roaming the streets or using drugs. Increased domestic violence, often stemming from disputes over the allocation of men's wages to household needs, was also reported.

Many in this community are worse off than before. Most men earn less in real terms, and many have resorted to temporary migration. Women have been forced to supplement household incomes, adding to the pressures they already faced. Children have often paid the price in poorer nutrition, impaired education, and loss of parental care.

of incomes; pricing and subsidy policies influence the prices that households face. Public spending on services, especially in the social sectors, can affect both the current welfare and the human capital of the poor.

The poor are not passive in the face of these developments: they adapt. Households draw down their savings and alter their expenditures—notably, in the direction of cheaper sources of calories. Laid-off workers move into the urban informal sector or return to rural areas. Secondary workers (often women) enter the labor force, usually in relatively low-return activities. And households adjust their relationships with each other. For example, the level of gifts or remittances may change, and families may regroup. Box 7.1 looks at the consequences of recession and adjustment for a low-income urban community in Guayaquil, Ecuador.

Macroeconomic policy and the poor

The evidence on poverty in the 1980s outlined in Chapter 3 suggests that developing countries can be placed in one of three broad groups. First are the countries that have made progress thanks to steady growth (as in China and India) or to the effective handling of macroeconomic disturbances (as in Indonesia and Malaysia). Second are those in which poverty has worsened because of recession; this group includes most of the severely indebted middle-income countries and Eastern Europe. And third are the low-income countries (most of Sub-Saharan Africa as well as such countries as Bolivia) in which slow long-term growth and macroeconomic crises have led already acute poverty to become worse.

A review of these three groups suggests that the mix and timing of adjustment measures are crucial. The best approach seems to combine two elements: (1) swift action on certain fundamental policies that are designed to provide the context for future growth and (2) macroeconomic policies that can moderate reductions in private consumption in the transition period. Such a mix can support effective adjustment and a relatively favorable outcome for the poor.

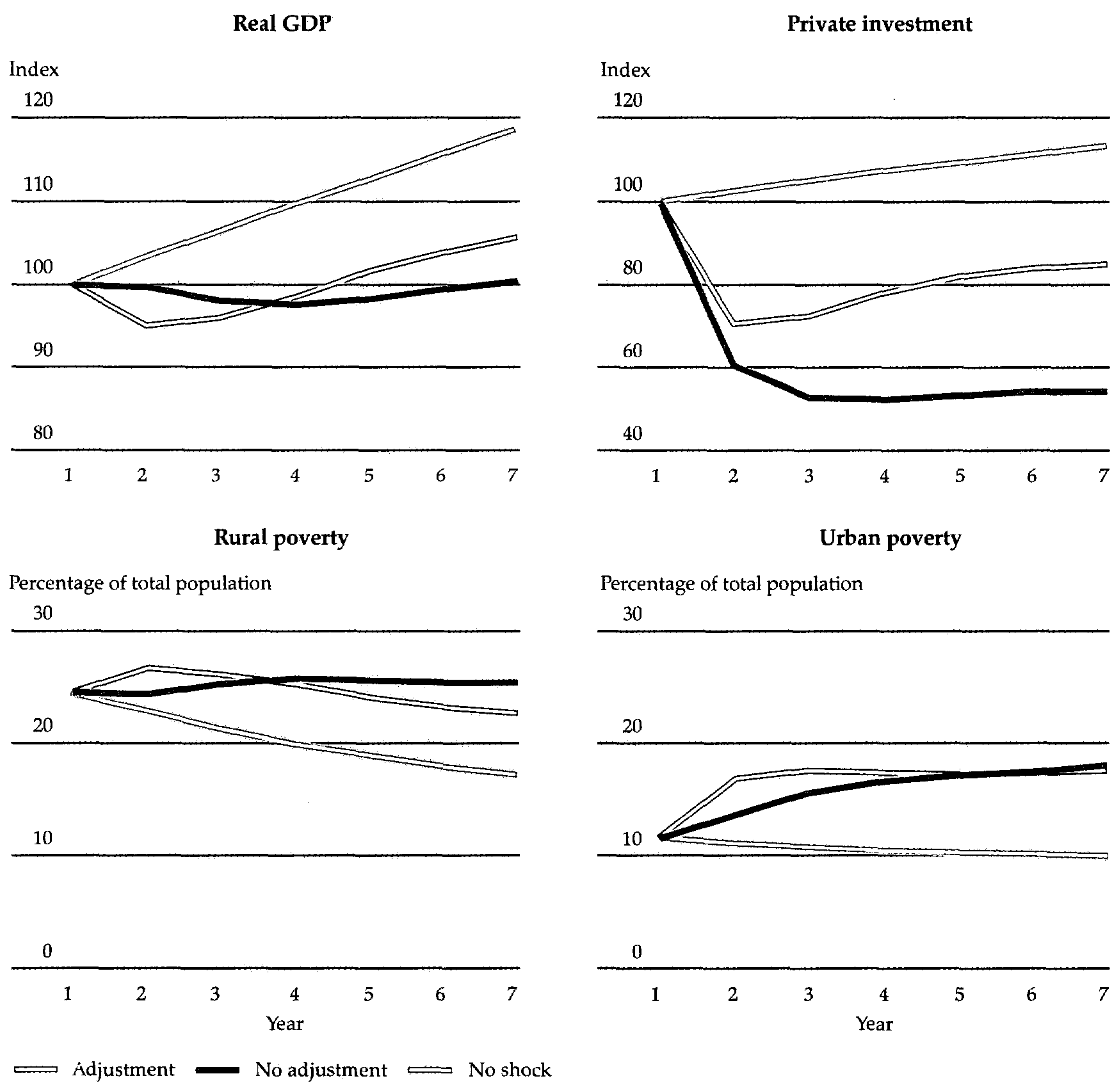
Swift action is essential on policies that have to

Box 7.2 Macroeconomic policies and the poor in Ecuador: results from a modeling analysis

Box 7.1 described the fortunes of a poor urban community in Ecuador during the 1980s. That account, however, sheds little light on macroeconomic causes of welfare changes. A model is helpful for understanding these causes. The model used here is designed to take account of both short-run macroeconomic developments and sectoral developments. It is based on a description of Ecuador's socioeconomic characteristics and contains three urban and four rural social groups. Box figure 7.2 shows alternative paths for Ecuador's GDP, private investment, and rural and urban poverty. It compares a "no-shock" case with two different policy responses to an adverse external shock. The shock is similar to the one that Ecuador actually experienced: a combination of a fall in the terms of trade (owing to a decline in the price of oil) and reduced access to foreign financing.

With no external shock, there is steady progress in reducing poverty. Most of this decline occurs in the rural sector, especially through rural-urban migration;

Box figure 7.2 Results of three scenarios for GDP, investment, and rural and urban poverty, Ecuador



Source: de Janvry, Fargeix, and Sadoulet (background paper).

Box 7.2 *(continued)*

urban poverty improves much more slowly.

The "no adjustment" case assumes an essentially passive stance in fiscal and monetary policy but a flexible exchange rate policy. Maintaining public spending moderates the fall in national income in the short run but leads to a real exchange rate depreciation of almost 20 percent, higher inflation, higher real interest rates (because of increased domestic financing of the fiscal deficit), and a 40 percent decline in private investment. This is a pattern seen in many Latin American countries. Welfare losses are moderate in the short run, for both the urban poor (maintaining spending leads to only small declines in labor demand and public services) and the rural poor, who benefit from higher agricultural prices thanks to the depreciation. But the gains are short-lived. The shock reduces GDP in the second and third years, and low investment delays the transition to the new growth path. Poverty worsens steadily.

The "adjustment" case involves fiscal and monetary contraction and substantial depreciation of the real exchange rate, leading to a larger short-run reduction in GDP than in the "no adjustment" case. A decline in investment—private investment falls by 30 percent in the first year—again moderates short-run consumption losses. But the domestic fiscal and monetary situation is more favorable than in the "no adjustment" case, and inflation is lower. These conditions support a rapid recovery after the third year as the economy shifts onto a new growth path with a stronger orientation toward tradable activities, notably in the agricultural sector. In the short run GDP is lower than in the "no adjustment" case, largely because of reduced demand. But GDP is higher and grows more rapidly in the medium term.

The clear beneficiaries are the rural poor. They are protected in the short run, in relation to their urban counterparts, by the depreciation of the real exchange rate (increased farm incomes partially offset the effects of declining wages), and they benefit in the long run from a growth strategy with a stronger agricultural orientation. After seven years rural poverty is down to its initial level and is falling steadily. Urban poverty rises because of the initial contraction of demand and the associated fall in real wages. Recovery along the new growth path is only a minor moderating force by the end of the period; in Ecuador's case this reflects the high initial proportion of the urban labor force in services and other nontradables—sectors that grow relatively slowly. In the longer term the outcome for the urban poor would be more favorable because of urban-rural migration and the expansion of urban production of tradable goods.

do with economic restructuring. Especially important are policies that concern relative prices and the management of public sector resources, including the budget and public enterprises. Poverty cannot be reduced in the long term without broadly based growth. But some policy changes can also help the poor in the shorter term. Exchange rate depreciation and other measures designed to raise agricultural prices will increase the incomes of some of the rural poor, especially small farmers.

Macroeconomic management can soften the impact of adjustment on consumption in several ways. The government might plan for a temporary "pause" in investment, for increased foreign capital flows, and for temporary increases in transfers from the budget. Some of these measures—public spending on investment, for instance—are directly subject to government control. Others, notably private investment, will respond to other aspects of the economic environment. When transfers are used, the budget deficit will be higher than otherwise; this will be justified only if effective action is taken on other aspects of public finance to ensure that the deficit is consistent with both short- and long-run objectives for inflation, investment, and savings.

Analyzing alternative packages is difficult. One approach is to use a model that consistently incorporates macroeconomic factors, markets, and the determinants of household welfare (Box 7.2). A modeling approach helps to clarify issues but cannot do full justice to the complexities of the real world. In this review we therefore rely more on the differing experiences of the countries in the three groups outlined above.

Adjustment is conditioned by initial macroeconomic imbalances, the depth of structural problems, and the severity of external shocks. The first group of countries, typified by many in East Asia, entered the decade with relatively stable macroeconomies, flexible production and trade structures, and a history of investment in human capital. These countries suffered relatively mild shocks, taking the decade as a whole (Table 7.1). As a result, adjustment there did not require a sustained reduction in demand. Countries in the second group, including many in Latin America, were living beyond their means at the beginning of the decade, and they suffered larger shocks. Their adjustment was inextricably tied up with the reduction of demand. These countries also had a greater need for economic restructuring than the first group. The third group, dominated by Sub-Saharan Africa, started the 1980s with substantial macroeconomic imbalances and severe structural weaknesses, and it experienced the worst shocks. In discussing each of the groups in more detail, it is helpful to focus on one or two representative countries.

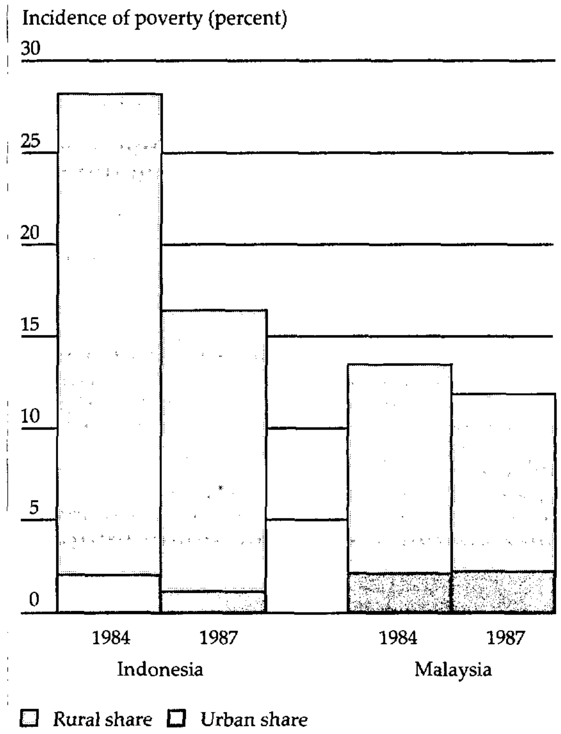
The benefits to the poor of effective action

Indonesia and Malaysia represent the first group. In Indonesia progress in reducing poverty was the result of gains across the board; in Malaysia reductions in rural poverty outweighed a small rise in urban poverty (Figure 7.1). These successes are the result of effective adjustment. Both countries acted swiftly on policy fundamentals while relying on changes in investment, debt, and public spending to prevent or moderate declines in consumption.

These countries needed to adjust because of the fall in the prices of oil and other commodities. Once it became clear that the shocks were not temporary, both countries acted decisively to stabilize their economies and establish a framework for economic restructuring. They adjusted their fiscal policies, depreciated their currencies, liberalized their trade regimes where necessary, and deregulated their industries. These policies raised the relative price of agricultural goods (Table 7.2), which protected the incomes of farmers in the short run and encouraged continued growth in farm output. The gains were fully passed through in the case of export crop farmers, who are a significant part of the farming population in both countries. Rice farmers in Indonesia also enjoyed significant gains. Well-developed rural infrastructure and markets—the fruits of the policies and investments of previous decades—greatly reinforced the benefits to farmers. The governments gave a high priority to maintaining public infrastructure, despite the need for fiscal stringency.

Although restructuring was effective, demand-reducing policies were also necessary. But these policies had only a moderate impact on private consumption. Investment was high at the beginning of the adjustment, following the increase in revenues from oil exports in the early 1980s, and

Figure 7.1 Poverty in Indonesia and Malaysia, 1984 and 1987



Note: The total incidence of poverty for Malaysia is slightly less than that reported in Chapter 3 because specific poverty lines for rural and urban areas have been used here.

Table 7.1 External shocks in the 1980s, by region
(percentage of GDP)

Region and country	*Terms of trade shock*[a]	*Interest rate shock*[b]	*Total*
Sub-Saharan Africa	−10.1	−4.4	−14.4
East Asia (excluding China)	−3.9	−4.3	−8.1
China	−0.6	−0.6	−1.2
South Asia (excluding India)	−7.9	−2.3	−10.2
India	−4.6	−1.0	−5.6
Latin America and the Caribbean	−6.3	−4.0	−10.3

Note: Numbers may not sum to totals because of rounding. The table shows changes in external conditions for 1985–88 compared with the average for 1970–80; it thus gives a measure of those shocks that persisted into the second half of the decade. Aggregations by region are not weighted.
a. The difference between changes in export prices and changes in import prices between the two periods. Prices are in dollars and are weighted by the share of exports or imports in GDP.
b. Calculated from changes in the real interest rate weighted by the debt-to-GDP ratio. The real interest rate is derived from the implicit nominal interest rate (the sum of public and private interest payments less interest receipts on reserves divided by total debt) and from U.S. inflation.

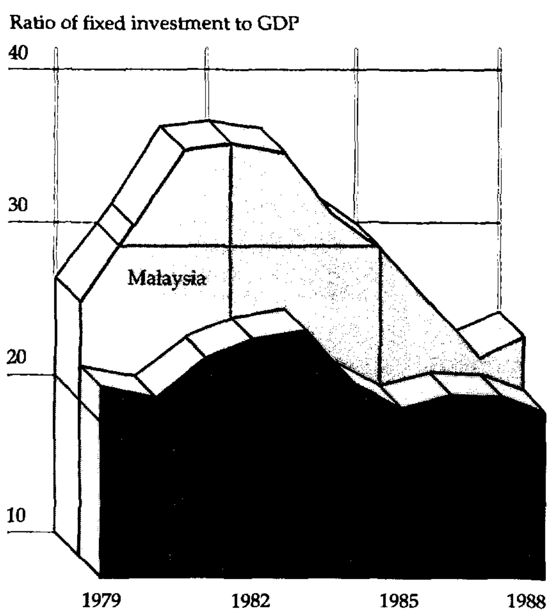
Table 7.2 Changes in key variables, Indonesia and Malaysia, 1984 and 1987
(1984 = 100, unless otherwise indicated)

	Indonesia		Malaysia	
Indicator	*1984*	*1987*	*1984*	*1987*
GDP per capita	100	107	100	98
Private consumption per capita	100	107	100	85
Fixed investment as a percentage of GDP	22	19	32	23
Real effective exchange rate[a]	100	55	100	76
Agricultural terms of trade	100	116	100	129
Urban wage	100	115	100	97
Rural wage	100	115	100	99

a. In terms of foreign currency per unit of domestic currency.

there was room for a "pause" in investment without a decline to unusually low levels (Figure 7.2). Both countries cut public investment substantially, especially in capital- and import-intensive activities. Private investment declined in response to the contraction in economic activity, tighter monetary conditions, and greater uncertainty. The convincing character of the adjustment policies provided the basis for a recovery in private investment, which was already beginning in 1988. Despite lower receipts from the oil sector, the governments were able to contain the budget deficits through reduced public investment, greater stringency in current spending, and increased revenues (notably, in Indonesia, from higher domestic fuel prices). In Malaysia overall fiscal control proved consistent with holding the consumer price of rice steady in nominal terms, thus increasing the fiscal transfers to rice consumers. Indonesia was able to combine adjustment and an increase in foreign borrowing without losing its creditworthiness. Concessional assistance also made a valuable contribution.

Figure 7.2 Fixed investment in Indonesia and Malaysia, 1979 to 1988



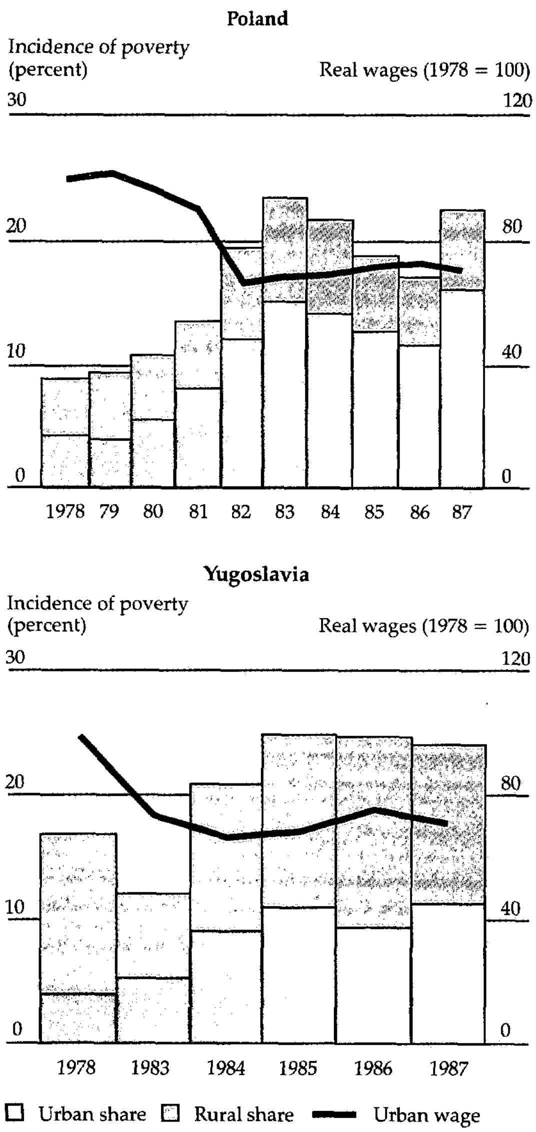
Box 7.3 The poor in Eastern Europe in the years of crisis

The evolution of poverty in Eastern Europe in the 1980s was dominated by macroeconomic developments. As in many highly indebted countries, structural defects were masked by overborrowing in the 1970s. Box figure 7.3 shows the pattern of changes in poverty in Poland and Yugoslavia. Whereas Poland was, until recently, a centrally planned economy, Yugoslavia has followed decentralized socialist policies since the 1950s.

Demand-reducing measures, coupled with halting attempts to reduce subsidies, led to declines in real urban wages in both countries and to increased unemployment in Yugoslavia. This was in spite of substantial declines in investment, which in turn helped protect overall private consumption. Farm incomes fell less sharply because of exchange rate changes (notably in Yugoslavia) and because farm households have greater access to the "second" economy that operates outside official markets. Urban poverty increased substantially.

Although reform was already under way in some Eastern European countries in the 1980s, much more radical measures are being implemented or are under consideration in the 1990s. These steps are likely to put added pressure on urban labor. A substantial shakeout of employment from the state sector will be necessary; the private sectors of these economies, although growing fast, are still very small. Subsidies are a major problem; in 1988 they were 14 percent of GDP in Poland, 12 percent in Hungary, and 9 percent in Yugoslavia. The task is clearly immense. Even so, the principle of effective and early action on policy fundamentals, together with measures to smooth consumption, applies here too.

Box figure 7.3 Poverty and wages in Poland and Yugoslavia



Note: For Poland wages are adjusted for shortages of consumer goods in 1980 and 1981.
Source: Milanovic (background paper) and Posarac (background paper).

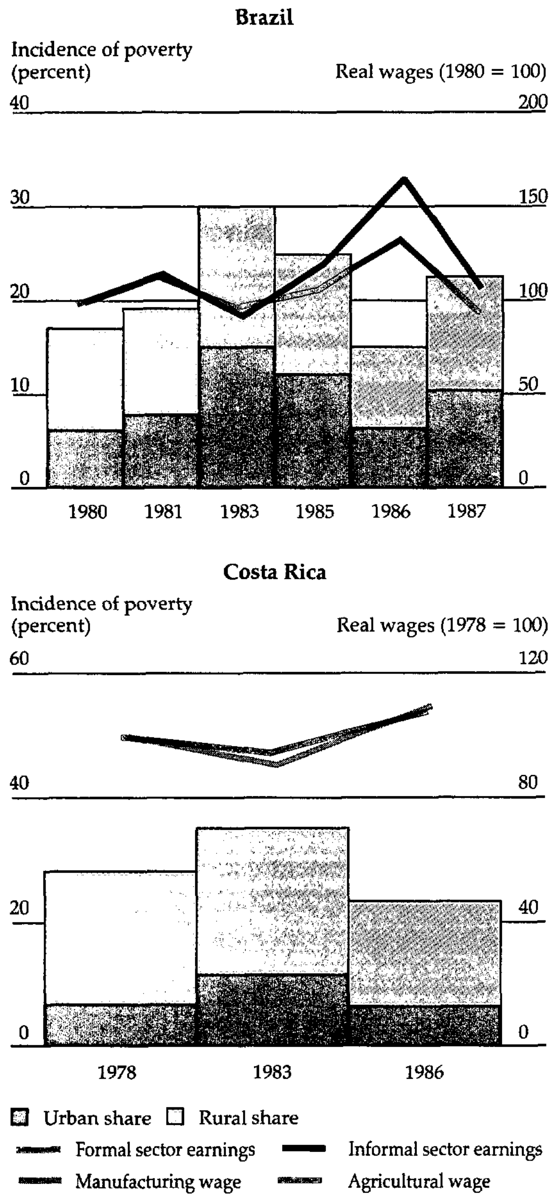
This mix of measures achieved macroeconomic stability with only moderate losses in welfare and (especially in Indonesia) fostered a political environment that supported strong adjustment. Initially favorable structural conditions helped short-run macroeconomic management as well as restructuring. The three most important factors at the beginning of the decade were a well-managed fiscal policy, high investment, and a relatively low debt burden.

The outcome for the poor was favorable. In both countries most of the poor are farmers, and land distribution was relatively even. Smallholders were able to benefit from higher farm incomes. Urban and rural households that depended on wages were potentially more vulnerable to the price increases associated with devaluation in both countries and with the declines in national labor demand as a result of recession in Malaysia. Wages did fall in Malaysia, causing the small rise in urban poverty seen in Figure 7.1, but in rural areas higher incomes for farm and nonfarm enterprises offset that effect. The decline in real wages was also moderated by a fall in the share of profits, especially in nontradables, and by the policy of stabilizing rice prices. Although public wages declined in Indonesia, the overall buoyancy of the labor market (thanks to deregulation and the rapid growth of nontraditional exports) appears to have raised real wages in the private sector. Survey evidence for Indonesia indicates that the incomes of poor households went up for all sectors and occupations.

The problem of sharply reduced demand

The second group consists of middle-income countries that were living beyond their means at the beginning of the decade as a result of easy borrowing in the past. There, reductions in demand were unavoidable, and there was little scope for using debt to smooth consumption. Because of these unfavorable initial conditions, it was hard to avoid a squeeze on the incomes of the poor in the wake of the debt crisis. In many of these countries the poor depend heavily on the labor market and are therefore vulnerable to a widespread drop in the demand for labor. The group includes much of Latin America and parts of Eastern Europe (Box 7.3). Many are severely indebted. Brazil and Costa Rica can serve as examples. Both experienced a sharp increase in poverty when wages fell in 1983 (Figure 7.3). Costa Rica was able to reverse this trend—by 1986 poverty was below the level of the late

Figure 7.3 Poverty and wages in Brazil and Costa Rica



1970s—but Brazil's recovery was incomplete and faltering. The difference can be linked to action on policy fundamentals.

Brazil failed to act decisively on the fundamentals: its public sector deficit (adjusted for inflation) remained high, and its real exchange rate did not change significantly (Table 7.3). The recession of 1983 was probably unavoidable. Poverty increased because of falling wages and incomes in urban and rural areas; informal employment grew as formal employment stagnated. Policy had much to do with the subsequent outcome. Failure to reduce the deficit undermined the effort to tackle inflation. High domestic borrowing by the public sector raised real interest rates and expanded the share of financial profits in the economy (at the cost of the shares of labor and of nonfinancial profits). In 1986 the Cruzado Plan sparked an economic boom that reduced poverty substantially. But the rise in consumption and wages was not sustainable, owing to rising imports and resurging inflationary pressures. When the inevitable contraction came, poverty rose again. In 1987 the incidence of poverty was higher than at the beginning of the decade. The country faced continuing fiscal difficulties and a larger debt burden. Brazil had undergone the recession of 1983 for nothing.

Brazil's policies led to high inflation and (through widespread import controls) an appreciated real exchange rate, in relation to what it would otherwise have been. Each of these effects had complex implications for poverty. In general, however, they made the poor worse off. The "inflation tax" is probably much more regressive than traditional tax instruments. And greater depreciation would have helped the rural poor—although to a smaller extent than in Malaysia, because more of Brazil's rural workers depend on wages. Evidence from the Philippines, another middle-income country that failed to adjust adequately in

Table 7.3 Changes in key variables, Brazil, 1980 to 1987
(1980 = 100, unless otherwise indicated)

Indicator	*1980*	*1981*	*1983*	*1986*	*1987*
GDP per capita	100	92	87	99	100
Private consumption per capita[a]	100	92	89	99	96
Fixed investment as a percentage of GDP	23	23	18	19	22
Public sector deficit as a percentage of GDP[b]	3.6	6.2	4.2	3.6	5.5
Annual inflation (percent)	90	108	141	144	209
Real effective exchange rate[c]	100	92	118	108	100
Formal sector earnings	100	115	98	135	95
Informal sector earnings[d]	32	37	30	53	35

a. Adjusted with the use of the GDP deflator.
b. The public sector deficit is the operational deficit after deducting the component of nominal interest payments that can be attributed to inflation.
c. In terms of foreign currency per unit of domestic currency.
d. The index of informal sector earnings is in relation to the 1980 formal sector wage.

Box 7.4 Macroeconomic policy choices and income distribution in the Philippines

The recession of 1983-85 in the Philippines illustrates the costs to the poor of declining labor demand, lack of real exchange rate movement, and inflation. As in many highly indebted countries, the crisis had its roots in past overborrowing and structural defects. Stabilization began with a nominal devaluation and strict import controls, followed by drastic cuts in public spending and a tight monetary policy. The effects were initially stagflationary: a sharp decline in output, faster inflation, and an appreciating real exchange rate. The currency did not depreciate in real terms until 1986.

How did all this affect the poor? An econometric study that used quarterly data for 1980-86 found that contraction in the labor market and increases in inflation reduce still further the share of the poor in national income; depreciation of the real exchange rate works in the opposite direction. The results indicate that when the inflation rate increases by 10 percent, the share of the poorest fifth of the population falls by 10 percent (other things being equal). By contrast, when the real exchange rate depreciates by 10 percent, the share of the poorest fifth rises by 20 percent. The study also found that lower public spending and higher real interest rates lead to smaller decreases in the incomes of the poor than of the rich.

Why is this? Recession and contraction in the labor market cause declining labor productivity and rising underemployment, which hit the poor hard. Accelerating inflation also hurts the poor because nominal wages fail to keep pace and because the poor lack access to assets that are protected from inflation. The poor gain from real exchange rate depreciation because exports are intensive in unskilled labor (and are often produced by peasants) and because tradables account for only a small part of the consumption basket of most poor people in the Philippines. Government spending mainly benefits the middle classes, and cuts here hurt the poor less.

The country's approach to stabilization was unfavorable to the poor in this period. If the government had chosen not to ration imports, relative prices would have changed more sharply and without such a large rise in inflation. Demand reduction through changes in fiscal and monetary policy was necessary, but greater reliance on changes in relative prices would have moderated the recession and protected the poor. Changes in the composition of public expenditures, although politically difficult, could also have made adjustment less painful for the most vulnerable.

the early 1980s, supports the view that real depreciation and lower inflation help the poor (Box 7.4). In Brazil and the Philippines alike, high inflation and overvalued exchange rates, combined with general uncertainty, also encouraged capital flight, which benefited the rich and hurt the poor.

Costa Rica stands in sharp contrast to Brazil. It suffered a deeper recession at the beginning of the period but undertook a substantial macroeconomic adjustment. Between 1980 and 1986-87 the government cut its budget deficit from 8 percent of GDP to 2-3 percent, and the real effective exchange rate depreciated by 30 percent. By 1986 output and wages had recovered and inflation had declined. These changes account for the significant improvement in poverty seen in Figure 7.3.

The success or failure of efforts to protect the poor does not depend on whether the government attempts to cushion the decline in consumption during adjustment. The successful and the unsuccessful alike have taken this route. Indeed, in both Latin America and East Asia the counterpart of a cushioned fall in consumption was lower investment (Figure 7.4). But Latin America's investment rate is now 27 percent lower than in the early 1980s—and far below East Asia's. This illustrates

Figure 7.4 Investment pause versus investment crash

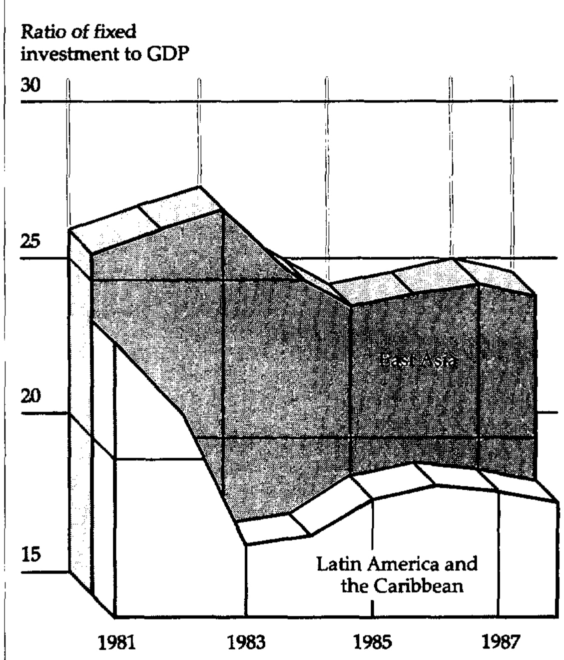
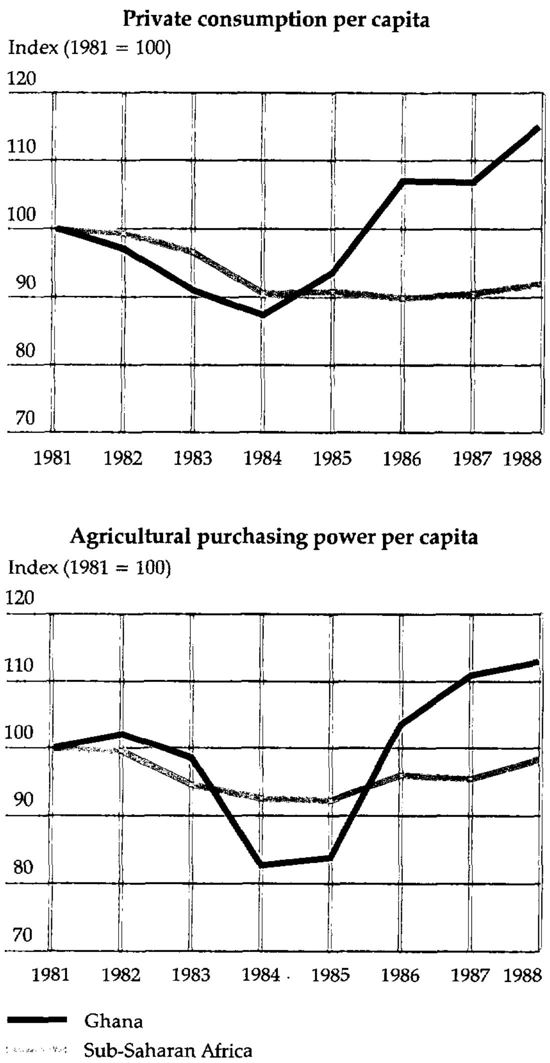


Figure 7.5 Consumption and agricultural purchasing power, Sub-Saharan Africa and Ghana



Note: Private consumption per capita is calculated on the basis of the total population; agricultural purchasing power is calculated on the basis of the rural population.

the limits of a pause in investment as a way of cushioning consumption: a pause makes sense only if it is followed by an investment recovery that prepares the way for future growth in output—as in Costa Rica and Malaysia. Otherwise a country may start with a smaller reduction in consumption but end with a permanently lower level.

A substantial reduction in demand was unavoidable in Brazil and Costa Rica. As a result, some decrease in the incomes of the poor was probably inevitable, even with significant declines in investment. As the model described in Box 7.2 illustrated, governments can maintain spending above sustainable levels only temporarily and at great cost. But with appropriate policies, governments can minimize the decline. Demand-reducing measures that moderate inflation and lead to a more competitive real exchange rate hurt the poor less than the alternatives. This is even more the case if the measures are resolute enough to maintain domestic economic stability and thus prevent capital flight. In the 1990s avoiding a further squeeze on living standards will require an increased inflow of capital; where policy reform is on course, this will be warranted. Beyond the short term, however, the only way to help the poor is to bring about sustainable recovery based on a growth path that involves efficient use of labor and widespread investment in human capital.

The problem of severe distortions

Sub-Saharan Africa dominates the group of low-income countries with severe distortions. These distortions were exacerbated by the macroeconomic shocks of the 1980s, and the region suffered badly. By the end of the decade many countries had initiated significant reform programs. As in the other groups, balancing the need to adjust with the need to protect the poor called for a mixture of (in some cases radical) changes in fundamental policy and measures to cushion consumption. Ghana provides an illustration. Like many

Table 7.4 Changes in key variables, Ghana, 1980 to 1988
(percent, unless otherwise indicated)

Indicator	*1980–84*	*1985–88*
Average growth rate		
GDP per capita	−4.1	1.7
Private consumption per capita	−3.4	1.6
Agricultural purchasing power per capita[a]	−10.3	10.6[b]
Share of GDP		
Fixed investment	5.0	9.9[b]
Fiscal deficit	4.2	0.5
Foreign aid receipts	0.8	3.8
Average value		
Real effective exchange rate[c]	172	32
Black market premium (percent)[d]	597	62

a. This is the growth in nominal value added in agriculture per capita rural population, deflated by the consumer price index as a rough measure of terms of trade gains for farmers.
b. 1985–87.
c. Based on the official exchange with 1980 = 100 and expressed in terms of foreign currency per unit of domestic currency.
d. The percentage of the black market exchange rate above the official rate—this had declined to 4 percent by 1988.

countries in this group, its economy has suffered from serious distortions, a long-term decline in its infrastructure and institutions, and adverse external shocks. Its experience since the mid-1980s, however, illustrates the benefits of effective policy (Figure 7.5).

In Ghana movement on the policy fundamentals meant large rises in many official prices. These increases were needed to deal with the distortions between official and parallel markets and between agriculture and the rest of the economy (Table 7.4). They were supported by strong fiscal adjustment, with an effort to redirect public spending toward the poor. This change in priorities allowed for the rehabilitation and expansion of some social services. Ghana's approach, in other words, was entirely consistent with the development strategy advocated in this Report. Moderating consumption losses by reducing fixed investment was not an option. Investment was already depressed in the mid-1980s, and it has yet to recover to a level that would be sufficient merely to replace worn-out capital. Foreign aid was therefore an essential element in supporting Ghana's recovery in consumption per capita, which grew at 1.6 percent a year in 1985–88. Continued aid will be necessary if investment is to recover and consumption is to continue to grow in the 1990s.

The changes in official prices in Ghana were similar to those made by many countries in the late 1980s. The alternative, which was commonly followed in the early 1980s, was to avoid changes in nominal exchange rates by rationing imports. This led to appreciation of real exchange rates and expansion of parallel markets for foreign exchange. Attempts to control domestic prices usually led to the dominance of parallel product markets, in which prices were more strongly influenced by the black market exchange rate than by the official rate. This happened, for example, in prereform Ghana and in Tanzania. And in countries in which general rationing and price controls were compounded by other sources of acute instability (such as war, as in Angola and Mozambique) rural markets disintegrated. Farmers were forced to withdraw into subsistence production.

In assessing the impact of adjustment on poverty, the main concern is with rural incomes. Rural areas accounted for 80 percent or more of those in poverty in countries such as Ghana in the 1980s. A strategy of rationing imports and reducing official producer prices clearly hurts rural areas. But how have the radical changes adopted in Ghana and other countries influenced the lives of the rural poor? The answer is that many have been helped, but some have been hurt (Box 7.5).

Box 7.5 The effect of macroeconomic adjustment on farmers in Sub-Saharan Africa

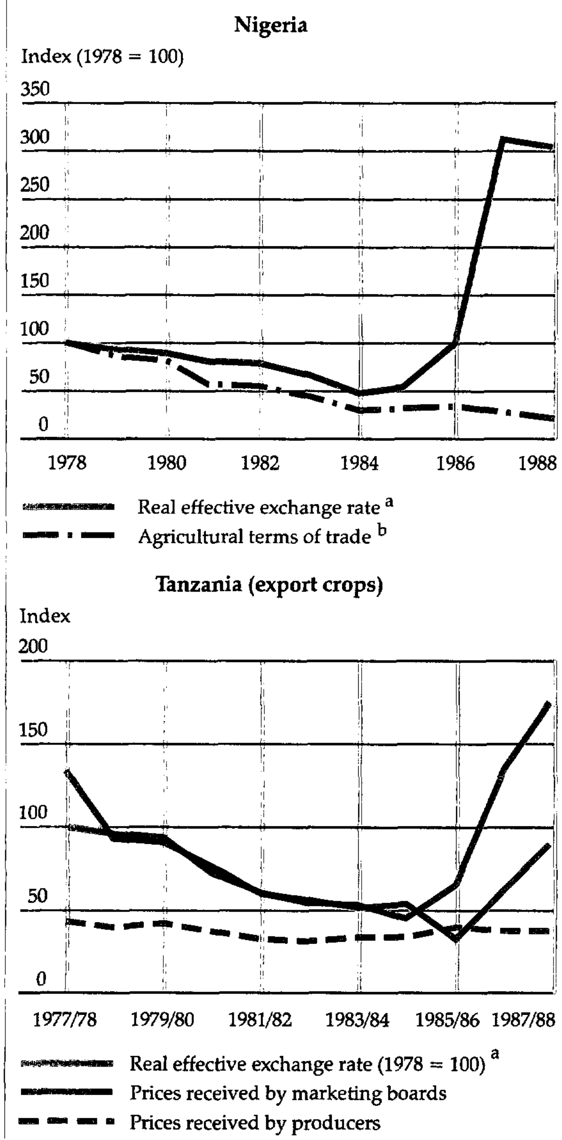
Regina Ofo is a farmer in Bendel State in Nigeria. For her, the structural adjustment program of 1986, which included measures to increase farm prices, has meant something concrete: she is better off. Because she earns more from farming, she can afford to buy new clothes for herself and her two daughters, and she was even able to prepare a Christmas feast for the less fortunate in her village. Babatunde Akinola, a former municipal employee, has also benefited. As a result of the scrapping of the government-run Cocoa Marketing Board in 1986 and the subsequent currency devaluations, independent merchants are offering prices for cocoa that are many times higher than prices in the early 1980s. Mr. Akinola spent his pension rehabilitating his father's cocoa farm in Ondo State. His income has risen substantially. Since 1986 he has built a large house, and he is able to send his children to some of the best schools in Nigeria.

Others have been less fortunate. Rising food prices are not always welcome to farmers who have to buy food part of the time. Before the change in policy, Nse Nnachukwu was able to feed his family of six with produce from his plot and his proceeds from petty trading. But higher prices for food and other basic goods have outrun his income. Furthermore, he cannot respond to higher prices by increasing food production because he lives in Imo State, where land is scarce.

Malawi's reforms, which date back to 1981, have included substantial price increases for maize. These increases have both helped and hurt small-scale farmers. Maize farmers—many of whom are poor—tripled their output in the early 1980s and have helped Malawi revive its export trade. But some lost out in the short run. Dester Mlondo is unable to produce enough maize to feed her family year-round. She has to sell her maize at harvest time, when prices are low, to obtain cash for other household needs. The removal of maize subsidies in 1987 has meant that maize becomes expensive in the months before harvest, when Mrs. Mlondo must buy maize to feed her family.

Adjustment measures that favor agriculture will gradually pull up the whole rural economy. In the shorter term they have helped many farmers but hurt others. Even the losers might soon have been worse off without the reforms—but that is little comfort to people such as Mr. Nnachukwu and Mrs. Mlondo. Measures to protect the most vulnerable during adjustment are discussed further in the section on "Public expenditure restructuring and the poor."

Figure 7.6 Agricultural terms of trade, Nigeria and Tanzania



a. In terms of domestic currency per unit of foreign currency.
b. The value added deflator divided by the consumer price index.

Price reform helps the rural poor by raising their incomes as producers. Sometimes, however, even large changes in the official exchange rate and in prices have failed to have much effect on poverty. Figure 7.6 illustrates the experience of Nigeria and Tanzania. Potential gains from depreciation of the exchange rate have not always been passed on; sometimes, notably in Tanzania, they have been absorbed by inefficient marketing chains. Moreover, many of the poorest farmers produce crops that are little affected by international price and exchange rate changes, and they have suffered from the contraction in economic activity; this was important in Nigeria. Finally, some of the poor in rural areas—in Malawi, for example—are net purchasers of food. These mixed short-run effects do not diminish the case for strong price incentives in agriculture. But they underline one of the central messages of Chapter 4: a coherent overall strategy that includes improved marketing and rural infrastructure is needed to support growth in rural incomes.

Rural areas tend to gain from adjustment, especially in the medium term. Indirect evidence suggests that it is the urban poor who are more at risk. Real urban incomes may fall—but not always because of higher prices, as is often supposed. In many cases poor urban consumers are paying parallel-market prices rather than official prices when adjustment begins, and higher official prices often have neutral, and perhaps favorable, effects on the prices actually paid by the urban poor. The main reason for decreases in urban income is the contraction in the demand for urban labor. In many countries this was unavoidable. Urban spending, especially in the public sector, reached levels in the 1970s that were clearly unsustainable. Even before the adoption of reform measures, both Ghana and Nigeria experienced a radical decline in the position of urban labor. Urban-rural migration has become significant in both countries—three-fifths of all internal migrants in Ghana during 1982–87 came from Accra, the capital.

In this third group of countries the problems of adjustment and poverty are at their most severe. But, as before, the appropriate path is to combine effective action on policy fundamentals with as much support for private consumption as macroeconomic resources allow. Two special factors deserve to be stressed regarding this group. First, price distortions are in many cases still so great that dramatic price reforms may be either neutral or beneficial for the poor, who in many cases have gained little from attempts to control official prices. Second, usually the only short-run option for moderating consumption declines is foreign aid. Given the depth of the structural problems in many countries, a lengthy transition during which aid finances consumption as well as a recovery in investment will probably be necessary.

Macroeconomic policy choices and political feasibility

Protecting the poor through macroeconomic policy has proved easier in some countries than in others. The East Asian countries were in a better position

Box 7.6 The political economy of adjustment

Effective adjustment can ease the burden on the poor in the short run and reduce poverty in the long run. Yet adjustment poses dilemmas for political leaders. The policies often impose costs on constituents—sometimes permanent costs, as when monopoly profits or transfers are cut. They also involve a tradeoff between present and future—a tradeoff that politicians, with elections to win, interest groups to satisfy, and coups to deflect, find awkward. The success of adjustment measures may depend on the feasibility of building coalitions of those who benefit and on careful sequencing with respect to political as well as economic objectives.

Favorable initial conditions, which many East Asian countries enjoy, reduce the political as well as the economic costs of adjustment. The openness of the Malaysian economy, Korea's strong export orientation, and Indonesia's long-standing stress on rural development created important constituencies that quickly benefited from adjustment. This reduced the risks for political leaders and contributed to a virtuous circle of sound policy and satisfactory economic performance.

Severe imbalances and large external shocks increase the temptation to delay adjustment. If people think, as they did in Zambia, that economic difficulties are externally caused and adjustment policies externally imposed, there is a high risk of losing political support. Weak or divided governments and those facing electoral challenges are likely to procrastinate. The governments of Costa Rica and Ghana in the late 1970s and early 1980s, Brazil in 1986, and the Philippines in 1984 all delayed because of political uncertainties. This increased the costs of adjustment.

Some have argued that authoritarian regimes are better at effecting adjustment, since they have no (parliamentary) opposition demanding compromise and they have the luxury of longer time horizons. The governments of Chile after 1973, Korea in the early 1980s, and Ghana from the mid-1980s are examples. But there are many cases of strong reform under democratic accountability—Jamaica in the 1980s, the Philippines in 1986, Turkey in 1983, Costa Rica in the mid-1980s, and so on. In these cases, leaders built on discontent with previous forms of economic management and defended market-oriented policies as "progressive." Under these circumstances the fit between the politics and economics of effective adjustment can be close. Where new economic teams have come to power and the policies of the previous team have been discredited, there is scope for ambitious reform. In such cases demand-reducing and restructuring measures should be introduced as quickly as is technically and economically feasible. Swift action establishes the credibility of the program, limits the opportunity for resistance to coalesce, and increases the likelihood that new leaders will reap the political fruits of reform. These lessons are particularly relevant for the new Eastern European democracies.

A mix of swift action on the fundamentals and efforts to cushion consumption is often justified on welfare grounds. The political case for this approach can also be strong. But there is an important difference between the two rationales. Concern with welfare puts the emphasis on the poor, whereas a preoccupation with politics points the other way, dictating that losses among politically powerful groups (such as formal sector workers) be moderated. In designing programs to compensate losers among the poor, some leakage to such groups may be both economically unavoidable (if the truly disadvantaged are to be reached) and politically advisable.

As painful as they may be, crises can strengthen support for policy change, weaken antireform interest groups, and increase politicians' willingness to rely on technocrats. For those governments that are willing to act, the political risks of undertaking difficult measures can be relieved by outside support. When governments lack the resources to cushion consumption, external capital inflows can play a vital role in the political sustainability of reform. Adjustment in both Ghana and Turkey was facilitated by timely outside support for committed governments.

at the beginning of the decade, they reacted swiftly to the shocks by taking macroeconomic and restructuring measures, and they used a pause in investment appropriately to moderate declines in consumption during the transition. Their economies responded powerfully, and the poor were relatively well protected, notably through changes in relative prices. A weaker initial position undoubtedly contributed to the plight of the poor in other areas. But policy was of critical importance, as the progress achieved in Costa Rica and Ghana testifies.

Political factors have a decisive influence on the choice of policies for dealing with macroeconomic disequilibrium (Box 7.6). Conflicts between political imperatives and the goal of reducing poverty are common. This is especially true when demand-reducing measures are required or when growth-promoting policies help the rural poor but hurt the towns. If experience is a guide, strong executives with a mandate for change seem best placed to pursue reform—and, given the opportunity, it makes sense to act quickly. In any case, external capital flows and measures to compensate losers play a crucial political role as well as a purely economic one.

Public expenditure restructuring and the poor

Macroeconomic and structural adjustment policies can evidently have a significant impact on the poor. In many countries reducing poverty has been facilitated by good macroeconomic policy choices. But many of the poor have suffered and continue to suffer in the wake of the shocks of the 1980s. Even if policy promotes the expansion of labor demand by reducing biases against labor-intensive activities, economies take time to respond, and some groups of laborers or small-scale producers will lose during the transition. Also, dealing with shocks and excessive public debt often involves cuts in public spending, which may hurt the poor directly. Table 7.5 shows how reductions in aggregate spending affected spending on social services in Sub-Saharan Africa and Latin America in the early 1980s. Social spending fell in both regions—but in Sub-Saharan Africa changes in allocation in favor of the social sectors provided a little protection, whereas in Latin America there were actually shifts in composition away from social spending.

With overall public spending under pressure, how far is it possible to protect the poor? There are three main elements in that task.

- *Cushioning consumption.* The poor lack savings and access to credit, and they are ill-equipped to protect their consumption on their own.
- *Maintaining physical and human capital.* Adjustment may mean a long-term setback for the poor if it undermines the resources that enable them to work as small-scale producers and laborers. Health and education, irrigation works, and rural roads are some of the investments that should not be allowed to deteriorate.

Table 7.5 Fiscal contraction and social spending, Sub-Saharan Africa and Latin America

Region and indicator	*1980*	*1985*	*Change (percent)*
Real expenditure per capita (1978 = 100)			
Sub-Saharan Africa			
Total noninterest spending	96	64	−33
Social spending	85	63	−26
Latin America			
Total noninterest spending	110	92	−16
Social spending	107	87	−18
Social spending as a percentage of total noninterest spending			
Sub-Saharan Africa	23	26	13
Latin America	23	20	−16

Note: The figures include all countries in which total real noninterest spending declined during the period.

- *Preparing the way for a recovery in investment.* Although a decrease in public investment is an appropriate initial response to a shock, a subsequent recovery is essential.

There are clearly tradeoffs here, and some of them become sharper in a macroeconomic crisis. Public spending to cushion declines in consumption becomes all the more important, but so does maintaining and expanding the capital stock. Accurate targeting is especially valuable in the face of these difficulties, but by definition, it entails cuts that hurt the rich or middle classes, making it politically as well as administratively awkward. Nevertheless, countries such as Chile and Indonesia have managed to alter their public spending priorities as part of an overall fiscal adjustment.

This section focuses on short-run changes in budgetary expenditures. But changes in government receipts can also be important. In many countries there is a case for reforming the structure of revenues in a manner that both serves long-run efficiency and is broadly progressive; well-designed direct and indirect tax structures and user charges for utilities, energy products, and social services have these characteristics. Where such reforms can be introduced swiftly, increased revenues can reduce the need for spending cuts. A good example is reduced subsidies on petroleum products in Indonesia. Often, however, reform of the tax system takes longer.

Restructuring public expenditure during adjustment

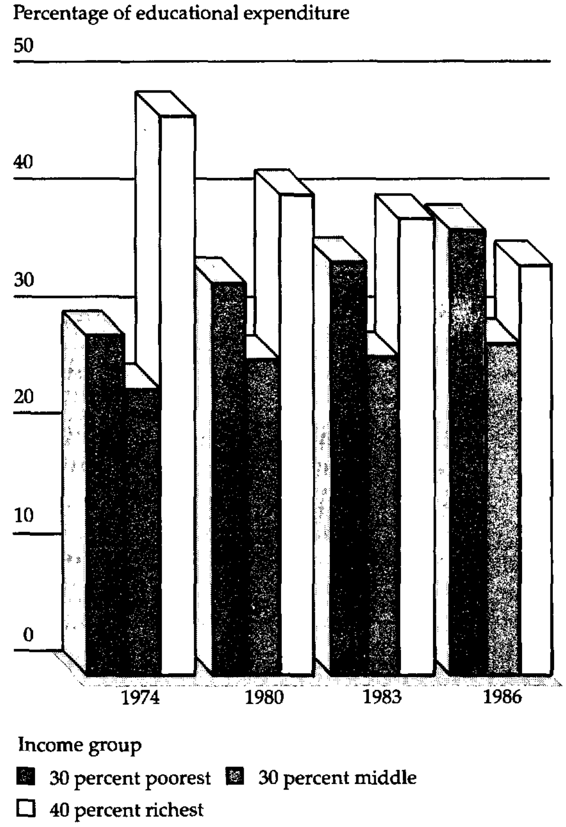
Many countries have cut spending across the board. The Philippines in the mid-1980s is an example. The share of spending on the social sectors, agriculture, and poverty-oriented programs remained roughly constant at about 30 percent of noninterest spending, but because of the overall cutbacks real per capita spending in these areas in 1986 was about two-thirds of the 1981 level. Since overall public spending in the Philippines benefits the nonpoor disproportionately, they also suffered substantial losses from the cuts. But it is the poor who are most vulnerable, and the pattern of spending did not change to protect them.

Indonesia also had to cut its public spending after oil prices declined in the early 1980s. Between 1982–83 and 1987–88 its real public spending fell by 17 percent. But despite an 80 percent increase in interest payments, spending to maintain economic and social infrastructure was protected, and transfers to the provinces increased by 29 percent. The reallocation was feasible because of a substantial reduction in development spending and a real decline in the wage bill. Within development spending, resources shifted from import-intensive industry and mining to human resources. The net effect was to increase the employment content of public spending and preserve adequate resources for maintaining and selectively expanding social and economic infrastructure. The Indonesian government has traditionally avoided explicit transfers, but shifts of public spending into activities with a high employment content helped to maintain the incomes and consumption of the poor.

The pattern of spending within sectors is as important as the pattern among sectors. It is often argued that when social spending is cut, services for the poor are cut most. The evidence is inconclusive. In some African countries primary education and health services suffered disproportionately, and the quality of service declined. Cuts tend to bear hardest on supplies and equipment; personnel costs are harder to adjust. (In Cameroon salaries rose to 99 percent of total recurrent health spending in the fiscal squeeze of 1985–87.)

Chile managed to protect services to the poor during its fiscal adjustment. Despite lower public spending on goods and services overall, basic health and child nutrition programs targeted to the poor expanded. This helped to sustain a continued improvement in social conditions in the 1980s, including further declines in mortality rates for children under 5. In education, too, the government maintained quality by ensuring an adequate supply of materials; expenditure on these items rose in real terms despite cuts in total education spending. The government also tilted its spending in favor of primary education. Survey data confirm that this reallocation was progressive. A longer-term reorientation of public spending on education toward the poor continued in the 1980s despite increasing fiscal austerity (Figure 7.7).

Figure 7.7 Who gained from public spending on education? Chile, 1974 to 1986



Source: Castañeda forthcoming.

Protecting the poor through transfers in a macroeconomic crisis

Should transfers rise or fall during adjustment? Reducing transfers may seem an obvious part of growth-oriented fiscal adjustment, but it can add to the burden of the poor. The alternative is better targeting, but this too is difficult at the best of times and rarely gets any easier in a macroeconomic crisis. There is some scope, however, for using three sorts of transfer—subsidies, public employment schemes, and compensation for laid-off workers—to help the poor during adjustment. These transfers often form part of the social action programs that many countries have recently introduced (Box 7.7).

Subsidies. General subsidies often benefit the urban poor (and occasionally the rural poor, as in Egypt and in Kerala, India), but leakages to the nonpoor are substantial. As a result, fiscal outlays must be large to have much of an impact on the poor, and the costs of maintaining them during a macroeconomic crisis are high. Better targeting is highly desirable—but difficult.

Jamaica and Sri Lanka, for instance, both shifted from general to targeted food subsidies in the late 1970s and early 1980s. The switch succeeded in reducing aggregate subsidies: in Sri Lanka these declined from 5 percent of GDP in 1975–79 to less than 1 percent in 1984, and in Jamaica they went from a peak of 6 percent of GDP in 1977 to less

Box 7.7 Packaging interventions: the role of social action programs

The late 1980s saw an increasing number of special multisectoral schemes that sought to mitigate the social costs of adjustment; those in Bolivia, Ghana, and Madagascar are the most advanced and best known. These programs included short-run measures to relieve distress (such as public employment, severance payments, and credit schemes for displaced workers) and other measures (ranging from urban sanitation to provision of textbooks) that form part of a longer-term strategy for reducing poverty. They often involve many donors and local and international NGOs.

Bolivia's Emergency Social Fund (ESF) and Ghana's Programme of Action to Mitigate the Social Costs of Adjustment (PAMSCAD) have entirely different designs. The ESF involved a new institution—essentially a domestic financing agency for projects chosen by local communities and executed by private contractors. Thanks to strong leadership, highly motivated personnel (who received salaries above civil service rates), and minimal government involvement, the scheme was implemented rapidly. By contrast, PAMSCAD works with established government agencies. It includes twenty-three antipoverty interventions that cover public works, credit, training, low-cost water, health, drugs, nutrition, and shelter, all with a strong orientation toward community involvement and the participation of indigenous NGOs. Problems of foreign and domestic coordination have badly delayed implementation. Both programs have served three important purposes: mobilizing foreign assistance, raising domestic awareness of poverty inside and outside the government, and easing the introduction of difficult adjustment measures.

Neither scheme is an ideal model for other countries, especially in Africa—Bolivia's because of its special, autonomous character and Ghana's because of its complexity. Newer schemes have been less complex than PAMSCAD, but most still have many components and mix short- and long-run measures. This raises problems of coordination and may divert attention and resources from where they are needed most. Sometimes immediate measures to start dealing with long-term problems will be desirable, but they should be compatible with longer-term strategies. The Economic Management and Social Action Project in Madagascar, for example, includes measures to provide drugs and support family planning, but these will feed into longer-term health interventions.

than 1 percent in the mid-1980s. But some of the poor lost out because coverage was incomplete. In Sri Lanka the real value of food stamps declined. Furthermore, there is evidence that income decreased for the poorest fifth of the population, whereas less poor households were protected by the general rise in economic activity and growth in real urban wages. Jamaica did somewhat better, especially in providing food in clinics to pregnant women and children under 5. Self-selection improved targeting for this group.

These and other cases suggest three conclusions. First, when subsidies are already well targeted—say through feeding programs for vulnerable groups that are held in clinics attended by the poor—there is a powerful case for maintaining them. (Chile is again a good example.) In such well-designed systems temporary increases in the ration may be considered. Second, where better targeting is feasible—through food stamps, a shift to goods consumed mainly by the poor, or geographic targeting—it should be pursued. Third, if improved targeting is practically or politically difficult, it may be better to cut subsidies across the board, releasing resources for other programs. The opportunity cost of subsidies in a period of adjustment is high.

Public employment schemes. Most countries that are undergoing adjustment have to cope with a temporary drop in labor demand. Public employment schemes are usually better than subsidies at reaching the poor under these circumstances. Bolivia, Chile, Peru, and, more recently, Ghana and Madagascar have used employment schemes in response to macroeconomic shocks. Similar programs in South Asia provide a safety net for the rural poor. These programs often take the form of traditional public works schemes, but in some countries, including Bolivia, Ghana, and Madagascar, the government acts as a financing agency for labor-intensive projects carried out by private contractors.

The poor may face a temporary decline in real wages owing to reduced demand for labor or shifts in relative prices—higher food prices, for instance. (A study in Bangladesh found that real agricultural wages first fell and then recovered after an increase in rice prices. Full adjustment took three to four years.) Public employment schemes can help the poor in both cases. If targeting is to be through self-selection, however, the wage must be set low.

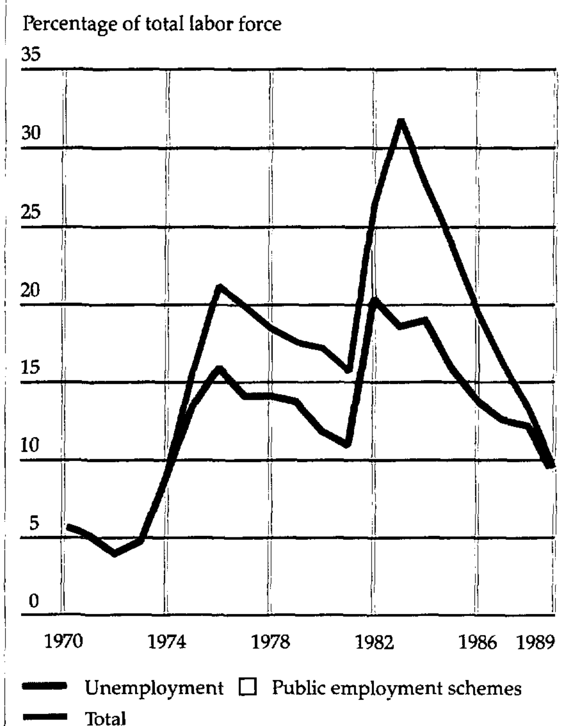
The public employment programs in Chile and Peru are good examples. At their peak in 1983 Chile's programs provided employment to a remarkable 13 percent of the labor force (Figure 7.8). Afterward, the programs were run down as the labor market recovered. At its peak in 1986 Peru's Programa de Apoyo de Ingreso Temporal (PAIT) employed 3.5 percent of the labor force. Both schemes paid low wages, thus reinforcing targeting through self-selection. In 1986-87 two-thirds of the employees in the Chilean programs were from the poorest 20 percent of the population, and both schemes attracted many women (half of the program's workers in Chile and three-quarters in Peru). Low wages also meant that relatively broad coverage was affordable, especially in Chile, where the total cost of the program was 1.4 percent of GNP at the peak in 1983. Chile's program was financed from domestic sources, partly through lower spending on civil service wages. Peru's program, at its height in 1986, cost only 0.2 percent of GNP and 4 percent of total public investment.

Both schemes were controversial. Chile's aroused much hostility and was viewed by some as a make-work scheme to reemploy sacked public sector workers. Peru's program was popular among workers but became discredited when it was increasingly used for political purposes. Nevertheless, both programs successfully targeted the poor and provided social security for the unemployed during the recession.

Bolivia's Emergency Social Fund (ESF) included employment measures with similar objectives but with a different design: a special agency, substantial donor finance, and the use of private contractors to hire construction workers at market wages. It succeeded in channeling donor finance to local infrastructure projects, and it softened the decline in activity in an economy that was contracting sharply. It recruited male workers almost exclusively and was much less finely targeted than the Chilean and Peruvian schemes—no doubt because it paid market wages. Fewer than half of the ESF workers came from the poorest 40 percent of Bolivian households.

These cases confirm the potential for public employment schemes, especially those targeted to urban labor markets. But can such schemes reach the rural poor, too? Chapter 6 concluded that a mixed strategy of cash-for-work schemes and measures to increase the availability of food through private and public channels can stop a drought from turning into a famine. The temporary shocks to the rural labor market under consideration here are very similar to the reductions in purchasing power that occur in a drought. In one respect adjustment is easier: since the initial source of the shock is not an interrupted food supply, the government can focus on employment without having to worry about the food distribution system. But since there is not a visible crisis, there is less information about destitution and less chance of special foreign assistance. If a government is to use public employment schemes to best effect, it must develop mechanisms for monitoring vulnerable groups, and it must be willing to cut spending that benefits the nonpoor. The demand for work provided through employment schemes can itself supply the government with information on the extent of need.

Figure 7.8 How public employment schemes alleviate unemployment: Chile, 1970 to 1989



Source: Riveros 1989 and World Bank data.

In Africa donor finance is often available, but the complementary supervisory and material resources are much scarcer than in Latin America and South Asia. It is too early to judge the schemes currently being implemented, although some of them have already proved effective in dealing with drought (for example, in Botswana and Cape Verde in the 1980s). The use of employment schemes to transfer income to the poor should be paralleled by efforts to introduce efficient labor-intensive techniques in infrastructure programs. Ghana provides an example of this parallel approach: a food-for-work scheme run by a local NGO has recently been substantially expanded with the aim of providing employment for the rural poor. Although the organizers expect some benefits in the form of improvements to rural infrastructure, transfers are the main objective. In addition, the Ministry of Transport has adopted efficient labor-intensive methods of building feeder roads. The Ministry works through local contractors, who employ roughly four times as much labor as with other common methods and use 40 percent less foreign exchange than is usual.

COMPENSATING THE LOSERS. The most visible losers in adjustment are often formal sector urban workers who lose their jobs. Governments often target benefits to laid-off workers—for example, through severance or other redeployment payments, special credits, and retraining schemes. Such measures are frequently prominent in social action programs. The newly unemployed often suffer losses, but they are generally not the poorest members of society. Civil servants, for example, are usually well equipped to withstand a spell of unemployment, and in many countries with overextended civil services, public sector workers have other sources of income. One study of Nigeria found that many laid-off civil servants had maintained their land rights and were able to return to farming (although this was less true of the young).

Reducing public employment is often an essential part of adjustment, especially in Sub-Saharan Africa. But it is politically difficult, and some form of compensation may be necessary. Payment of compensation, however, implies that fewer resources will be available to soften the consumption declines of the poor, protect the capital stock, and support a recovery in investment. By contrast, in Eastern Europe those who lose their jobs are also likely to be among the poor. There, notably in Poland, state employees made up an increasing share of the poor in urban areas in the 1980s. Job losses in the public sector are likely to be heavy, and they will lead to deepening poverty. Unemployment compensation, which may be politically necessary in the 1990s in any case, will also make sense as a means of reducing poverty.

If compensation is necessary, direct payments are better than special credit and retraining schemes. Special credit programs have been tried in Ghana, Guinea, Mauritania, and Senegal. In general, such programs have had a sorry record and have brought few benefits to the poor (see Chapter 4). Measures to promote investment by small-scale enterprises are an important part of any growth strategy, but they should not be mixed up with compensation schemes. As for training, the emphasis should be on developing a training system that increases the flexibility of skilled labor rather than on special initiatives to equip displaced workers for specific new jobs.

Lessons for adjustment in the 1990s

Even if the 1990s prove less turbulent than the 1980s, many countries will confront the need to adjust. Some will face new adverse shocks, and many will be continuing the process of adjustment that started in the 1980s. The experience of the 1980s suggests that efforts to restructure economies in the wake of a macroeconomic crisis are, by and large, consistent with a medium-term shift toward a pattern of growth and human capital formation that effectively reduces poverty. In the short run, however, some of the poor may lose out. A combination of effective action on the policy fundamentals (notably changes in relative prices to favor agriculture) and efforts to moderate declines in consumption (through a pause in investment, for instance) can help many of the poor in most cases. But shifts in the pattern of public spending toward goods and services consumed by poor people and transfers targeted to them will often be necessary as well. Increased capital inflows can also help to soften the impact of adjustment on the poor, and they could be particularly important in Latin America, Eastern Europe, and Sub-Saharan Africa. But without sound economic policies, increased capital flows can provide only temporary relief. They are no substitute for domestic action to protect the poor.