ECONOMIC POLICIES FOR GROWTH AND POVERTY REDUCTION

WORLD BANK INSTITUTE
INDEX

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INTRODUCTION

Policymakers and technocrats in developing countries often assume that the vast majority of citizens cannot understand and contribute to economic policy. Some even assume that participation sooner or later leads to higher public spending and fiscal indisclipline. In tum, the citizens in developing countries do not trust the policy experts to make the right decisions on economic policies. This monograph aims to raise awareness among the civil society about macroeconomic and pro-poor policies in an accessible language, in order to foster knowledge, participation and informed debate on macroeconomic issues in developing countries.

Economic literacy means having a basic understanding of how the economy works. Most people find economics boring or intimidating, or maybe both. They tend to think that it is an area that is best left to the 'experts' but the truth is that the economy is much too important to ignore its fundamental mechanisms. The development of basic economic literacy is an important goal for any democratic society that relies heavily on informed citizenry and personal economic decision-making. Economic literacy gives people the tools for understanding their economic world while it improves the public's ability to comprehend and evaluate critical issues. At the same time, it improves the competence of each individual for making personal and social decisions about the multitude of economic issues that will be encountered over a lifetime.

This publication tries to demystify the economy so that people develop a sense of ownership over the economy rather than ceding it over to the so-called experts and strengthen Civil Society or people's capacity in general to participate and engage in economic discussion, by empowering them with ideas and skills that are fundamental to participating in economic debate and decision making. This is especially relevant in the case of the development of Poverty Reduction Strategies, as they should include a strong participatory element. In the table below we can see a few examples of participatory efforts in macroeconomic policies.

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This publication is part of a World Bank Institute multi-year project to increase the capacity of Civil Society Organizations (CSOs). The Poverty and Growth Program has been working with civil society since 2001, in order to boost its participation in the formulation, monitoring and evaluation of Poverty Reduction Strategies. The monograph is divided in eleven chapters that introduce several readings on basic macroeconomic concepts whose contents have been used for training in several economic literacy courses of the Institute.
CHAPTER ONE. WHAT IS POVERTY AND HOW WE MEASURE IT

To design effective policies and strategies aimed at reducing poverty, it is critical to understand the characteristics of poverty in a country or in a geographic area. Poverty measurement techniques can help shed light on whether or not poverty is increasing or decreasing, or whether general economic growth has benefited the poor. Poverty profiles of countries or geographic regions can help governments identify potential target groups for specific programs by region, employment, education and gender. With good poverty data, we can evaluate how the poor are affected by economy-wide policies, and in turn, how to develop strategies for economic growth that have a better chance of benefiting the poor.

The Concept of Well-being

To measure poverty levels and characteristics of poverty, we begin with a definition of well-being, a concept which can be approached from many different angles. We can think of well-being as command over commodities or resources, or access to assets, or ability to function in society, and we can think of poverty as a lack of each of these things. Generally, poverty measurement focuses on assessing whether households or individuals have enough resources to meet their needs. Many techniques for measuring poverty focus on the monetary aspects of poverty, but we know that non-monetary dimensions are important. Poverty is associated not just with lack of resources that can be easily quantified, but also with lack of access to health services, education, and with low self-confidence and a sense of powerlessness.

There are other concepts of well-being that stretch beyond poverty, which can be thought of as monetary and non-monetary dimensions. For instance, inequality within a country is a measure of the distribution of resources across the population, and high levels of inequality can be viewed as related to well-being of those at the bottom of the resource scale. Vulnerability, which is generally defined as the risk of being poor, or of falling deeper into poverty, is another important factor related to well-being.

The Geography of Poverty

Most of the world’s poor live in South Asia (over 40 percent), Sub-Saharan Africa (almost 25 percent), and East Asia (about 23 percent). Almost half of the world’s poor live in just two large countries--China and India. The highest incidence of poverty is observed in Sub-Saharan Africa, with almost half of its population living below the $1 poverty line. Sub-Saharan Africa is followed by South Asia, where over the 1990s the incidence of poverty went down from about 41 percent to about 32 percent mainly because of the good macroeconomic performance of China and India, although the absolute number of poor people decreased very modestly.
Analysts have found a strong positive relationship between economic growth and poverty reduction. For example, East Asia (including China), which contains the world’s fastest-growing economies, reduced the share of its population living below the international poverty line from about 29 percent in 1990 to about 15 percent in 2000. In China alone, nearly 150 million people were lifted out of poverty. But in Sub-Saharan Africa, where negative growth of GNP per capita predominated during that period, both the incidence of poverty and the absolute number of poor people increased—from 47 percent to 49 percent and by 74 million. In relative terms, the fastest growth of poverty took place in the region of Eastern Europe and Central Asia that lived through the acute economic recession associated with market-oriented reforms. Between 1987 and 1998, the incidence of poverty in this region increased from 0.2 percent to 5.1 percent and the number of poor people from about 1 million to 24 million.

Percentage of population living with less than US$1 a day

Steps in Measuring Poverty

The three main steps to be taking in measuring poverty are:

1) define an indicator of welfare
2) establish a minimum acceptable standard of that indicator to separate the poor and the non-poor (often known as the poverty line) and
3) generate a summary statistic which aggregates the information we get from looking at the distribution of the welfare indicator that we have chosen, and it’s position relative minimum acceptable standards.
We have discussed the broader concept of well-being that forms the basis of our overall approach to poverty measurement, but the most common approach to measuring poverty focuses on economic welfare, which looks at monetary aspects of poverty. Measures of economic welfare are usually based on household consumption expenditure or household income, to which each resident in the household is assigned a share of the total amount.

Consumption-based Measures versus Income-Based Measures

In general, consumption-based measures of living standards are generally preferred to income-based measures because the incomes of the poor often vary considerably over time, which might be the case, for example, in rural areas where income is generated primarily from rain-fed agriculture. Consumption measures reflect a greater degree the level of resources households control, and may also reveal information about incomes in both the past and the future. Consumption includes both goods and services that are purchased, and those that are provided from one's own production ("in-kind"). Consumption is often more practical to measure than income as households may be more able or willing to recall what they have spent rather than what they have earned.

It is possible to measure household welfare by looking at household income, but there are some complications that make it often a second choice for poverty analysts. For one, as mentioned above, households maybe more be more willing to recall what they have spent then what they have earned, since people may fear that a tax collector might hear of their
total income, or because people may be reluctant to report income they have earned illegally, for instance from smuggling. In addition, certain types of income are not always easy to measure, such as farm income, or changes in the value of farm inventory or changes in the value of a house that one owns.

For these reasons, consumption expenditure is often the indicator used to measure economic well-being. We face several major challenges when we use consumption as our measure of well-being. In order to make comparisons across households using consumption/expenditure measures of poverty, it is necessary to calculate the value of durable goods owned by the household in the year of measurement, including both the depreciation of the item during the year, and the interest cost of having locked money up in the item, as opposed to in an interest-bearing account. It is important to measure durable goods because we know that even some households that cannot afford adequate quantities of food devote some expenditure to other items, (such as clothing and shelter) so we can assume that these items represent very basic needs of the household, and should be included in our poverty measures. This means that we need to do a calculation of the value and of the depreciation for each durable good that that household owns, and the potential for error in this process can be quite large. We also need to include housing services in consumption, and generally we value these services by asking if you paid rent instead of owning your home, how much would you need to pay? Another element of consumption is expenditures on weddings and funerals.

In brief, if we choose to assess poverty based on household consumption or expenditure per capita, as discussed above, we can use an expenditure function in our analysis. In simple terms, an expenditure function shows the minimum expense required to meet a given level of utility, which is derived from a list of goods, at prices. Using an expenditure function, which incorporates a given level of prices of goods and services, and takes into consideration household characteristics (e.g. number of adults in the household, number of young children, etc.) we can measure the amount of spending that is needed to reach a certain level of utility. Typically, we compute the actual level of household spending from household survey data that include information on consumption, and then construct per capita household consumption for every individual in the household. This approach assumes that all individuals in the household have the same needs, which in reality is not true, since household members of different ages, for instance, will have different needs.

**Accounting for household consumption differences**

Since households differ in size and composition, a simple comparison of aggregate welfare can be misleading about the well-being of individuals in a given household. The most straightforward way of dealing with this problem is to convert from a measure of household consumption to a measure of individual consumption by dividing household expenditures by the number of people in the household. This is the easiest procedure, but it does not take into consideration the obvious fact that different individuals have different needs (e.g. a young child typically needs less food than an adult) and also that there are economies of scale in consumption of non-food items. We deal with this
problem by assigning a system of weights using an equivalence scale that measures the number of adult males that the household is equivalent to. This way, each member of the household counts as some fraction of an adult male. Selection of the scale is not straightforward because there is no generally consensus on an appropriate scale, or on its usefulness in practice, and there are two general methods for dealing with the problem: pick one of the scales that is already being used (for example the “OECD scale” which assigns a two-adult household an “Adult Equivalent” of 1.7, and a three adult household and AE of 2.4) or to estimate an equivalence scale for the population by looking at house aggregate household consumption of various goods during some survey period tends to vary with household size and composition.

Other measures of household welfare

There are other measures of household welfare that we can use, but each also has its own drawbacks. We can measure well-being through the number of calories consumed per person per day, for instance, or food consumption as a fraction of total expenditure. We can also measure outcome rather than inputs, such as rates of malnutrition rather than food intake. This can be problematic, however, as developing measures by which we can compare children by size and growth to assess their nutritional needs can be very difficult. We can evaluate welfare at the community level by looking at life expectancy, or infant mortality rates, or school enrollment rates, but these are not replacements for consumption per capita. They can be used to get a more complete and multidimensional view of the well-being of a population. In sum, there is not perfect measure of well-being. This does not mean we should avoid measuring poverty, but it does imply argue for approaching poverty measures with a certain degree of caution, and for looking carefully at how the measures were constructed.

Household surveys

The main instruments for collecting data to support poverty analysis are household surveys, and it is important to have an understanding of the key issues associated with setting up and interpreting the data obtained from these surveys.

Measures of poverty and inequality are always based on data that have been collected using sample surveys of households. This has two important implications 1) it means that actual measures of poverty and inequality are generated from a sample and not from the entire population. For these this reason, they estimate the true population parameters with some error. This should be noted with, for example, with confidence intervals, which indicate the chance that a statistics is accurate within a certain range. Survey data may also need to be weighted to get the right estimates of certain measures such as mean income, or poverty rates, which means that information about the sample frame (which is essentially the design of the sample selected) needs to be clearly documented.

Coverage of goods and income sources in the survey should be comprehensive, covering both food and non-food goods, and all income sources. Consumption should cover all monetary expenditures on goods and services consumed plus the monetary value of all consumption from income in kind, such as food produced on the family farm,
and the rental value of owner-occupied housing. Similarly, the definition of income should include income in kind. Valuation of non-market goods can be quite complicated, and there is no widely preferred method, but there are a number of techniques to choose from.

Another issue is how to compare households at similar consumptions levels. Households size and composition vary across households, as do prices with which they are faced and wage rates. As a result it takes different resources to make ends meet for different households, that is to say, two households with the same level of expenditure may achieve different levels of well-being. The most general approach to measuring across households is to look at demand patterns to reveal consumer preferences over market goods, and to look at the minimum total expenditure that would be required for a consumer to achieve his or her actual utility level, but evaluated at pre-determined and arbitrary reference prices and demographics fixed over all households. Deflators are used in these calculations, which depend on preferences.

Ideally, we should not have to rely solely on a household level survey in making interpersonal comparisons of welfare. A separate community survey (done at the same times as the interviews, and possibly by the same interviewers) can provide useful supplementary data on the local prices of a range of goods and local public services. By matching these to the household level data, one can greatly improve the accuracy and coverage of household welfare assessments. This has become common practice in the World Bank’s Living Standards Measurement Study surveys.

**Living Standard Measurement Study Surveys**

The LSMS surveys ask about a wide variety of topics, not just demographic characteristics or specific narrow issues. The LSMS survey includes a household questionnaire, which often runs 100 pages or more, and which can be adapted to the needs of each country. There is also a community questionnaire, which asks community leaders (teachers, health workers, village officials) for information about the whole community, such as the number of health clinics, access to schools, tax collection, demographic data, and agricultural patterns. The third part is a price questionnaire, which collects information about a large number of commodity prices in each community where the survey is undertaken. This is useful because it allows analysts to correct for differences in price levels by region, and over time.

**Introduction to Poverty Lines**

Once we have chosen a measure of well-being (consumption expenditure, say) the next step is to choose a poverty line. Households whose consumption falls below this line are considered to be poor. A poverty line is obtained by specifying a consumption bundle considered adequate for basic consumption needs and then by estimating the costs of these basic needs. In other words, the poverty line represents a minimum standard required by an individual to fulfill his or her basic food and non-food needs.
Once we have computed a household's consumption, we need to evaluate if that amount places the household "in poverty", or defines the household as "poor". The threshold that we use for this is the poverty line. In reality, it makes sense to define more than one poverty line, since there are many ways to evaluate whether or not an individual or household is in or has come out of poverty. We can generate a poverty line for each household, and adjust it from household to household to take into consideration the differences in prices that they face as well as differences in the demographic composition of the households. For example, a small household in a rural area may face low housing costs and relatively modest food prices. Thus their poverty line may be low compared to a large household living in a city where housing more expensive and food prices are perhaps higher. This gives a different poverty line for each household. A second approach is to construct one per capita poverty line for all individuals, but adjust per capita income for differences in prices and household composition. The adjusted per capita income is then compared with the one poverty line to determine if the individual is living below the poverty line.

A poverty profile done in Cambodia in 1999 used an approach somewhere in between, by constructing one poverty line for each of the three major regions in the country based on the prices prevailing in those regions. Whether a household in any given region is poor, is then determined by comparing its expenditure per capita with the appropriate regional poverty line.

Nominal poverty lines (as opposed to relative ones) can change over time, due to changes in prices (typically from inflation), or because the real poverty threshold is revised over time. This raises the question of whether we should look at relative, or absolute poverty lines.

Relative Poverty Lines

Sometimes we are interested in focusing on the poorest segment of the population, those that are relatively poor. It is often helpful to have a measure such as this in order to identify those who are poor today, and to help us design targeted programs that are geared toward the poor. Relative poverty lines need to be tailored to the overall level of development of a country, as countries using them will tend to revise them upwards with increases in per capita consumption. For instance, a $1 per day poverty line might be useful in Vietnam, where 27% of the population would be considered poor by this standard in 1998, but this line would be of little relevance in the United States, where almost nobody would be poor by this standard.

Absolute Poverty Lines

An absolute poverty line is fixed over time, which enables poverty analysts to judge the impact of anti-poverty policies over time. Comparisons of poverty rates between countries can only be made if the same absolute poverty line is used in both countries. The World Bank commonly uses two absolute poverty lines 1) people living on less than $1 dollar per day, and 2) people living on less than $2 dollars per day.
Several important conceptual problems come up when working with absolute poverty lines. For one, it is often difficult to agree on how to define a "standard of living" that the poverty line measures. In practice, almost all poverty lines are set in terms of the cost of buying a basket of goods (a "commodity-based poverty line"), but one can argue that individual "standards of living" or "utilities" are interdependent. That is, a household of four with an income of $12,000 per year would not be considered poor in Indonesia, but when this household compares its position with average incomes in the US, it may feel very poor. This implies that a commodity-based poverty line would rise as a country becomes more affluent, because the minimum resources needed to participate fully in society probably rises over time. Thus the absolute poverty line is more of a real poverty line. In addition, it may be difficult to define the correct commodity value of the poverty line, because both size and demographic composition of households vary.

One way to determine poverty lines is to set "objective" poverty lines, that is, to set the poverty line at a level that enables individuals to achieve certain capabilities, including a healthy and active life and full participation in society. A common way of approaching this is to begin with nutritional requirements. Two common methods are the Food Energy Intake (FEI) method, and the Cost-of-Basic-Needs (CBN) approach.

The goal of the FEI is to find the level of consumption expenditure (or income) that allows the household to obtain enough food to meet its energy requirements. First one needs to determine the amount of food that is adequate (for example, Vietnam sets this value at 2,100 calories per day, while recognizing that different individuals may need more or less food than this). After the calorie level is set, food expenditure lines can be estimated by obtaining the cost of obtaining the 2100 calories of food per day. There are important weaknesses to this approach however, so it should only be used when other alternatives are feasible. For instance, important difference exist between urban and rural food consumers not just access to food, but also in prices, both of which will influence the type of calories that people consume, making comparisons difficult.

The CBN approach uses a consumption bundle that is deemed adequate, including both food and non-food components, and it estimates the cost of the bundle for each subgroup of a population (urban/rural, each region, etc.). The key difference in this approach is the poverty line is measured in money, so it does not insist (as with the FEI) that each basic need be met, only that it could be met. There are challenges with this approach, namely decisions on how to measure the non-food components of the poverty line (for example, countries in colder climates may put more emphasis on the cost of energy needed for home heating that countries in warmer climates).

Measures of Poverty

Given information on per capita consumption, and a poverty line, there are several aggregate measures of poverty that can be computed.
Headcount index:

By far the most widely-used measure is the headcount index, which simply measures the proportion of the populations that is counted as poor. The headcount index is simple to construct and easy to understand, which are important qualities. The measure has several weaknesses, however: the headcount index does not capture the depth of poverty, that is, if a somewhat poor household were to give to a very poor household, the headcount index would remain unchanged, even though poverty as a whole has dropped. In using the headcount index, we can see that the easiest way to reduce poverty would be to target benefits to people just below the poverty line because they are the ones who can be moved across the poverty line most cheaply. In addition, what is calculated using the headcount index is the percentage of individuals who are poor, and not the percentage of households, which means that we are making a critical assumption that all household members enjoy the same level of well-being, which may not be the case.

Poverty Gap Index:

Another measure of poverty is the poverty gap index, which adds up the distances that poor people fall from the poverty line, and expresses that as a percentage of the poverty line. The poverty gap index is thought of as a way to measure the total cost of bringing each poor member of a society up to the poverty line, but it should be noted that this is not a precise measure because it requires exact information on each poor member of society, and this assumes that the government has a lot of information. The main drawback of the poverty gap index is that because it is an average measure over all people of the gaps between poor people’s standard of living and the poverty line, it is not capable of capturing inequality among the poor. For instance the poverty gap index maybe the same for two countries, but one of the countries may have many more very poor people, and more people close to the poverty line, which would generate a poverty gap index that is similar to a country where most of the poor people are considered moderately poor. The main advantages of the poverty gap index are that it gives an idea of the minimum amount of financial resources that are needed to tackle poverty problems, and that it highlights the importance of identifying the characteristics of the poor, as it demonstrates the potential savings of well-targeted poverty alleviation programs.

Squared Poverty Gap

To solve this problem of identifying inequality among the poor, some researchers use the squared poverty gap index, which is simply a weighted sum of poverty gaps (as a proportion of the poverty line), where the weights are proportionate poverty gaps themselves. For instance, a poverty gap of 10% of the poverty line is given a weight of 10%, while one of 50% is given a weight of 50%, which contrasts with the poverty gap index, where they are weighted equally. By squaring the poverty gap index, we put more weight on the observations that fall well below the poverty line.
Poverty Profiles – A poverty profile is a comprehensive poverty comparison, showing how poverty varies across various sub-groups of society, such as region of residence or sector of employment. It sets out the major facts on poverty and inequality, and then examines the pattern of poverty to see how it varies by geography (by region, urban/rural, mountain/plain, etc) by community characteristics (e.g. in communities with and without a school, etc.) and by household characteristics (e.g. by education of household head, by size of household). A well-presented poverty profile can be immensely informative and useful in assessing how sectoral or regional patterns of economic change are likely to affect aggregate poverty, although it typically uses basic techniques, such as graphs and tables. For example, regional poverty comparisons are important for targeting development programs to poorer areas. A recent poverty study for Cambodia showed that headcount poverty rates were highest in the rural sector and lowest in Phnom Penh in 1999. Approximately 40% of the rural population, 10% of Phnom Penh population, and 25% of other urban residents live in households that are below the poverty line. Poverty profiles can show access to services by households in different regions, and can shed light on the relationship between education levels in a household and the likelihood that a household will be poor. Key questions that can be included in a poverty profile are:

-- Which are the most important goods in the consumption basket of the poor? To what public services do the poor have access? What is the quality of the service? What are the main sources of income for the poor? Can the poor access formal or informal credit markets? Are certain population groups in society at a higher risk of being poor than others are?

Divergence Between Household Surveys and National Accounts

One issue in poverty measurement that has become a topic of debate in recent years is related to the question of how best to measure whether or not economic growth is benefiting the poor, how to achieve growth that benefits the poor if it is not happening naturally. The central question is how to assess whether income or consumption of the poor increases by at least as much as for the economy as a whole. Studies from the 1990s showed that in many cases economic growth did not bring with it expected rates of poverty reduction, although there was no evidence of rising inequality. The main poverty measurement issues revolve around the use of Household Budget Survey (HBS) data versus data from National Accounts in assessing consumption levels, and how to deal with biases that may occur in the HBS data. There is strong evidence that rich households are less likely to comply with HBS reporting, for a variety of reasons, perhaps in an effort to conceal income or consumption. The result is that upper incomes are underrepresented in the HBS, but National Accounts will pick up the transactions of these upper incomes through key economic aggregates. Thus there is a tendency of “average” national accounts consumption to be higher than “average” consumption from the HBS. But because the HBS is better at capturing consumption that takes place in the informal sector, it is argued that while the National Accounts measure of consumption may be a more accurate measure of the consumption of a population, the HBS is better measure of consumption for the poor. This debate is particularly important for countries...
undergoing high rates of economic growth, but the issues are relevant for other countries as well.
CHAPTER TWO. MEASURING ECONOMIC GROWTH.

Economics is the social science of production and distribution of goods and services. All economies are characterized by the scarcity of resources. Macroeconomics studies the aggregate economy. It tries to understand why economies grow, and why they go through cycles, and how various economies interact. On the other side, microeconomics is the study of the behaviour of individual agents, either households or firms. Understanding the response of a household to changes in prices and wages, or similarly, trying to understand how firms make their production and pricing decisions, all are microeconomic subjects. Macroeconomics refers to the whole economy - and includes factors such as growth, inflation, unemployment, interest rates, trade, budgets, etc. so in this chapter we will succinctly present some of the basic notions in economics that will help us understand better the content of the following sections.

At the same time, the central issue of macroeconomics is growth. Growth in a country’s economy is measure through the Gross Domestic Product (GDP), that is a measure of total production of goods and services in an economy. The two obvious features of GDP, as we will see later in the chapter, are its upward trend (GDP has generally been increasing worldwide for the past decades) and the short-term fluctuations or in this generally upward-sloping line. We refer to these two issues as economic growth and business cycles, respectively.

First, the notions of market economy and production. For economic activity to take place there must always exist demand for the product. A market takes place when buyers and sellers are in contact with one another. Therefore, the market economy is an economy in which the major parts of production, distribution and exchange are carried out by private individuals or companies rather than by the government, whose intervention in the economy is minimal. Although innumerable, independent producers and consumers make decisions about resource allocation, the whole thing is coordinated by the market mechanism. Therefore, this is the system by which the market allocates resources is the price mechanism and prices are determined by the interaction between supply and demand. Two key elements drive the efficiency of a market economy: competition and the profit motive. In a market economy we know a business will try to produce as efficiently as possible because its owner gets to keep its profits and his income depends on it: therefore, he/she will try to get the cheapest supplies, organize work procedures as efficiently as possible. What will prevent him/her from charging outrageous prices is competition from other businesses. Note then, that for the market to operate as efficiently it needs to be a competitive market; in a monopolistic market, private ownership combines with the profit motive and there is no incentive to innovate or to produce efficiently and there is the incentive to charge as high a price as people will pay.

Market economies are characterized by specialized production, the freedom to exchange commodities between individuals and the use of the market mechanism to determine prices. There are three basic concepts that tie economics together:
1. Demand - Demand summarizes the behavior of buyers. The quantity of a product or service that buyers demand varies with its price. As the price rises, the quantity demanded falls, and vice-versa.

2. Supply - Supply summarizes the behavior of producers and sellers. The quantity of a product or service produced and offered for sale depends on its price. As the price rises, the quantity supplied rises, and vice-versa.

3. Equilibrium - Equilibrium summarizes the outcome of the market process. If the price of a product or service is "too high," the quantity supplied will exceed the quantity demanded, creating a surplus of the product. That surplus leads sellers to cut prices. However, if the price of a product or service is "too low," the quantity supplied will fall short of the quantity demanded, creating a shortage of the product. That shortage leads sellers to raise prices. In equilibrium, the price is "just right," with no surplus or shortage, because the quantity demanded equals the quantity supplied. The familiar integration of Demand, Supply and Price looks similar to the following chart.

![Supply and Demand Curve Example](chart)

The market system, on the contrary, is a dynamic system that tends to engender economic growth because: it fosters a reallocation of resources (of land, labor and capital) to these activities in which they are most productive and it fosters, through competition and the profit motive, technological breakthroughs: with the same resources you can produce more. Finally, the market can be an important catalyst for social change.

Production is the process of putting together the means of production to yield finished goods and services. In order for human beings to satisfy their wants, there is need for production to take place. This process involves the use of inputs such as entrepreneur, land, labor, capital, technology, and material inputs in order to produce the needed
output. For each level of the output of one good, the production possibility frontier shows the maximum amount of the other good that can be produced.

![Production Possibility Frontier](image)

**Gross Domestic Product**

Gross Domestic Product is defined as the value of the final goods and services produced in a country. The economy of a country is usually denoted by the GNP (Gross National Product) or GDP (Gross Domestic Product), that basically represent the total amount of goods and services produced in a country. GDP is the total market value of all final goods and services produced in an economy in a given year. Although GDP does not account for differences in the types of goods produced, nor for differences in the distribution of income, GDP per capita (GDP divided by population) is often used to compare the economies of countries and the well-being of their citizens.

The difference between GNP and GDP is a matter of the nationality of the producers and the location of production:

**GNP** = goods and services produced by national corporations in the country + goods and services produced by national corporations in other countries

**GDP** = goods and services produced by national corporations in the country + goods and services produced by foreign corporations in the country.

GDP in current currency (nominal) is calculated by multiplying the number of goods and services produced by their current prices. So if prices double from one year to another nominal GDP will double even though the number of goods and services produced may stay the same. Real GDP (GDP in constant currency) adjusts for price increases and only measures the changes in the volume of goods and services produced (and is therefore a
better indicator of economic activity). Also, economists talk sometimes of Net Domestic Product that includes everything in Gross Domestic Product, but subtracts the value of depreciated capital goods. To illustrate how GDP is computed, let's suppose that a country only produces two products: chairs and tables.

One chair is priced at $1 and 5000 are produced each year. Tables sell at $40 each and 100 are produced per year. What is this country’s GDP? The value of the chairs amounts to $5000 (5000 times $1.) and the tables are worth $4000 (100 times $40.--.) for a nominal GDP of $9000.--. Note that if the prices of these products double, nominal GDP would rise to $18,000. It might appear that our economy improved one hundred percent. However, you may have observed that this increase resulted from a rise in prices and not from an increase in production. For that reason we say that nominal GDP has doubled, but REAL GDP stayed the same. Real GDP, therefore, measures the actual amount of goods and services a country produces.

Another common kind of GDP is “per capita GDP.” This is the average value of gross domestic product per individual of a country and it results of dividing the total value of GDP in a year between the total population of the country.

The Calculation of Gross Domestic Product

Government accountants include only final goods and services produced for purchase by consumers, businesses, and the government, as well as changes in business inventories, in the calculation of GDP. No intermediate goods are included. A microchip bought by a computer company used in the production of its computers is an intermediate good, because the ultimate purchase of the chip is as part of a final good, the computer. The computer can be purchased by consumers, in which case it is called consumption. If it is purchased by a business it is included as investment. And when the government buys it, it is called government expenditure.

In addition to excluding intermediate goods, other goods are excluded as well in the government’s calculation of GDP: any good produced in another year, even though it is sold in the current one; any good not directly representing production (like financial transactions); goods which are difficult to measure or which government accountants choose not to measure: illegal transactions, household goods and services produced and provided by household members themselves (do-it-yourself activities, cleaning the home, painting the walls, etc.), and barter trade.
GDP, as we learned, is the total value of all final goods and services produced in our country. These final goods and services are bought by four different groups: consumers, businesses, our state and local governments, and foreign countries. Therefore, GDP can be calculated by summing these four components: Consumption (C) + Investment (I) + Government Expenditures (G) + Net Exports.

\[ \text{GDP} = C + I + G + (X-M) \]

Consumption includes expenses by individuals on food, clothing, dishwashers, education, banking services, etc. Investment means purchases by businesses of machines and equipment. It also includes inventory changes (some goods may have been produced, but not sold; remember that GDP measures production, not sales). Investment does not mean the purchases of financial products, such as stocks and bonds. These are merely transfers of ownership and do not necessarily represent production.

Government Expenditures are expenses by the government on items like roads, supplies, tanks, weapons, education, etc. It does not include welfare payments as this does not represent production. Net Exports stands for exports (products foreign countries buy from us) minus imports (goods we buy from other countries).

GDP can also be computed by adding everyone's measurable income. Allowing for some indirect taxes (for example, sales tax) and depreciation, we will find that computing GDP from the income approach will give approximately the same value as using the expenditure approach. The income approach adds these six categories to arrive at GDP: wages and salaries (w) + interest (i) + rent (r) + corporate profits (p) + indirect business taxes (IBT) + capital consumption allowance (CCA = depreciation).

**Interpretation of GDP**

GDP and most notably real GDP is a measure of how economically active a country is. The higher real GDP, the more products we produce during that year. It measures, therefore, the total or aggregate supply of goods and services, consumer and capital goods, produced in a country during one year. The more we produce, the more goods we enjoy for consumption and production, and typically, the better off we are. There are a few instances where a higher real GDP does not necessarily mean a greater standard of living (including problems of environmental degradation, leisure time, inequality, etc).
Business cycles

The economic systems traditionally go through 'booms' and 'busts' cycles called business cycles. An active macro policy tries to smooth out the business cycle by balancing growth, unemployment, and inflation. Policies that reduce unemployment might lead to a rise in inflation, while keeping the lid on inflation may prevent growth in jobs. Thus, there is often a political struggle over what an acceptable level of inflation and what acceptable levels of unemployment are. The solid line in the graph below represents the economic booms and busts as measured by GDP growth.

When we look at the GDP growth rate, we notice that it reaches maximum and minimum points (peaks and troughs) with a certain regularity. Generally, after a boom, there is a slowdown. One cycle of the economy is defined as 'the period between two peaks'. A question we want to ask is, "Where are we in the current cycle?" Some element of an answer can be given by looking at other indicator series.

Business cycle graph
The economy is described by a series of documenting movements in variables that are related in some way to output (GDP, GNP, growth, employment, unemployment, prices, job creation, interest rates, housing, consumption, etc.) Some variables follow a cycle similar to GDP; when GDP is growing faster, they are also growing faster, and vice versa. These variables are said to be procyclical, like consumption, imports, etc. Other variables go in the opposite direction, and are said to be countercyclical, like net exports or the unemployment rate. Finally some variables are acyclical, meaning they are not moving in a way that is linked somewhat systematically to GDP.

**Volatility**

Another important concept is that of volatility. By volatility, we mean how big the deviation from the mean is. This is usually measured by the standard deviation. A variable is more volatile if the swings from a peak to a trough are big. GDP is relatively volatile: it does swing around. By looking at the variables that compose GDP, and comparing the share of GDP they are accountable for, as well as their relative volatility, we can form an idea of which of them influences the changes in GDP the most. Consumption of non durables and services accounts for roughly 60% of our measure of GDP, with broad investment and government consumption accounting for 20% each.
CHAPTER THREE. PRO-POOR ECONOMIC GROWTH

Economic growth is the increase in the real GDP per capita over a period of time. It can be shown by an outward shift of the production possibility curve. The production possibility curve shows the combination of two goods that a country can produce using all of its resources in the most efficient way. Economic growth will increase the amount of goods and services that a country can potentially produce. To do this, the quantity or quality of factors of production must be increased.

![Graph showing agricultural and manufactured goods]

Development is a broader process that includes raising living standards and poverty reduction. Economic growth may result in an improvement in the standard of living of a relatively small proportion of the population whilst the majority of the population remain poor. It is how the economic growth is distributed amongst the population that determines the level of development. Some economists argue that economic growth will eventually lead to a general improvement of peoples' living standards as trickle down occurs. Trickle down as its name suggests is the process whereby part of the population experiencing an increase in their income spend money on the domestic economy thus setting in motion multiplier effect which generates income for the poorer sections of the population. However there is considerable evidence from a number of countries that this process does not make any meaningful improvement to the lives of the poor. It is thus possible to have economic growth with no or little development, although this is the exception.

On the basis of cross-country studies, the current state of knowledge is that economic growth is associated with improvements in indicators of well-being. Little has been conclusively proved, however, about which macroeconomic policies help raise economic growth, and even less is known about the individual policies that help reduce poverty for a given rate of economic growth. Of course, examining a wide range of country experiences has made it possible for policymakers to develop some expertise about how they can go about achieving these important economic objectives.
GDP per capita, PPP ($ current)

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<td>335.1</td>
<td>952.6</td>
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<td>4235.5</td>
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<tr>
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<td>..</td>
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<td>6788.5</td>
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<tr>
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<td>6195.6</td>
<td>6986.0</td>
</tr>
<tr>
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<td>3173.8</td>
<td>4531.0</td>
<td>5315.3</td>
</tr>
<tr>
<td>SAS</td>
<td>450.5</td>
<td>906.6</td>
<td>1775.0</td>
<td>2405.3</td>
</tr>
<tr>
<td>SSA</td>
<td>803.6</td>
<td>1169.1</td>
<td>1507.2</td>
<td>1705.0</td>
</tr>
</tbody>
</table>

Source: World Bank

We know that, in principle, **growth is good for the poor**. Gross Domestic Product (GDP) growth is usually one of the central economic objectives of any government and even in situations where inequality is high or not everyone can reap directly the gains from growth, the poor can profit from the effect from growth. In order for growth to be pro-poor, it will have to disproportionately benefit the poorer levels of any given society.

**Various channels through which the macroeconomic policies are transmitted**

At the government level, policy reform can be expected to have an impact on poor households and other stakeholders through five main transmission channels: employment; prices (markets for goods and services); access to all markets); assets; and transfers and taxes. At the same time, the real determinants of income are complex (see graph below) and therefore it is relevant to study carefully policy changes and its possible outcomes.
The "deep determinants" of income

Development and its determinants are related in multiple and complex ways, making the task of determining and quantifying causality difficult.

**Employment.** The principal source of income for most households is through employment. To the extent that a policy change affects the structure of the labor market or the demand for labor, particularly in sectors which employ the poor (e.g. unskilled labor, off-farm and agricultural rural labor), the welfare of low income households will be affected. There may be direct transmissions through this channel in the case of certain policies (e.g. retrenchment of workers in restructuring of a state enterprise) or indirect transmissions in the case of other policies (e.g. macro policies leading to faster growth may lead to increased employment among the poor; an exchange rate depreciation or trade liberalization could lead to contractions and layoffs in the non-tradeable sector).

**Prices – production, consumption, and wages.** Prices determine real household income. Prices in the markets for goods and services differentially affect real income of households to the extent they are consumers or producers of these products. How policy affects prices will have an important bearing on income and on non-income measures of welfare. For all households, but especially for small farmers and the self-employed price changes will affect both consumption and resource allocation decisions. On the consumption side, policies that cause an increase in the prices of goods consumed by the poor will have a direct negative effect on household welfare. These can include import tariffs on traded staples, or increased utility tariff rates. Consumer prices may be indirectly affected, as well, e.g. through expansionary monetary policy that leads to general price inflation. Producers will also be affected by policies that cause relative price
changes – particularly changes to the price of their outputs or their inputs. Producer incomes are further affected by the difference between farm gate and market prices, often conditioned by transport costs and the degree to which private markets are efficient and competitive, rather than monopsonistic. Wage changes will affect net buyers and sellers of labor differently; and policies that change relative prices will induce shifts in both demand and supply.

Access. Well-being will be affected by the access of households to goods and services, be it through physical or effective access to markets, or through access to publicly or privately provided services. Policy can affect access directly by enhancing the provision of infrastructure or services in question, or indirectly by removing constraints to particular households’ or groups’ access. For example, improved road infrastructure could dramatically enhance the access of groups in certain geographic areas to markets. A policy that expands connections to an electricity grid, particularly among the poor, can also represent a welfare gain. Policies that address issues of social exclusion are also relevant here.

Assets. Changes in the value of households’ assets will affect income and non-income dimensions of welfare. Changes in asset values can be due to changes in their levels or their returns. Assets themselves can be categorized into five classes, all of relevance to poor households: physical (e.g. housing); natural (e.g. land, water), human (e.g. education, skills); financial (e.g. savings account); and social (e.g. membership in social networks that increase access to information or resources). Policy changes can have a direct or indirect impact on these assets and their returns. For example, land reform may directly result in an increase or decrease in land assets to the poor. Policy changes may also impact assets through indirect channels. For example, inflationary policies will have a negative wealth effect on those with monetary savings; participatory budgeting or community programs may increase social capital; pricing or trade changes could affect the natural resource assets of households or groups (e.g. increasing/decreasing deforestation or desertification).

Transfers and taxes. Household welfare, finally, is affected by the extent of transfers to and from the household. These transfers can take the form of private flows (e.g. gifts and remittances) or that of public flows (e.g. subsidies and taxes). Public finance has a direct impact on welfare of specific groups through transfers and tax policy. In particular, public expenditure programs may directly focus on granting additional resources to particular groups through transfer policies. These may be in the form of direct targeted income transfer programs, or subsidies. Tax policy has direct distributional effects to the extent that the resources or income of a household are taxed.

Macro policies. Changes in fiscal policy takes the form of a reduction in real wages either by freezing/cutting nominal wages of government employees and/or laying off a number of employees. Wage freezes and cuts as well as layoffs directly affect poverty rate unless there is unemployment benefit or other compensatory transfers to the adversely affected groups. A cut in subsidies on goods and services such as basic foods and kerosene can also have a strong impact on the poor.
Recent improvements in well-being

The Human Development Index (HDI, see annex) is a simple average of a country's achievements in three basic dimensions of human development, namely longevity (measured by life expectancy at birth); educational attainment (measured by a combination of the adult literacy rate and the enrollment ratio in primary, secondary, and tertiary education); and living standards (measured by GDP per capita in U.S. dollars at purchasing power parity). The HDI ranges between zero and one with zero depicting a country with low human development and one for a country with very high human development.

The HDI was created to not only take into account the per capita income as a measure of well-being but also take into consideration the importance on non-income indicators, such as educational attainment and life expectancy. The HDI closely correlates with income. Moreover, for countries with a given per capita income, those where income is distributed more evenly tend to display greater average longevity and educational attainment, and therefore a higher HDI value.

Both the HDI and per capita income are highly correlated with other widely used measures of poverty, such as the share of the population with income of less than $1 per day (a World Bank measure) and the share of the population that is undernourished (a Food and Agriculture Organization measure).

Despite the basically unchanged ranking of countries, there is some evidence that low-HDI countries have been catching up, though slowly, with high-HDI countries. Considering the countries for which data are available for both 1975 and 1998. The countries that displayed the greatest improvement in HDI from 1975 to 1998 are from Africa and Asia (Nepal, Mali, Pakistan, The Gambia, and Chad. The countries with the least improvement were Guyana, the Democratic Republic of the Congo, Romania, and Zambia.

Macro policies, well-being, and HDI

Poverty in a given country can be reduced by increasing per capita GDP growth (expansion of the pie available to the population) and by increasing the share of those resources going to its poorer segments (redistribution). Cross country research while not conclusive shows that economic growth can be fostered by a set of policies aimed at promoting macroeconomic stability (low and stable inflation, low budget deficits, and sustainable external debt), openness to international trade, education, and the rule of law.

Casual observation also broadly suggests an association between sound macroeconomic policies and rapid improvement in HDI. We have seen that—within low-HDI, medium-HDI, and high-HDI groups of countries—lower inflation, lower fiscal deficits, lower variability of inflation, lower external debt, more effective rule of law, lower black-
market foreign exchange premium, and lower frequency of financial crises were associated with greater improvement in HDI. As in the economic growth literature, though, it is difficult to show conclusively whether individual policies cause countries to experience more rapid improvements in well-being.

There is also a debate about the policies that improve the well-being of the poorer segments of the population for a given growth rate of GDP per capita and an even more fervent debate about whether certain policies imply a trade-off between increasing total available resources (increasing growth rates) and improving their distribution. In the latter respect, there seems to be broad agreement that policies aimed at improving basic education and health care can both increase economic growth and improve distribution, but, of course, there certainly is no consensus on the policies that will be most effective in improving education and health care.

**Growth and poverty reduction policies**

We have previously discussed the concept of poverty and well-being, the various indicators used to measure poverty or the idea of growth. In this section, we consider
poverty reduction strategies and certain policy implications of the Poverty Reduction Strategy Papers (PRSPs)

Is growth good for the poor?

Few economists doubt that economic growth is necessary for the long-term reduction of poverty. But how close is the link between the two? If the incomes of the poor rise closely in line with incomes overall, then the key to poverty reduction is rapid economic growth; on the other hand if the relationship is weak, then other policies, such as targeted subsidies, are likely to be important and the concept of "pro-poor growth" might have some relevance.

In any case, the importance of deepening our understanding of the linkages between growth and poverty reduction is important for both middle- and low-income country agendas. While many MICS have experienced important poverty reduction largely through economic growth, in many of them inequality has increased (China) or continues to remain high (Brazil, Mexico), threatening to undermine future returns to poverty reduction from growth.

In low-income countries, the need to accelerate pro-poor growth for poverty reduction has emerged as critical, particularly in the context of poverty reduction strategies and the efforts to accelerate progress towards the Millenium Development Goals (MDGs). Reviews of the PRS process suggest that the growth strategies and their linkages to poverty reduction are not often well spelled out making it difficult to identify a credible set of prioritized actions to accelerate poverty reduction.

David Dollar and Aart Kraay address the problem directly, in a paper entitled "Growth is Good for the Poor" that appeared in March 2000. They gathered information on the per capita income of the poor (the bottom quintile of the income distribution) and on overall per capita income. The data come from 80 countries over four decades, and Dollar and Kraay were able to piece together 236 "episodes," - periods during which it was possible to measure changes in the income of the poor and of the country overall. This relationship, and the underlying data, are reproduced in the figure below.

The main conclusions of this study have been that:

1. The per capita income of the poorest quintile grew in line with overall per capita GDP for the 80 countries in the same over the four decades covered. In short, growth matters.
2. The relationship in equation has not changed over time, and applies both in rich and poor countries. In short, growth still matters.
3. The incomes of the poor do not fall disproportionately during an economic crisis.
4. Greater economic openness, the rule of law, fiscal discipline, and low inflation all contribute to (or are at least associated with) faster economic growth, and in this manner help the poor.
5. Democracy, and higher public spending on health and education, do not have a measurable effect, one way or another, on the incomes of the poor.

Other researchers have also found that poverty trends tracked growth trends very closely in 1980s and 1990s. According to Chen and Ravallion (2000), on average, growth in the consumption of poorest fifth of the population tracked economic growth one-for-one over this period. In the vast majority of countries that they study, growth led to rising consumption in the poorest fifth of the population, while economic decline led to falling consumption. So pro-growth policies in most cases actually are also pro-poor.

**Pro-poor growth**

If the incomes of the poor are closely tied to overall economic growth, how much room remains for a poverty reduction policy per se? Put another way, is there any substance in calls for “pro-poor” growth? In a recent controversial paper, Aart Kraay (2004) argues that “in the medium run, most of the variation in changes in poverty is due to growth, suggesting that policies and institutions that promote broad-based growth should be central to pro-poor growth.” He goes on to argue, “most of the remainder is due to
poverty-reducing patterns of growth in relative incomes,” but “cross-country evidence provides little guidance on policies and institutions that promote these other sources of pro-poor growth.” In other words, we do not know enough about what drives pro-poor growth – roughly, growth accompanied by a reduction in inequality – to be in a position to design viable pro-poor policies.

That has not stopped the World Bank and others from trying! The World Bank (2000) separates its anti-poverty – as distinct from pro-poor growth – activities into three groups: promoting opportunity, facilitating empowerment, and enhancing (income) security. We will consider each in some more detail. Finally, it is important to note the recent development of Poverty Reduction Strategies in many developing countries tries to combine this ideas in order to grow while reducing poverty (see graph below).

**PRSP Approach**

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<tr>
<th>Goal:</th>
<th>Poverty Reduction</th>
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<td>Means:</td>
<td>Pro-Poor Policies</td>
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**Opportunity**

The lack of material opportunities such as jobs, credit, and public services, including schools and health services, is a direct cause of poverty. Well-functioning markets are important in generating sustainable growth and expanding opportunity for poor people because poor people rely on formal and informal markets to sell their labor and products, to finance their investments, and to insure against risks. For example, recent studies have examined the impact of market-friendly policies – such as openness to international trade, low inflation, a moderate-size government, and strong rule of law – on the incomes of poor people in a large cross-country sample. The findings: these policies on average benefit poor people more than others. Case studies of Chile, China, Ghana, Uganda and Vietnam show that agricultural reforms have helped raise producer prices for small farmers by eliminating marketing boards, changing real exchange rates through broader economic reforms, lowering tariffs and eliminating quotas.

The human, physical, natural, financial and social assets that poor people possess – or have access to – affect their prospects for escaping poverty because these assets can enable poor people to take advantage of opportunities. Expanding the assets of poor
people can strengthen their position and their control over their lives. A recent study of irrigation in Vietnam has uncovered important complementarities between education and gains from irrigation. Households with higher education levels received higher returns to irrigation.

Policies to Enhance Opportunity
The World Bank argues that creating more opportunities involves complementary actions to stimulate overall growth, make markets work for poor people, and build their assets, including addressing inequalities in the distribution of endowments such as education. More specifically:

- Encouraging effective private investment is essential because investment and technological innovation are the main drivers of growth in jobs and labor incomes. Fostering private investment requires reducing risk for private investors—through stable fiscal and monetary policy, stable investment regimes, sound financial systems, and a transparent business environment. Certainly, the rule of law and anti-corruption measures are also important. Special measures are frequently required to ensure that micro enterprises and small businesses can participate effectively in markets that are more vulnerable, yet employ a large number of poor people. For example, ensuring access to credit, lowering transaction costs of reaching export markets, and reducing restrictions on the informal sector will all help creating a sound business environment for poor households and small firms. Public investment in expanding infrastructure and communications, and upgrading the skills of the labor force have to complement private investment to enhance competitiveness and create new market opportunities.

- Opening to international markets offers an important opportunity for income growth as long as countries have the infrastructure and institutions to stimulate a strong supply response (e.g. call centers in Ghana, garment factories in Vietnam). Therefore, the opening needs to be well designed with special attention to bottlenecks.

- Building human, physical, natural and financial assets that poor people own or can use requires actions on at least two fronts. First, sufficient public spending on basic social and economic services such as primary education. Second, reform public delivery or privatize those services in order to ensure good quality service delivery.

- Addressing asset inequalities across gender, ethnic, racial and social divides. Special action is required to tackle socially-based inequality such as concentrated farm land ownership in rural communities, under-schooling of girls relative to boys, and the limited independence of women due to lack of access to productive means. Ethnic inequalities can easily flare up into violence, which in turn can set back economic development for a generation.

- Getting infrastructure and knowledge to poor areas. Special action is also needed in order to improve the social and economic infrastructure in poor and remote areas, which to a great extent also contribute the poverty problem. Similarly, basic urban services should be provided to city slums so that urban poor people may have chance to participate more actively in overall growth.
Empowerment

The premise underlying an emphasis on empowerment is that a lack of representation in the process of policy-making, due to social and institutional barriers, has impeded poor people’s access to market opportunities and to public sector services. It follows that empowerment – defined succinctly as “including people, who were previously excluded, in the decision making process” – should help. Unfortunately, there is very little empirical evidence, to date, on how well empowerment policies along the lines discussed below contribute to reducing poverty.

Broadly, empowerment refers to being able to make informed decisions and choices effectively. But there is some disagreement about the true content of empowerment. Mahatma Gandhi emphasized self-reliance; Paolo Freire stressed the need for conscientization, for helping the poor to learn about and perceive “social, political and economic contradictions” and then to stir to act against “the oppressive elements of society.” The World Bank fineses these differences by defining empowerment as “the expansion of assets and capabilities of poor people to participate in, negotiate with, influence, control, and hold accountable institutions that affect their lives.” It sees the four major elements of empowerment as (i) access to information, (ii) inclusion/participation, (iii) accountability, and (iv) local organizational capacity.

State institutions must be responsive and accountable to poor people. In nearly every country the public sector often pursues activities that are biased against poor people, and poor people have trouble getting prompt, efficient service from the public administration. Accountability is helped when there is good access to information.

Example: The Public Expenditure Tracking Survey (PETS) conducted in 1996 in Uganda found that only 22% of the central government funds intended to support schools run at the local level were reaching their intended destination. By 1999-2000, after the government made the budgetary transfers public via the media and required schools to share financial information, 80-90% of the funds began to reach the schools for which they were intended.

Amartya Sen sees poverty as consisting of a “deprivation of capabilities,” so that the poor have inadequate resources (financial, informational, etc.) to participate fully in society; in short, they are socially excluded. It follows that inclusion, which encompasses economic and political participation, is inherently part of the solution to poverty. The process of including the poor is likely to require the development of their social capital, the “features of social organization, such as trust, norms, and networks, that can improve the efficiency of society by facilitating coordinated actions.” Social capital takes time to build, but contributes to stronger local organizational capacity.

Good social institutions—kinship, community organizations, and informal networks—can play an important role in poverty reduction. For example, many development programs succeed because they mobilize local groups of project beneficiaries in program design and implementation. On the other hand, when social institutions are weak,
fissures such as ethnic cleavages can explode into open conflict; most of the world’s poorest countries have experienced civil war within the past generation.

Some social norms and practices help generate and perpetuate poverty. Discrimination on the basis of gender, ethnicity, race, religion, or social status can lead to social exclusion and create barriers to upward mobility, constraining people’s ability to participate in economic opportunities and to benefit from and contribute to economic growth. For example, one cross-country study indicates that countries that invest in girls’ education have higher rates of economic growth.

It is difficult to empower the poor if decision-making is concentrated in a far-away capital city. Hence the conclusion that a major component of empowering the poor is the need to decentralize power, particularly through delegating it to sub-national levels of government, and privatizing some activities (e.g. grain marketing). Decentralization is not, however, a panacea; when done badly, power may be captured by local elites, who may be even less concerned about the poor than the central government. In India, for instance, the state of Kerala has used its powers to spread development widely, while in the state of Bihar local decision-making has not been particularly beneficial to the poor.

Empowerment is difficult to measure. The UNDP’s *Gender Empowerment Measure (GEM)* includes indicators such as male and female shares of parliamentary seats, managerial positions, and earned income, but also has serious limitations in that it does not include information on the informal sector, or on such items as the right to vote. By design, the GEM focuses on gender empowerment, and not on the empowerment of the poor per se.

**Policies to enhance empowerment**

To empower poor people, policies need to facilitate active collaboration among poor and other groups in society include strengthening the participation of poor people in political processes and local decision-making; making changes in governance that make public administration, legal institutions, and public service delivery more efficient and accountable to all citizens; and removing the social barriers that result from distinctions of gender, ethnicity, race and social status. Worthy as this sounds, it is not at all obvious how to achieve such changes, but here are some policies that have been suggested:

- To improve access to **information**, encourage the development of the media. For instance, Besley and Burgess show that there is a robust link between media development and government responsiveness in India; states with higher newspaper circulation also undertake more extensive relief efforts in the wake of natural disasters.
- To increase **participation and inclusion**, it helps to institutionalize transparent, democratic and participatory mechanisms for making decisions and monitoring implementation. In this context, it may also be useful to provide legal assistance to poor people who usually have limited access to the legal system.
• **Accountability** is increased by strengthening the mechanisms used to monitor the performance of public administrations and by providing access to budgetary information and participatory mechanisms. There are many possible ways to do this, including:
  
  o Publish complete and timely budgetary information. Vietnam does not do this, for instance, so it is impossible to hold the government accountable for how it spends its money.
  o Institutional and Governance Reviews (IGR), which use surveys and other quantitative measures to analyze the functioning of public institutions.
  o Citizen Report Cards, which allow citizens to express their opinions on the performance and quality of government services.
  o World Bank Corruption Surveys, which are designed to extract information on corruption from households, the private sector, and public officials. Based on such a survey, for instance, Albania requested an anti-corruption program to undermine patronage in judicial and civil service appointments.
  o Public Expenditure Tracking Surveys (PETS), which have helped ensure that budgeted funds get to their intended recipients in places such as Ghana and Uganda.
  o Private Enterprise Surveys of the Business Environment, and Investor Roadmaps. These indicate the problems and costs faced by entrepreneurs.
  o Participatory Poverty Assessments (PPA). Using focus groups, in-depth interviews and other measures, these complement survey data to help build a more detailed picture of the nature and roots of poverty; they have been influential in Vietnam, for instance.

• To increase **local organizational capacity**, it helps to
  
  o Promote decentralization and community development to enhance the control that poor people and their communities have over the services to which they are entitled. Decentralization needs to be combined with effective participation and monitoring mechanisms.
  o Promote gender equality by promoting women's representation in decision-making and providing special assistance for women's productive activities.
  o Tackle social structures and institutions that are obstacles to the upward mobility of poor people by fostering debate over exclusionary practices and supporting the socially excluded participating into political processes.
  o Support poor people's social capital by assisting networks of poor people to engage with market and non-market institutions so as to strengthen their influence over policy.

Opportunities for CSO participation in PRS
**Income security**

Poor people are exposed to a wide array of risks that make them vulnerable to income shocks and losses of well-being. Reducing poor people's *vulnerability* to ill health, economic shocks, natural disasters, and violence enhances well-being on its own and encourages investment in human capital and in higher-risk, higher-return activities as well.

Households and communities respond to their risk exposure through diversification of assets and sources of income and various types of self-insurance and networks of mutual insurance mechanisms. For instance, some family members may travel to the cities to seek work, sending remittances home; if they cannot find work, then return home. Or farmers may store grain from one season to the next, in case the crops fail. In some very poor countries, such as Mali, some very poor rural women wear large gold ornaments – in effect carrying their savings, which could be sold if necessary to tide the household over a bad year.

Mechanisms such as these help to reduce the risk or soften the impact, but the effect may be limited. To counter the incentive and information problems that exclude poor people from many market-based insurance mechanisms, the state has a special role in providing or regulating insurance and setting up safety nets. Health, environmental, labor market, and macroeconomic policies can all reduce and mitigate risk.

Large adverse shocks – economic crises and natural disasters – cause poor people to suffer not only in the short run. They undercut the ability of the poor to move out of poverty in the long run as well, by depleting their human and physical assets, which may be irreversible. So it is crucial to prevent economic crises and natural disasters, as well to protect/compensate poor people when they occur.
Policies to enhance security and reduce vulnerability

National programs to manage economy-wide shocks and effective mechanisms to reduce the risks faced by poor people, as well as helping them cope with adverse shocks when they occur, are useful. Appropriate measures might include:

- Formulating programs to help poor people manage risk. Microinsurance programs, public works programs and food transfer programs may be mixed with other mechanisms to deliver more effective risk management.
- Developing national programs to prevent and respond to macro shocks—financial or natural.
- Supporting minority rights and providing the institutional basis for peaceful conflict resolution, to help prevent civil conflict and mobilize more resource into productive activities.
- Tackling health problems including widespread illnesses such as malaria and tuberculosis, as well as moderately common but serious conditions such as HIV/AIDS.

There is no simple, universal blueprint for implementing this strategy. Each developing country needs to prepare its own mix of policies to reduce poverty, reflecting national priorities and local realities. Given the important complementarities among these three dimensions, an effective poverty reduction strategy will require action on all three fronts, by all stakeholders in society—government, civil society, the private sector and poor people themselves.

Lessons for how to achieve pro-poor growth

We have seen that “Pro-poor growth” is growth that reduces poverty. Economic growth is typically (though by no means invariably) pro-poor. However, that does not mean that every policy that is good for growth will reduce poverty. Economy wide policies often have distributional implications that cannot be ignored if one is interested in the impacts on poverty.

The case of India is instructive. Poverty incidence in India has been falling at a trend rate of about one percentage point per year since about 1970, and the country appears now to have returned to this trend decline since the macroeconomic difficulties of the early 1990s. However, performance has been uneven between states. Some states have been doing far better than others, both in the longer term, and in the wake of economic reforms over the last 10 years. But the growth rate needed to achieve this trend decline has been rising over time. The responsiveness of national poverty incidence to both non-agricultural output per capita and agricultural yields have been declining over time, especially so for non-agricultural output.

Here the geographic composition of India’s growth has played an important role: widening regional disparities and limited growth in lagging areas has made the overall growth process less pro-poor over time. By and large, economic growth in India has not occurred in the states where it would have the most impact on poverty nationally. These
differences in the impact of growth on poverty relate in turn to differences in access to infrastructure and social services (health care and education) that make it harder for poor people to take up the opportunities afforded by aggregate economic growth (Ravallion and Datt, 2002).

This heterogeneity in the impact of growth on poverty holds important clues as to what else needs to be done by governments to promote poverty reduction, on top of promoting economic growth. According to some observers growth by itself is just sufficient. (Bha lla, 2002, p.206). The basis of this claim is the evidence that poverty reduction has generally come with economic growth. But that misses the point. Those who are saying that growth is not enough are not typically saying that growth does not reduce absolute income poverty, which (as an empirical generalization) is hard to deny. They are saying that combining growth-promoting economic reforms with the right policies to help assure that the poor can participate fully in the opportunities unleashed by growth, will achieve more rapid poverty reduction than would be possible otherwise. Redressing the antecedent inequalities of opportunity within developing countries as they open up to external trade is crucial to realizing the poverty-reducing potential of globalization. That is the real challenge facing policy makers striving for more pro-poor growth in the world.

Conclusions

On the basis of cross-country studies, the current state of knowledge is that economic growth is associated with improvements in indicators of well-being. Little has been conclusively proved, however, about which macroeconomic policies help raise economic growth, and even less is known about the individual policies that help reduce poverty for a given rate of economic growth. Of course, examining a wide range of country experiences has made it possible for policymakers to develop some expertise about how they can go about achieving these important economic objectives.

Nonetheless, the effectiveness of specific policies still needs to be confirmed by systematic empirical studies, which leaves economists with an important and comprehensive research agenda. Further cross-country studies appear unlikely to yield much more useful information about the effects of macroeconomic policies on poverty unless the dynamic effects of these policies are appropriately considered. Greater payoffs are likely to be obtained by conducting studies based on regional or national survey data (for households or firms) for periods encompassing clearly identifiable macroeconomic shocks. However, the number of developing countries for which reliable surveys are currently available is relatively limited. Data-collection efforts undertaken to remedy this deficiency may greatly contribute to our knowledge about the links between macroeconomic policies and poverty reduction.
Measures of poverty focus on the situation of individuals or households at the bottom of the income distribution, but sometimes we are interested in measuring the distribution of income over an entire population, and not just looking at the distribution below the poverty line. This is a relevant issue, taking into account the extremely unequal distribution of wealth worldwide (see graph below). Evaluating inequality in a population, and in particular looking at how inequality changes over time, can provide useful information to analysts and policymakers designing policy interventions. For instance, it would be useful to look at the distribution of income in a certain economic sector or population group and how it changes over time relative to changes in income over the entire population, or within a sector. If rural incomes have increased at the same time as income inequality has increased in the rural sector, this effect could be linked to some policy reform, say agricultural price policy, with the benefits of the change accruing to wealthier farms and not to the poor and less-efficient farmers.

The simplest way to evaluate inequality over a population is to divide the population into fifths (quintiles) from poorest to richest, and reporting the levels or proportions income (or expenditure) for each level.
The most widely used measure of inequality is the Gini coefficient, a measure which is based on the Lorenz curve, a cumulative frequency curve that compares the distribution of a specific variable (for instance, income) with the uniform distribution that represents equality. One axis of the graph measures the cumulative percentage of a population, graphed from richest households to the poorest and the other axis measures the cumulative percentage of either income or expenditure, whatever it is that is being measured. The Lorenz curve would be a 45 degree line if all income recipients (or expenditure levels of individuals or households measured) had equal shares, that is if 10% of the population had a 10% share of income, and 20% had a 20% share of income. The extent to which the Lorenz curve deviates from the 45% line (of absolute equality) indicates the degree of inequality within the population. The curve shows the actual relationship between the percentage of income recipients and the percentage of income that they did in fact actually receive.

![Lorenz Curve](image)

The closer the Lorenz curve of a country is to the 45-degree line the more equal the distribution of income is. In the case of the Lorenz curve in the diagram above 20% of the population earns 5% of the income and 50% of the population earns 20% of the income. The more the Lorenz curve bends away from the 45-degree line of absolute equality, the less equal is the distribution of income. In reality no country exhibits a totally equitable distribution of income.

The ratio between the areas A and B (B being the whole triangle under the line of absolute equality) is called the Gini Coefficient. If a country had a completely even distribution of income the areas A and B would be the same and the Gini Coefficient would be zero. If the income were distributed so unevenly that one person had 100% of all the countries income and the rest of the population had nothing the Gini Coefficient in this case would be one. The closer the Gini Coefficient to one the greater the inequality of income distribution. Countries with Gini Coefficients between 0.5 and 0.7 are regarded as having unequal income distributions whilst countries having Gini Coefficients between 0.2 and 0.35 are considered to have relatively equitable.

One use of Gini coefficient is to examine how the distribution of income varies between sectors of the population. The Gini Coefficient differs between the rural and urban populations. It can also be used to indicate how the distribution of income has changed.
within a country over a period of time. Whilst level of GDP per capita is a measure of economic growth one should also keep an eye on the Gini Coefficient. A country showing evidence of economic growth, but with an increasing Gini Coefficient, means that income is becoming less evenly distributed indicating that development and poverty are not necessarily improving.

**Figure 1:** Income inequality in selected countries, various years

<table>
<thead>
<tr>
<th>Year</th>
<th>Gini Index (%)</th>
</tr>
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<tbody>
<tr>
<td>2000</td>
<td>10</td>
</tr>
<tr>
<td>2001</td>
<td>15</td>
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<tr>
<td>2002</td>
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<td>2007</td>
<td>45</td>
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<tr>
<td>2008</td>
<td>50</td>
</tr>
<tr>
<td>2009</td>
<td>55</td>
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Source: World Bank

**Costs and Benefits of Income Inequality**

Is a less equal distribution of income good or bad for a country's development? There are different opinions about the best pattern of distribution—about whether, for example, the Gini index should be closer to 25 percent (as in Sweden) or to 40 percent (as in the United States). An excessively equal income distribution can be bad for economic efficiency. Take, for example, the experience of socialist countries, where deliberately low inequality (with no private profits and minimal differences in wages and salaries) deprived people of the incentives needed for their active participation in economic activities—for diligent work and vigorous entrepreneurship. Among the consequences of socialist equalization of incomes were poor discipline and low initiative among workers, poor quality and limited selection of goods and services, slow technical progress, and eventually, slower economic growth leading to more poverty. Also, some studies show that countries with more equal distribution of certain assets (public goods, land, etc) tend to grow faster—see graph below.

The effects of income distribution (i.e. inequality) on growth and the effects of growth on inequality are less understood. Until recently, it was believed that income distribution first worsened at early stages of development and then as per capita income growth increased, the income distribution would also improve and there is some evidence for this.

According to a recent study by Bourginon and Morrison, between 1820 and 1950 income growth coincided with rising inequality. In contrast, between 1950 and 1992 growth accelerated but income inequality did not increase. The transmission mechanisms for this
are little known. Theoretically, the relationship between the degree of inequality and growth rate of per capita income depends on a number of factors:

- If the marginal propensity to save of high-income individuals is higher than that of the poorer segments, then a redistribution of income from the poor to rich is likely to increase aggregate savings, thereby increasing income inequality. However, increased savings are said to lead to higher investments and ultimately to higher growth in incomes. If this proposition were true, almost all the Latin American countries should be growing faster because inequality is higher in this region.
- Inequality, especially in assets such as land ownership, other property, and educational attainment, may hamper growth by constraining credit availability to the poorer segments of the population because they do not have collateral security (assets that can be pledged). In such circumstances, the poor are likely to undertake less investment (say in education and businesses) and then lower growth. More equal societies are more likely to grow faster, a proposition that fits the East Asian countries.
- Unequal (democratic) societies are prone to redistribute taxes and transfers to cater to the higher income groups. Such a policy is distortionary and could hamper growth.

There is some tentative evidence that inequality slows growth but there is little evidence in favor of any of the above three arguments.
We do however know that different sectoral sources of growth affect income distribution differently. For example, rapid expansion in hi-tech industries world-wide resulted in a demand for higher (computer) skills with higher wages relatively to lower-skilled jobs. For example, Dollar and Kraay showed that growth in income not only dramatically reduced poverty in China and India (which account for one-third of world population) but that in 137 countries there is almost a one-to-one relationship between average per capita income growth and average per capita income of the poorest quintile. What are the mechanisms that link growth to income distribution – little is known.

In many high-income countries relatively low inequality of incomes is achieved with the help of considerable transfer payments from the government budget. However, economists often argue that mitigating inequality by increasing the burden of government taxes tends to discourage investment, slow economic growth, and undermine a country’s international competitiveness.

On the other hand, excessive inequality adversely affects people’s quality of life, leading to a higher incidence of poverty, impeding progress in health and education, and contributing to crime. Think also about the following effects of high income inequality on some major factors of economic growth and development:

High inequality reduces the pool of people with access to the resources—such as land or education—needed to unleash their full productive potential. Thus a country deprives itself of the contributions the poor could make to its economic and social development. At the same time, it threatens a country’s political stability because more people are dissatisfied with their economic status, which makes it harder to reach political consensus among population groups with higher and lower incomes. Political instability increases the risks of investing in a country and so significantly undermines its development potential.

High inequality may discourage certain basic norms of behavior among economic agents (individuals or enterprises) such as trust and commitment. Higher business risks and higher costs of contract enforcement impede economic growth by slowing down all economic transactions. Also, inequality limits the use of important market instruments such as changes in prices and fines. For example, higher rates for electricity and hot water might promote energy efficiency, but in the face of serious inequality, governments introducing even slightly higher rates risk causing extreme deprivation among the poorest citizens.

These are among the reasons why some international experts recommend decreasing income inequality in developing countries to help accelerate economic and human development. But the simple fact that high levels of income inequality tend to strike many people as unfair, especially when they imply starkly different opportunities available to children born in the same country, also matters for sustainable development.

Are pro-growth policies also pro-poor policies?
We know from the poverty-growth-inequality literature that growth is generally good for the poor (defined as the bottom 20 per cent of the population), growth usually does not adversely impact on inequality, and the impact of growth on poverty is reduced when inequality is high, implying that higher income growth is needed to reduce poverty in unequal societies. However, we have seen that only now we are starting to know whether or not the same policies that generate income growth can also positively impact upon inequality and thus poverty. Kuznets had indicated that growth initially worsens income distribution and later improves it. So it is likely that some growth-enhancing policies may simultaneously increase inequality and mute the impact on poverty reduction.

In the short run, low and moderate inflation (less than 25-30 per cent) enhances macro stability and is conducive for growth, but moderate inflation decreases the real incomes of the poor. Some studies show lower inflation would reduce inequality, but other studies indicate that because inflation also hurts the middle class and the rich, the impact of inflation on income distribution is ambiguous. Investment in education and infrastructure is not only important for growth but that it is likely to reduce inequality. Thus policies in these areas support both higher growth and lower inequality, and hence have a positive effect on poverty reduction.

Reducing the size of government while conducive for private sector-led growth and employment, is likely to reduce essential services for the poor, and is found to be associated with increases in inequality.

Financial development facilitates a growing economy through competition among banks resulting in modernization of banks, lower interest rates, and better financial services at lower administrative costs. But, financial services are typically accessed by the middle class and rich, while the majority of poor in most developing countries do not even maintain a checking or savings accounts. Moreover, the banks require collateral (usually land) security for loans, and the poor are unable to access the bank loans, including micro-credits, if any. Because of these factors, income distribution could worsen as a result of financial liberalization.

In the short run, trade reform by removing export bias and in the long term by creating incentives and investment with openness attracting foreign direct investment, trade policies can be conducive for growth. However, trade policies have to be complemented by other macroeconomic and structural policies such as removal of exchange rate controls and maintaining competitive exchange rate and roads to move exports from the rural areas to the markets and ports for them to growth-enhancing. While trade policies are found be growth-oriented, they can also have a positive impact upon the welfare of the poor by lowering the price of imports (e.g. basic foods, pharmaceuticals), keeping the prices of substitutes for imported goods low, thereby making them affordable to the poor, and opening to new technologies such as packaging perishable goods or improved seeds and fertilizers. The poor would also benefit if export taxes (e.g. on agricultural products that are generally produced by the poor) are removed. Also, trade policies by changing the relative wages of skilled and unskilled labor and the cost of capital, impacting upon employment of the poor. On available option is that different sectors could be liberalized.
at different speeds – where the poor are predominantly involved (say Maize in Mexico, cotton in Mali, etc) the phasing of reforms could be slower if the analysis indicates that liberalization is likely to reduce the producer prices for such commodities. Even a well-designed trade reforms creates winners and losers and transitory safety nets should be in place to mitigate the impact on the losers. Studies have found that trade policies are likely to increase income inequality.

On one hand, low inflation, investment in physical and human capital may be both growth-enhancing and inequality reducing policies, but on the other hand, financial development, trade openness, and decreases in the size of government are likely to be associated with increases in inequality. Thus, reducing government spending, trade and financial liberalization present some tension between growth and inequality objectives. To the extent that their positive impact on growth offsets the negative impact on inequality, these pro-growth policies would also be pro-poor.

**How important is growth and inequality to changes in poverty?**

The short answer is: (i) growth is fundamental for poverty reduction, (ii) growth accompanied by progressive distributional change is better for poverty reduction than growth alone; and (iii) high initial inequality reduces the impact of growth on poverty reduction. Moreover, the extent to which governments should focus on growth or distributional change to achieve poverty reduction depends on country conditions and in particular the levels of economic development and initial inequality. The current state of analysis suggests that both growth and inequality are important for pro-poor growth and that their relative importance depends on country conditions, most notably the initial level of income and inequality.

Also, we have to consider the links between growth, inequality and institutions. According to a recent body of literature, inequality can affect economic growth through several channels. Equal societies have more social cohesion, more solidarity, and less stress: they offer their citizens more public goods, more social support, and more social capital...and are hence more capable of sharing the costs and benefits of improving economic policies, which hence facilitates forming consensus and decision making. More equality also facilitates agreement on the provision of public goods such as health, water supply and waste disposal which have strong externalities.

Recent studies explain the positive impact of equality on growth on the basis of market structures and micro-economic incentives. A better distribution of wealth reduces credit constraints, and greater availability of credit is found to have a significant and positive effect on growth rates. If individuals are limited in their borrowing capacity, then reallocation of capital towards the poorest will increase aggregate productivity. Another factor relates to instability. Better distribution of wealth will reduce instability at the individual level and hence at the aggregate level and hence mitigate the impact of greater instability on aggregate growth.
While there is clear evidence that greater equality influences growth positively, there is considerable ignorance as to the exact mechanisms or arrangements through which greater equality can be achieved. Distributive programs -- through land redistribution, through employment programs, through subsidies, or through access to credit, to public goods, to infrastructure, to health, or to education -- have long been the channels through which governments, with varied degrees of success, have thought to redistribute income. A large agenda for further, deeper research exists in this area, directly related to the impact of public spending on equity, both in a static (incidence of public spending) and dynamic sense (changes in individuals' earnings potential).

There is a false tradeoff drawn between growth, poverty and inequality. To rapidly eliminate absolute poverty, which is one of the major goals of development policy, a country-specific combination of growth and distribution policies may be required. One method of defining absolute poverty is to estimate a poverty line that has a fixed purchasing power determined in terms of physical (caloric intake) and socially essential (accepted) basket of goods. Such a poverty line is country specific and changes over time. Once absolute poverty is accepted as a meaningful goal of a country's development agenda, poverty reduction (in terms of head count ratio of the poor) in that country is determined by the rate of growth of mean income of the population and the change in income distribution.

**Pro-Rich Politics, Middle Class Consensus and Pro-Poor Spending**

When politics is pro-rich, how can spending be pro-poor? When policymakers and bureaucrats are driven by different self-interests and motivations, how can the poor influence policy? When middle class consensus is needed for policy reforms, why should the status quo change towards pro-poor? Why would PRSP approach succeed when other initiatives such as Basic Needs, Integrated Rural Development, and Redistribution with Growth failed?

The behavior of government in most countries and the allocation of public goods reflect the distribution of political power and the organizational capacity of different societal groups. Unequal access to political rights increases the likelihood of misallocation of public investment and spending on public services as elites capture the state. The politically influential and wealthy who maintain access to public services and subsidies (e.g. education, health, water and sanitation) challenge any efforts to improve the targeting the subsidies to the poor. Such public actions could hinder economic growth. While in theory, voters in unequal societies could opt for redistribution or populist economic policies that could hinder growth, empirical findings on this hypothesis are inconclusive. In countries where redistributive public spending is more needed -- countries with lower per capita income and high inequality of income -- recent studies have found that such countries are less likely to redistribute income through public policies.

While waiting for the politics to improve, poor people and civic groups can push for appropriate solutions. In general, the poor should organize themselves in to groups to: (i)
participate in budget formulation, monitoring and where possible implement local projects by themselves, and ensure greater transparency in all public actions; (ii) increase their influence on policymakers and reduce the diversion of public services to the politically powerful and non-poor; (iii) ensure policymakers change the incentives by rewarding the effective providers of services and penalizing the ineffective. For example, in education, the poor benefit from having communities and households do more to manage schools. While immunization services could be contracted out by the government, the poor could monitor the performance of doctors and nurses in hospitals. Similarly, the parents could monitor the availability and performance of teachers.

We now know from the political economy of macroeconomic policy reforms that changes in macro policies were implemented only when the countries faced a fiscal or financial crises, or during ‘honey moon period’ of newly elected governments or when a consensus among the middle class and rich has been reached. It would be useful to know from the political scientists when and how would governments undertake reforms in the delivery of social services. At the same time, it remains always interesting to do a stakeholder analysis of reforms that would include also the middle class.
CHAPTER FIVE. INSTITUTIONS AND GROWTH

Defined as the rules and norms constraining human behavior (North), institutions include the informal rules and norms that govern personal and social behavior and the formal rules and norms governing economic, social and political life. Institutions emerge because rules and norms along with adherence to them provide the predictability needed for social interactions and for societies to function. In short, society is an organization in which exchange and production are mediated by formal and informal institutions which are themselves the background for markets. The study of institutional quality has gain momentum in the past years and the studies show how much institutions matter for growth and how difficult they are to change.

Williamson has a four-level classification of institutions that appears to be all encompassing. At the first level are informal institutions, such as social customs and norms as well as religion, which are very slow to change over time (social capital). At the next level are formal institutions, such as constitutions, political parties and legal systems, which are also slower to change but still faster than social capital (positive political theory). The third level is where the day to day transactions take place to minimize the transaction costs (a la North’s transactions cost economics). The fourth level is primarily institutions for market-oriented economic activities. But, the study of institutions is hampered by the endogeneity of institutions (e.g. good governance may be imperative for growth but also the demand for good governance rises with incomes).

While variation in economic growth rates across countries is partly explained by input accumulation and partly by research and development investment, much still remains to be explained to complete the explanation. Institutions are needed to encourage appropriate policies for accumulation of land, machinery, equipment and human capital, knowledge, adoption of new technologies, all of which impact upon growth. Institutions that protect property rights pertain to promotion of rule of law and order and enforcement of contracts (judiciary). The institutions or government that protects private property and settles infringements among individuals should also protect us from the predatory state (that encourages rent-seeking, corruption, theft and conflict) and expropriation risk. The institutions in a democracy, promote freedom, scrutiny and debate, which in turn might correlate with the effectiveness of government (see below).
While, in general, there is ample evidence that good governance causes higher income growth, Kaufmann et al present contrary evidence where higher incomes on average lead to worse governance, which implies that in countries, possibly natural resource extractive countries, there is a higher likelihood of rent-seeking and state-capture.

Notwithstanding the work of Paul Collier and others, knowledge is limited about institutions and mechanisms that are conducive for conflict prevention, conflict recurrence, and economic recovery. After the conflict ends, there is likely to be insecurity at the household level as well as at the macroeconomic level. At the micro level, conflict usually leaves behind armed civilian populations that are prone to violence (e.g. Somalia, Sudan). At the macro level, whether the conflict has been resolved by military victory (e.g. Uganda, Ethiopia) or through a negotiated settlement (e.g. Cambodia, Mozambique), there are significant risks that the government will not survive for long. How did successful countries cope with other problems (e.g. demobilized soldiers; issue of large fiscal needs because peace dividend is dwindled by the spending needed for demobilization of soldiers, social development and infrastructure, uncertain revenue collection during the early years of the transition as tax administration capacity is weak and private investment uncertain). Too few personnel in civil services is one of the characteristics of conflict-affected countries. More than policymaking capacity, implementation capacity is needed and this is usually supported by equipment purchases and training, especially in budget and financial management, and aid management. How have post-conflict countries been able to avoid recurrence of violence and achieve high growth rates (Uganda, Rwanda, Cambodia, Mozambique)?

This implies that the political institutions have to underpin such a ‘modernization.’ It also implies private property, private litigation, government regulation and enforcement, and state ownership are continuum in the institutional development or institutional frontier curve. In recent decades, one finds that there could be a trade-off between
disorder and authoritarianism (e.g. Pinochet’s Chile, Suharto’s Indonesia) and therefore, it is the interaction between political and economic institutions that determines capital accumulation, adoption of new technologies and thus growth and poverty. Institutions are now defined as systems of rules, beliefs and organizations. Others would also include social norms and networks (social capital) as institutions.

Protection of property rights and constraining the predatory powers of the state is central for growth process, which in turn depend on the quality of judiciary/legal system. In recent years, the study of legal systems has received much attention. For example, about 40 percent of variation in legal procedures or efficiency of courts across countries (as reflected in eviction of non-paying tenant, collection of bounced checks) is explained by the colonial origins of legal structures. Higher procedural formalism in French civil-law leads to longer duration in dispute settlement than in English common-law countries. Regulation of courts, entry of new firms, and labor market functioning in socialist and French civil-law countries was found to be more cumbersome (burden) than in English common-law countries.

Figure 1. Growth and property rights insecurity in 20 transition economies

Such influence of colonial powers was extended to the study of the development of various institutions. Soil and climate suitable for sugar and coffee production (as in Southern Africa, West Indies, Mauritius) were organized around large plantations with slave and indentured labor by the colonial powers, which formed the basis for inequitable wealth and political powers. In contrast, in South America and some African countries, rich mineral resource endowments resulted in extractive industries.
Other researchers have argued that local conditions rather than the identity of colonial power determined that nature and development of institutions and economic performance. Extractive institutions were set up when local conditions were not conducive for (European) settlers because of higher mortality rate. European institutions could not be replicated in such countries because the climatic conditions prohibited European settlements. For example, per capita income in 1995 was higher in areas where the Europeans settled (in seventeenth to twentieth century) and low mortality rates in such colonized countries are also correlated with low risk of expropriation during 1985-95.

Therefore, local conditions (e.g. settler mortality rates) in the erstwhile colonies and the identity of colonial powers (French, English or Spanish) affected the formation of institutions and their quality (e.g. legal systems).

Sachs among others found that geography played a major role in the economic performance of countries, in particular temperate climate regions and coastal zones had higher per capita incomes. Latitude or distance from equator is used as a variable for geography. However, the debate over institutions versus geography as the fundamental determinants of economic performance is a false one because it is the relative importance of each that appears to influence growth.

Political Institutions

Economic, political and social interests shape economic policy and performance. Evidence is however mixed whether or not democratic regimes have systematically better economic and social outcomes, except that democracies have higher real wages. There is also mixed evidence that as countries become richer in terms of higher per capita
incomes, social structures evolve towards complexity and newer interest groups emerge, which could result in loosening of authoritarian regimes through easing of civil liberties and move towards democracy. It appears that redistributive channels are key for political change. For example, the large proportion of poor people have some influence in democracies but in authoritarian regimes the elite few have the political power. In such a situation, the situation is exacerbated by larger inequality, which makes revolution by the poor more attractive, while repression to maintain the status quo is more attractive for the rich. Therefore, democratization is unlikely where inequality is too small or too large, and most likely when inequality is at the intermediate level. This is in contrast to Veblen's conjecture that the poor do not overthrow the rich (a la Marx) because the poor emulate the rich and hope to be like the rich one day. Hope springs eternal.


As discussed in trade policies, the level of protection in a country may depend upon the emphasis (weight) placed by the policy makers on overall welfare for the benefit of all its citizens as opposed to gaining political support from active interest groups. Interest groups are likely to coalesce along the lines of exporters vs. importers; farmers vs. urban workers; For example, in Turkey, a move from military rule to democracy appears to have raised the importance of aggregate welfare, which in turn coincided with a reduced level of trade protection.

It was Olson who pointed out that the formation of interest groups does not further economic efficiency and also that growth periods are followed by redistributive periods because growth brings together interest groups with common objective of getting a larger share of the expanding economic pie and growth would soon be slowed (i.e. growth can be socially destabilizing). However, we do not have an adequate theory of growth, inter-group formation, and dismantling of such groups.

There is some evidence that in well-established democracies, economic policies are more growth oriented in presidential regimes than in parliamentary systems, while in weaker democracies the opposite is true. Further, parliamentary democracies have better structural policies which appear to raise labor productivity by almost 40 percent.
Political, administrative and fiscal decentralization holds a lot of promise, but all three aspects of decentralization have to go hand in hand for decentralization to work. Whether decentralization checks the predation of central government (there is some evidence that budget deficits and corruption are lower in decentralized countries) and improves public service delivery depends on the institutional arrangements. Several preconditions must exist for the gains from decentralization to materialize. For decentralization to increase allocation and productive efficiency for growth, local governments need to have the authority to respond to local demand and be accountable because granting authority without accountability can lead to corruption and lower productive efficiency. Functions need to be devolved to a lower level of governments for allocation efficiency to increase as local governments are more likely to be aware of local preferences and adjust service delivery accordingly. To effectively influence public policies and monitor local governments, citizens need to have “voice” for which information on policies and programs is required, which has to be provided by media (primarily radio) through both local as well as national news stories.

Non-state institutions and social capital

In several developing countries, rule of law is absent or ineffective. It is not the quality of governance that is impacting upon economic performance. In such countries, how can property rights be protected and contracts enforced? Private institutions, such as corporate governance, long-term relationships, arbitration, social networks for information dissemination have proliferated in place of formal public institutions. Even in countries with strong institutions, including legal systems, many such mechanisms continue under the shadow of the rule of law. For example, in modern countries, disputes automatically are initially tried to be resolved through arbitration and other methods, and rush to courts is usually a last resort. Only about 10 percent of marriage disputes end up in filing for divorce in courts. It is because the costs of resolution of dispute in formal systems are likely to far exceed the costs of informal resolution.

Institutional quality scores high

Institutional quality can boost income significantly, while global integration and geography, on their own, do not.

As institutional quality rises, so does income... but increases in integration may not help... nor does a more benign geographic location.

Source: Authors
Note: The graphs capture the causal impact of each of the determinants on income, after controlling for the impact of the others. The indicators of integration and geography used are the ratio of trade to GDP and distance from the equator, respectively. For further details, see Rodrik, Subramanian, and Trebbi (2002).

1Expressed in terms of purchasing power parity, 1995.
How to move from one system of governance to another or one set of institutions to another is difficult. So the interaction between two systems (say coexistence of private Islamic and modern banking in Pakistan and Bangladesh) for some time before one of them begins to dominate should also be studied to understand economic performance.

Much of the reform effort in the 1990s—in response to the costs and perceived inefficacy of interventions with weak institutions—sought to limit government discretion through policy reform. It was hoped the strength of policies could overcome the weaknesses of institutions. Policies able to generate economic prosperity would ultimately generate incentives for the establishment of effective institutions. Recent emphasis on rules and on reducing discretion in decision making through dollarization, fiscal rules, or integration in larger economic unions are consistent with the sense that, on balance, the risks of failures are larger than the benefits of discretion of an activist developmental state. However it is near impossible to eliminate the discretion exercised by the nation-state. One of the ways forward is to look for institutions to control the exercise of discretion rather than policies or rules which attempt to eliminate discretion—which comes with a risky down-side.

While there are some functions institutions need to perform in any society, the form institutions can take to perform these functions can vary considerably. Almost none of the empirical work on the importance of institutions in fact examines the link between de jure institutional design and performance. The focus, rather, is on the link between institutional performance (e.g. perceptions of the rule of law or protection of property rights) and economic performance. This emphasis leaves open the question of how to improve institutional performance. All now recognize that merely adopting some other countries' laws and formal regulations is no guarantee of their producing the same institutional performance.

Security of property rights, for instance, has been achieved through a variety of arrangements—in China through institutional arrangements different from those in India. Yet, in both countries, there is relative security on the appropriability of returns to investment. In Soeharto's Indonesia, the enforcement of property rights was dependent on closeness to the ruling elite. A further complication is that institutions do not function homogenously within a country. De Soto's work has shown that within a country enforcement of property rights varies across income and social groups, with the least security for the least privileged and has documented the ensuing, adverse consequences on incentives to invest and on incomes. Similarly, financial systems in the USA and EU have different institutional foundations, but both perform at comparable levels of efficiency.

**Inequality and institutions**

Recent literature has emphasized the important links between the distribution of assets and the institutions that emerge. While knowledge about how institutions emerge and are established in a society is rudimentary, economic research in the 1990s has provided a
few insights. The first is that economic incentives influence the type of institutions that emerge and their timing. Enforcement of property rights on land will depend on the benefits of enforcement relative to its costs, a ratio that depends in turn on the extent to which other landowners enforce their property rights. In an extractive economy for example, if all landowners enforce their property rights, alternatives for labor decline, and so do their wages. As a result, rents on land increase. If landowners do not enforce their property rights, it is uneconomical for one of them to enforce his—alternatives for labor and hence their wages will be higher because workers can exploit land where property rights are not enforced. It is only when this coordination problem is resolved, that economic incentives become sufficient for enforcement of property rights (Stiglitz and Hoff 2000). The WDR 2001 provides other examples of how economic incentives affect the emergence of institutions that sustain the functioning of markets and the different coordination or risk-reducing problems they are meant to resolve.

A second insight describes how history influences institutions and economic growth and the role of inequality in this process. In 1800, Argentina’s per capita income was equivalent to that of the USA, whereas Brazil’s, Chile’s, Mexico’s and Peru’s were between 40 and 50 percent that of the USA. Two centuries later, Argentina’s per capita income is one fifth that of the USA, whereas Brazil’s, Mexico’s and Peru’s are one-fifth or less, and Chile’s has remained at about the same relative level.

Why was there such divergence in economic performance? The answer is that somehow the USA was able to create a far greater flow of economic opportunities. Access to economic, social and political opportunities was much greater in the US. Whereas only 2 percent or less of the population voted in Argentina, Brazil or Chile at the end of the 1800s, more than 10 percent voted in the US, where the participation rate also increased much faster. Three-fourth of the US population owned land, whereas less than a fifth did in Argentina, and much less in Brazil, and access to education was similarly better distributed in the US. Fundamentally, because population densities were much lower in the US, there were fewer incentives to establish predatory institutions oriented towards extracting rents for the benefit of a small elite. The conclusion is that except in the US and Canada, growth in former European colonies has been influenced by the concentration of economic and political power which limited access to economic and social opportunities, created less secure property rights and influenced the course of development for several centuries.

Some recent instances illustrating the influence of inequality on institutions and economic growth come from India. In India, Maharashtra’s less fertile western region has had sugar cane yields superior to those achieved in the more fertile eastern region. The explanation for this puzzle is that land is more unequally distributed in the eastern region, and the wealthier owners control the sugar cooperatives which set low prices for the other members—hence reducing incentives for increases in productivity. Another Indian example comes from West Bengal, where tenancy reform in the late 1970s increased the share of output that tenants could retain and strengthened tenancy rights. A sharp increase in yields ensued.
An important realization of the 1990s is that different institutions can achieve similar results—various forms of institutions can achieve the same function. Political institutions provide a clear example: democracies perform very differently—the formal institutions of democracy are insufficient to ensure accountability and credibility. While in some countries they have delivered satisfactory outcomes, in others they have not. Better understanding of the influence on institutions of history and of the distribution of economic and political power and of how these factors influence development still leaves open the question of which institutions matter most for development.
CHAPTER SIX. THE ROLE OF THE STATE

As we have seen, the market is a system of resource allocation that results from the fact that resources are scarce. The system by which the market allocates resources is the price mechanism and prices are determined by the interaction between supply and demand. Two key elements drive the efficiency of a market economy: competition and the profit motive.

The views on the role the state should play in the economy have varied widely throughout history and still do. Analyses on this subject are affected by how serious one considers the failures of the market to be and how effective one believes the government can be in remedying them. They depend on two sets of issues:

a) How one believes the economy actually works. Adam Smith and, in general, economists of the classical and neoclassical schools believe market economies to be a most efficient system due to the twin workings of the "invisible hand" which through the price mechanism allocates resources efficiently and through the profit motive that allows individuals to create the public good by pursuing private profit. They see a flexible market mechanism responding swiftly to supply and demand forces and creating optimal outcomes. Prices and wages adjust swiftly to demand shortages ensuring full employment. The only role for the state in that case, would be the provision of public goods such as law and order, defense and the protection of property.

On the other hand, economists of the Keynesian persuasion (very much influenced by the Great Depression) argue that market economies do not always respond swiftly to changes and, unless the government intervenes, can go through long periods of slow growth and unemployment. According to these economists, therefore, the government should intervene through the use of monetary and especially fiscal policy to even out business cycles, spending more in times of recession to substitute for low private consumption and investment and spend less during the upswings (countercyclical macroeconomic policy) and use monetary policy in a similar manner.

b) Value judgments on how the economy should work. We can believe that freedom is the highest value (and therefore the distribution of income created in a free market environment should be accepted), or that is equality (thus the need for an economy system that would allow that). Those are extreme, pure ideals, but each society needs to make choices on how much they value efficiency and growth, how much they value equality and stability...and then decide whether citizens should be provided with free health care by the state, free public education, social safety nets (welfare, unemployment pay, pension schemes), should the government intervene with macroeconomic policy to try to even out the ups and downs of the market? Should the government redistribute income through the tax system and to which extent?, etc. These are societal choices which give us many different types of capitalism (US, Western European, Japanese...).
In a market economy we know a business will try to produce as efficiently as possible because its owner gets to keep its profits and his income depends on it: therefore, he/she will try to get the cheapest supplies, organize work procedures as efficiently as possible, etc... What will prevent him/her from charging outrageous prices is competition from other businesses. Note then, that for the market to operate as efficiently it needs to be a competitive market; in a monopolistic market, private ownership combines with the profit motive and there is no incentive to innovate or to produce efficiently and there is the incentive to charge as high a price as people will pay. Therefore, the market is the most "efficient" system of resource allocation because it produces the goods people most want at the lowest prices due to the roles of the profit motive and competition operating through the price mechanism and international trade.

Accordingly, under ideal circumstances, we say that the market will allocate resources efficiently. However, sometimes there are less-than-ideal circumstances that might lead to inefficient location of resources by the market. This suggests that the government might intervene to improve resource allocation in imperfect markets. The government can tax or regulate externalities, produce public goods, and define and enforce property rights. One might also question whether the distribution of income is fair or whether citizens of nation might want the government to undertake activities to help out those who are less fortunate. Furthermore, in a macroeconomic context, the government might have a role to play in stabilizing the economy. At the same time, we have seen in the previous chapter the importance of institutions for growth and this chapter will briefly explore the role of the state and its institutions, including hence a few justifications for state intervention.

Protection of rights

Market exchange presupposes that the parties to an exchange have clearly defined and well-protected rights to the goods and services that they exchange. The protection of individuals' rights is almost everywhere done by government, although a substantial amount of private sector protection augments government protection. There are two reasons to consider the protective role of the state in an economic framework. One is that the protection of rights is necessary for a functioning economy, and the other is that this protection makes up a sizable fraction of the public budget.

The government uses three basic institutions to protect individual rights in a market economy. Police protection is used to prevent individuals within a society from violating one another's rights. National defense is used to protect the rights of individuals within a nation from foreign aggressors. The courts and criminal justice system are used to resolve disputes among individuals within a society so that those who have disagreements do not have to resort to the use of force to settle their disputes. In all cases, the use of government to protect individual rights is intended to create a system in which all individuals interact with one another through voluntary agreement, and the legitimate use of force against others is reserved to the government. The granting of a monopoly on the
use of force to government can help protect individual rights but raises potential problems because the government itself might violate the rights of its citizens.

This raises the interesting question of democracy and how government power can be constrained. The democratic model of checks and balances uses one branch of government to constrain the others, while democratic election of officials can also have the effect of constraining the power of government. Furthermore, constitutional rules can be used as guidelines to limit government power—if those in government can be enticed to abide by those rules.

How Much Protection Is Optimal? The economist's answer is that resources should be expended to protect rights up until the point where the marginal cost of additional protection just equals the marginal benefit. Although this answer is good in theory, it does not provide much practical guidance. We could assume that the government protects the rights of its citizens to allow them to participate in market exchange and that the government enforces its laws so that, for example, citizens pay the taxes they are obligated to pay. A number of interesting issues arise, however, when this assumption is abandoned and the marginal costs and benefits of additional protection are analyzed. The issue is complicated when we realize that the government that has the power to protect us also has the power to exploit us and that a government powerful enough to protect our national borders is also powerful enough to project its power across national borders.

Government production

If there are externalities, public goods, or poorly defined property rights, then the market may not produce goods and services efficiently, leading to a role for government to get involved. Government involvement not only can include regulation of the private sector, to be discussed later, but also can include public production, as is done with highways, schools, and public radio. This is especially the case of public goods and goods and services involving externalities.

Public goods are those which can be enjoyed by an unlimited number of people (nonrival) without prejudice of each other and where one cannot exclude people from using them (nonexcludable) (i.e. a light house, defense; law and order; a road; a park...). Because of these characteristics, it is unfeasible to charge for the consumption of public goods and therefore private suppliers will lack the incentive to supply them. If the state does not provide these goods, the market will not provide them (free rider problem). Therefore, the state should raise taxes and provide these goods for the community.

There is an externality when the actions of one person or firm hurt or benefit others without that person or firm paying or receiving compensation. Some externalities have a beneficial effect on others and are referred to as positive externalities and others have a detrimental effect and are referred to as negative externalities. A firm that pollutes the air is imposing a negative externality on all individuals who breathe the air and on all firms whose machines wear out faster. Normally, marginal cost equals marginal benefit; in the case of externalities, social marginal cost is higher than individual marginal cost and the
good will be overproduced; in the case of a positive externality social marginal benefit is higher than individual marginal benefit and the good or service will be under produced.

Without state intervention, the level of production of negative externality-generating commodities will be excessive. Efficiency requires that social marginal costs equal social marginal benefits; therefore, there is a need for a tax equal to the marginal cost of the pollution. (Or regulation). In the case of a positive externality, in the absence of government intervention, there will be too little production and consumption of that good or service. The solution is for the state to Pollution or logging is an example of a negative externality while investment in R & D, training, or a literate population is an example of a positive externality. The market, left on its own will tend to produce too much of the goods involving negative externalities (need to tax them) and too little of goods involving positive externalities (need to subsidize them). Basically, there is a wedge between the profit of a certain activity to the producer and to society and the state needs to even that out in order to ensure an optimal quantity is produced.

Externalities and public goods provide the main theoretical justifications for government production. Even when the production is undertaken to protect individual rights or for redistributive purposes, public production to achieve those goals tends to be rationalized based on an externality or a public good argument. National defence is a public good, in addition to protecting individuals' rights. Public education is redistributive in that it provides everyone with an equal opportunity, and public production is often justified based on a positive externality that is produced. The productive state promotes economic efficiency by undertaking production in areas where the market would fail to optimally allocate resources.

**Government Regulation**

The market does not provide regulation for property rights, financial markets, a judicial system for the enforcement of contracts, labor or environmental legislation, trade legislation, health and safety standards, etc... Hence the role of the state in providing those. Problems arise too in cases of monopoly situation. Monopolies do not have the same incentives to produce efficiently and charge market prices because there is no competition forcing them to be competitive and because consumers have nowhere else to turn to obtain the good or service at stake. Therefore, the state should step in and either provide this service publicly or regulate the monopoly to ensure consumer interests are protected (telecoms, public utilities...).

Some times resources might be allocated inefficiently because producers do not have an incentive to take account of the social costs of their actions. Other times market participants might be better able to allocate resources if better information were available to them. Although the government might directly take over production in these areas, another alternative would be for the government to regulate the behavior of private sector economic activity. The regulatory state might, in one sense, be viewed as a subset of the productive state. Regulation is applied in cases in which the private sector allocates resources inefficiently but in which the imposition of rules can provide the incentive for
more efficient private sector production without the government having to take over production itself.

There is, however, good regulation and bad regulation. Good regulation allows markets to operate efficiently while bad regulation interferes with the market. Developing countries tend to have too little of the good kind of regulation (property rights, well-functioning judiciary, environmental and financial market regulation) and too much of the bad kind of regulation (many steps required to obtain a license to open a business, overregulation of trade, marketing boards, regulating prices...).

The stability of regulation is also important: one of the most damaging sources of state action is uncertainty (very much affecting FDI): if the state changes the rules often or does not clarify the rules by which the state itself will behave, or you are not sure property rights will be respected, business and individuals cannot be sure that what is profitable or even legal today, will still be so tomorrow (therefore affecting investment, both foreign and domestic).

Redistribution

At first glance, the reasons why government might engage in some redistribution of income might appear obvious, but a closer look reveals that there are several closely related rationales for redistribution. One underlying principle is to use public policy to improve the well-being of those members of society who are least fortunate, providing a safety net for people who have fallen on hard times and ensuring that everyone has access to some minimal standard of living. Alternatively, greater equality might be desired as a social goal. Although these two goals have a similar ring to them, note that they are different goals and might imply different public policies. Helping the poor is not necessarily the same thing as promoting greater equality.

Obviously, the poor in wealthy nations tend to be better off than the poor in poorer nations, suggesting that improving the well-being of the poor can be consistent with increasing everyone's standard of living. At the extreme, the goal of equality could be achieved by confiscating the wealth of above-average wealth holders and giving it to those below average until everyone's wealth is the same. This would destroy the incentive to be productive and would result in equality by creating a very poor society for everyone. This extreme example shows that the goals of equality and the alleviation of poverty are not necessarily the same.

Regarding income distribution (equity), although a market economy benefits society as a whole, it does not benefit everybody. There are always winners and losers. People's income depends on the value of the marginal product of their productive factors, namely, labor and capital: capital from earned and inherited wealth and their labor, whose productivity depends on their education. Since people's levels of education and capital vary enormously, so does their income. Now, whatever the origin of unequal income distribution may be, the truth is that the market will produce inequalities and each society decides how much state intervention they want to use to even it out.
If a state wishes to influence income distribution, the best way to do it is: In the long run, the best way to influence it is through education, since that is the single most important determinant of income distribution (LA area in the world with highest income inequality, compared with Asia, key difference education inequality).

However, other measures can be used such as social insurance mechanisms (unemployment pay, pension system) and welfare state for the poor. The features shared by the most egalitarian societies are a public education and health system, unemployment insurance and public pension systems and a well-developed welfare state. There has been much more emphasis on income distribution in Europe than in the US.

Higher taxes on upper-income individuals will further the goal of equality but might reduce the incentive for upper-income individuals to earn income, resulting in less total tax revenue. Likewise, taxation of investment income can discourage saving and investment, making the economy less productive. This will further the goal of equality, but perhaps at the cost of reducing economic growth and making those at the lower end of the income scale worse off, too. Issues like this must be considered when designing a tax system, but a different tax structure will be called for depending upon whether the goal of redistribution is to create more equality or whether it is to help those who are the least fortunate in society. Likewise, redistribution programs themselves might be designed differently depending upon what goals the programs are intended to accomplish.

Stabilization

Monetary policy and fiscal policy are the primary tools that are used to stabilize the economy. Monetary policy is aimed at controlling the money supply and the banking industry, while fiscal policy uses taxes and government expenditures for the purpose of maintaining growth, employment and low inflation.

The level of activity of an economy (GDP) depends, in the long run, on the supply side (ability to produce, depending on factor endowment and total factor productivity). In the short run, however, there can be fluctuations in the level of activity of an economy because of either supply shocks (like the discovery of oil or natural gas in a country or the quadrupling of the price of oil in the 70s oil crises) or demand shocks.

Active stabilization policies were very popular in the post second World War period (postwar model) because the conventional wisdom was that one of the key reasons for the great depression was failure of the Federal Reserve and the government to react and cut interest rates and increase expenditure. However, in the 1970s, many governments found that these policies do not work if the "short" side (or limiting side of the economy to the generation of faster growth) is not the demand side but rather the supply side. If a government attempts to use expansionary policies (creating more demand through expansionary monetary or fiscal policy) in an economy with the supply side either at full employment or below full employment but without ability to expand due to some bottleneck or rigidity, it leads to inflation (thus the stagflation of the 1970s) and, if it is an open
economy, to a balance of payments deficit (as people attempt to import more). Since the 1980s there has been increasing skepticism about countercyclical macroeconomic policy and the common wisdom now is that macroeconomic policy (monetary and fiscal policy) should be used to ensure "price stability," namely low inflation and growth rather than full employment.

Can the government perform these functions?

The world is far from perfect, as the previous chapters have indicated. Externalities create harm because individuals do not consider the effects of their actions on others, and public goods create a situation in which valuable goods might be underproduced. Monopolies can dominate markets and lower economic welfare. However, just because a problem exists in the market does not necessarily mean that the government can allocate resources more efficiently. Consider first the protective, productive, and regulatory functions of government, which for efficiency all require the government to either produce some public good or regulate the private economy in such a way as to produce optimally. In all cases, a substantial amount of information was required to find the optimal allocation of resources.

Another issue is that at times there will be conflicts among the government’s many goals. If the government pursues redistributive goals, for example, the burden of the tax system on the economy from transferring income from one group of people to another will reduce the efficiency of resource allocation. Thus, there is an explicit trade-off between efficiency and equity. Also, perhaps there is enough information to solve a problem in the market, and an efficient policy is clear to policymakers. Even then the government might not act efficiently. Interest groups will always become involved in public policy issues that affect them directly, and their interests are not necessarily the interests of the general public. It remains therefore relevant to monitor the state’s role in any given economy and see if it has provided with a stable regulatory and investment environment that will help growth.
CHAPTER SEVEN. FISCAL POLICY.

As we have noted, governments have two tools, fiscal and monetary policy, which are used to balance growth, inflation and unemployment by affecting aggregate demand (AD). Aggregate means total, so aggregate demand is the total demand in a country for goods and services. Fiscal policy affects AD through government expenditures or through tax changes. Monetary policy (as we will see in the next chapter) affects AD through the money supply and interest rates.

Fiscal policy is a central government’s attempt to change economic activity by increasing or decreasing government expenditures, for example on highways, defense, education, public works projects, and social programs, or by increasing or decreasing taxes on individuals or corporations. But fiscal mismanagement has been the key factor in the problems of several developing countries in the 1970s and the 1980s. Fiscal measures in adjustment programs aim to reduce excess pressures arising from excess demand and to reorient the public sector to enhance growth prospects, in particular through restructuring of the tax systems and expenditure priorities. Therefore, reduction of deficits of the consolidated public sector, financing of the deficits with limitations on government spending and borrowing, review of the expenditures and reform of the tax structure are all part of the adjustment strategy.

The use of fiscal instruments depends on the country’s fiscal situation. If persistent transfers to the loss-making public enterprises are the main cause for the fiscal deficits, then a tax increase would balance the budget temporarily but would not resolve the underlying problem. Perhaps, private management or sale of assets or commercialization of the loss-making enterprises is a better solution. If the fiscal deficits are persisting due to excessive wage payments to government employees than cutting capital expenditures is a temporary solution and in the medium to longer term would impact upon growth.

In the face of a recession, the government could use a expansionary fiscal policy. As we remember from the economic growth chapter, there are four components of aggregate demand: AD = C + I + G + (X-M)

- I = investment. Business demand for goods and services. This is the most volatile component.
- C = consumption. Consumer demand for goods and services. This is the largest component.
- X-M = exports minus imports = net exports (could be positive or negative).

The government could use expansionary fiscal policy by raising government expenditures (G) or lowering taxes. The aggregate demand (AD), or spending on goods and services, is raised either directly through higher government expenditures (G) or due to lower taxes (T) giving consumers more money to spend. Business responds to the increased demand for their goods and services by increasing business investment. As businesses invest
more, they hire more workers, increasing employment. There are now more workers with a paycheck and their spending creates an increase in AD for goods and services. Businesses respond to the increased AD for their products by increasing business investment. As businesses invest more, they hire more workers, increasing employment. As a result, more workers with a paycheck and their spending create an increase in AD for goods and services. And so on...the rationale will be the opposite in the case of a contractionary policy. It is also important to note that the total change in AD is greater than the initial amount of government expenditure due to the multiplier effect. This is due to the ripple effect of the change in government spending or taxes.

Now what would happen to inflation? Well, at some point, it is likely to rise as AD (spending) outstrips the aggregate (total) supply (AS) of goods and services. In other words, businesses can hardly keep up with orders and respond to the 'excess' demand by raising their prices. Employers may also be forced to raise wages in order to attract new workers and retain old workers, both of whom are spoiled for choice in the job market.

Supporters of conservative economics argue that expansionary fiscal policy is likely to lead to inflation because if the economy is growing very rapidly and the demand for goods, services and labor is outstripping supply, then the price of all of these factors will rise. They would also criticize expansionary fiscal policy because it generally means that the government has to go into debt to pay for the increase in expenditures or a tax cut and increasing its deficit. Supporters of conservative economics, because of their belief in minimal government, are generally opposed to increases in government spending, especially deficit spending, even if it is for the purpose of stimulating the economy.

**Public expenditure**

Public expenditure is the value of goods and services bought by the State. Public expenditure plays four main roles: it contributes to current effective demand; it expresses a coordinated impulse on the economy, which can be used for stabilization, business cycle inversion, and growth purposes; it increases the public endowment of goods for everybody; it gives rise to positive externalities to economy and society, the more so through its capital component.

Public expenditure analysis can begin by looking at the total government expenditure as a share of the economy (generally as a share of GDP). There is no single desirable level of spending. However, the aggregate level of spending must be consistent with the macroeconomic framework. If not, high or rising budget deficits, depending upon how they are financed, will result in particular macroeconomic imbalances. The permissible aggregate level of spending depends upon the sustainable budget deficit and the composition of that deficit. To calculate the sustainable deficit, future projections of debt to GDP need to be made, given assumptions about the demand function of money, the desired inflation rate, the real interest rate and the growth rate of the economy.

First, public expenditure can be classified in terms of the kind of goods and services bought, also with very general items (capital goods; consumption goods; personnel
expenditure). Second, public expenditure can be classified according to the official body and organization from which budget it is paid, as for example the central state and its ministries, regional and local authorities, etc. Also, public expenditure can be classified according to the macro-function at which it is directed: justice and public order; education, health, etc.

Comparing macro-function shares in public expenditure, one can get insights in the kind of state under analysis. Public expenditure is determined by political will of the leading forces in the state: their priorities, their desired state model, and their interpretation of current economic and political phase. Past choices have relevant impact on public expenditure because of inertia and incrementalism. Bureaucracy may play an important decision role for the actual expenditure.

A GDP component as it is, public expenditure has an immediate impact on GDP. An increase of public expenditure rises GDP by the same amount, other things equal. Moreover, since income is an important determinant of consumption, that increase of income will be followed by a rise in consumption: a positive feedback loop has been triggered between consumption and income, exactly as in the case of shocks in export, investment or autonomous consumption. The full extent of this mechanism will depend, however, by the reactions of the other economic agents. Firms have to decide whether to increase production or prices in response to demand.

Moreover, if consumers interpret the increase in public expenditure as a fall in their disposable income (i.e. after-tax income), consumption may fall accordingly. Public expenditure is also told to crowd-out investment, possibly through an interest rate increase, further leading, in a floating exchange rate regime, to a currency appreciation. Exports would then be displaced as well.

Expenditure is also important for the poor, as the government can have a pro-poor bias in its policy. Pro-poor spending is one that benefits the poor more than the non-poor, or gives the poor a higher percentage of benefits than their national income share, that actually reaches or has an impact on welfare of the poor. Typical pro-poor expenditures are primary education and health or rural roads.

In any case, automatic stabilizers, which may change government spending and tax revenues without direct approval of the government, also act in the case of recession or expansion. One example of automatic stabilizer is the unemployment compensation - if the economy turns down, the government's expense on unemployment compensation automatically increases as more people are without jobs. This increase in government spending prevents the economy from receding more than what would occur if no unemployment compensation existed, according to Keynesian thought.

**Tax Policy**
Taxes are necessary as they provide the main tool to finance the administration and the budget. However, many policy issues are to be considered in the context of actual and potential tax revenues and the administrative structure in particular countries. Just to give a quick outlook, direct taxes, such as income taxes, when levied tend to be more equitable than the indirect taxes but could discourage investment and production depending upon the size of the tax increases. Separation of personal income taxes from corporate taxes may be justified on equity and revenue objectives. Direct taxes are much easier to evade. Indirect taxes, such as international trade duties, are easier to collect but tend to be regressive. High nominal rates and ad hoc exemptions from direct taxes may encourage tax evasion and adversely impact upon savings, investment, work effort and capital flows. Import duties with high and variables rates provide effective protection to some sectors and lead to inefficient import substitution. Export taxes, overvalued exchange rates, and attraction of surpluses through the marketing boards discourage production and exports.

The Five Desirable Characteristics of Any Tax System

It is widely believed that there are five properties of a “good” tax system:

1. **Economic efficiency**: the tax system should not interfere with the efficient allocation of resources.

2. **Administrative simplicity**: the tax system ought to be easy and relatively inexpensive to administer.

3. **Flexibility**: the tax system ought to be able to respond easily (in some cases automatically) to changed economic circumstances.

4. **Political responsibility**: the tax system should be designed so that individuals can ascertain what they are paying for so that the political system can more accurately reflect the preferences of individuals.

5. **Fairness**: the tax system ought to be fair in its relative treatment of different individuals.


The desired features of an effective tax system are least cost for administration, simplicity in structure for compliance, broad based in application, and tax neutrality to avoid production, consumption or trade distortions. The tax system should be a stable and assured source of revenue, understood by both taxpayer and administrator, easy to administer and able to distribute taxes in a manner that is perceived to be fair and equitable.

Fiscal incentives for investment in the form of preferential tax rates and so on have usually been found to be ineffective in most developing countries. Raising revenues from a few taxes and rates would contain administrative and compliance costs and avoid the perception of excessive taxation. Broadening the tax base with limited exemptions enables revenues
to be raised with lower rates and the revenue stream is more predictable. A value added tax or a single-stage sales tax when levied at a low and uniform rate on a broad base is efficient and avoids the cascading or cumulative taxation of goods as they move along the successive stages of production. Excise tax on luxury goods and on alcohol and tobacco can discourage consumption...so it is clear that tax reform has to take a careful look to the consequences of changes. However, recent studies have shown (see below) that tax revenue, measured as a percentage of GDP, correlates positively to per capita income.

Also, it is important to keep the equilibrium between the different types of taxes. Direct taxes are a better tool to improve income distribution: those who earn more, pay more while indirect taxes (VAT) generate more revenues and are conducive to macroeconomic stability but they are not necessarily progressive since all population groups pay the same (unless basic goods are taxed at rate zero). On the other side, exemption or relief (fiscal incentives) which is not part of the essential structure of the tax is a common tool that can be a useful tool in attracting investments. However, it is key to estimate the costs of a particular tax incentive program and estimate well the compliance and enforcement costs, the erosion of the tax base due to exonerations, shifting of tax burden to immobile tax bases (labor), the distortion of resource allocation, its administration and the possibility of facing lobbying and unproductive rent seeking activities that benefit from the relief. In any case, it is relevant to have a good system, as discretionary practices create opportunities for corruption. Both sides, revenues and expenditures, need to be considered when analyzing impact of a fiscal system on the poor (macroeconomic stability, efficiency and equity). Some systems that appear to be regressive on the revenue side may become highly progressive if the expenditure pro-poor side is included.

![Graph: Tax revenue (% of GDP)](image)

Source: Bird and Gupta, 2004
Expenditure reform in the form of improving the quality of expenditure and rationalizing the tax system is positive. The standard theory of fiscal deficits states that if a government cuts taxes and runs a budget deficit, then the private sector including households respond to the increase in disposable income partly with higher desired private savings and partly with higher consumer demand, depending upon each household's marginal propensity to consume. Since desired private savings rise by only a fraction of the budget deficit, desired national savings (private and public savings) would decline. National savings must equal domestic investment in a closed economy without inflow of foreign savings. As such, a decline in national savings would lower national savings, rise real interest rates and reduce investment demand, and raise desired private saving. This is the crowding out of investment in the short term.

Pro poor budgeting

The national budget is the instrument that governments have to regulate and prioritize public expenditure. The reason why it is necessary to prioritize in production for the provision of goods and services is that the resources required to produce the goods and services are limited. This setting of priorities in production and consumption is carried out through a system of budgeting. A budget therefore, is concerned with the prioritization of expenditures that can be made given a certain level of income. A government budget is a list of intended government expenditure given the amount of revenue to the government at a given point in time. Government budgets are normally drawn annually. There are experiences of the budget being effectively affected by CSOs representing the poor. The table below exposes the example of Uganda.

<table>
<thead>
<tr>
<th>Participation at the central level</th>
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<tr>
<td>Since 1998/99 civil society organizations are involved in the dialogue on priorities and spending commitments, and public debate in the media is encouraged. However, officials recognize that there is still a long way to go in opening up civil society and media engagement.</td>
</tr>
<tr>
<td>In 1998/9 the government implemented the Uganda Participatory Poverty Assessment Project (UPPAP) where the poor in both rural and urban areas were directly consulted. The results of the UPPAP influenced budget allocations. For example, a higher weighting was given to provision of safe water supply in budgets at central and district levels as a result of communities identifying access to clean water as a priority. Findings from UPPAP were also included in the Background to the Budget 1999/00.</td>
</tr>
<tr>
<td>Involvement of civil society is also encouraged by publishing: a) an abbreviated version of the Budget Framework Paper (the version that goes to cabinet before expenditure allocations are approved); b) annual &quot;Background to the Budget&quot;; and, c) detailed summary of composition of expenditure for all sectors for the three year Medium Term Budget Framework as an appendix table in the Budget Speech document.</td>
</tr>
<tr>
<td>Donors are invited to join sector working groups and participate in the public expenditure review</td>
</tr>
<tr>
<td>In the 2000/01 budget process, the Poverty Eradication Working Group was established, comprising Ministry of Finance officials, donor and civil society representatives. The group reviews each sector working papers for the poverty focus. It then makes recommendations on inter and intra sectoral allocations of resources and poverty focused output indicators utilizing the latest poverty analysis.</td>
</tr>
<tr>
<td>The Budget process provides an opportunity for Parliament to take a more strategic look at the government's expenditure plans and examine how the government is performing in the implementation of its overall budget strategy.</td>
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A strategy to increase public awareness and transparency of the budget process is currently being developed. This involvement will enhance the evolving partnership between civil society and government.

Participation at the district level
- Responsibility for the provision of a large number of services was devolved to district and urban authorities with increased people's participation in the decision making process, making decisions more transparent and public officers more accountable. The long term aim is to integrate central and local government budgetary processes and involve spending decisions to local governments to enable them to respond to district poverty priorities.
- Recent UPPAP findings demonstrate major differences in the poverty profile between districts. This resulted in policy makers recognizing the need for more flexibility in the use of central government conditional grants to districts.
- With the Ministry of Local Government, the UPPAP will work directly with nine districts initially to strengthen their capacity to consult poor communities for the purposes of district planning and budgeting.

Monitoring budget expenditures
- The government established a Poverty Action Fund (PAF) to enhance transparency and monitoring of HIPC and other donor resources to expenditure programs focused on poverty. The PAF involves both civil society and government in monitoring the impact of PAF outlays and quarterly meetings are held to discuss delivery against budget allocations.
- The budget process is being further developed to open up multiple channels of accountability. For example, to increase transparency in decentralized management of resources, advertisements are placed in the press indicating amounts disbursed to each district by sector. In the education sector, budget allocations for schools are posted on school notice boards.
- In addition, the Poverty Monitoring Unit integrates annual household surveys, conducted by the Uganda Bureau of Statistics, with other data sources (e.g. participatory analysis, sector surveys, line ministry data sources) to ensure that impacts of policy are understood and policy development is informed by poverty data and perceptions of the poor.

Source: “Can the Poor Influence Policy? Participatory Poverty Assessments in the Developing World” (forthcoming), Caroline M. Robb. Second Edition, Directions in Development, World Bank, Washington DC, with inputs from the Poverty Assessment processes requiring participation of citizens and the poor in resource allocation, expenditure tracking, and monitoring service delivery systems, can help make fiscal institutions more demand-driven and pro-poor. For example, participatory budgeting has been used in many Brazilian municipalities since the mid-1980s. It involves, first, checking that the previous year’s budget was spent according to the budget and in line with policies; and secondly, bringing together people from different geographical areas and interest groups to define expenditure priorities for the next budget. Participatory budgeting has allowed public expenditure to more closely reflect citizens’ preferences. In Itabuna, for example, participatory budgeting resulted in a large shift toward investment in water and sanitation, the top priorities expressed by its citizens.

A final example is that of South Africa. In 1995, the NGO Women’s Budget Initiative began to analyze South Africa’s budget for its impact on different groups by gender. The initiative analyzes whether the budget addresses women’s needs and makes adequate provision for implementing gender-sensitive policies. It looks at both revenue and expenditure and highlights areas where a greater budgetary allocation is needed, balanced by identifying potential savings from expenditure it sees as subverting gender equity. A Gender Budget Manual for government officials was produced as a result of research and presentations related with these meetings. Since 1998, material from these research and hearings has been disseminated through accessible language to the wider public.
CHAPTER EIGHT. MONETARY POLICY AND INFLATION

This chapter deals with money, monetary policy and inflation. Money has three main roles as:

- A Medium of Exchange – Instead of exchanging potatoes or leather shoes directly (barter), one can exchange the potatoes for money (i.e. coins) and use the coins to buy leather shoes. It saves the potato supplier to have to look for someone who not only wants to buy potatoes, but also wants to sell leather shoes. Money, in this sense, encourages and speeds up trade.

- A Standard of Value – How many potatoes are worth one pair of leather shoes? Without money it is difficult to reach an agreement every time you enter into a trade like that. Money allows us to put values on the goods, and services we sell. For example, if a pound of potatoes sells for $1.- and a pair of leather shoes costs $8.-, then 8 pounds of potatoes would be worth one pair of leather shoes.

- A Store of Value – By exchanging goods and services for money, you can accumulate money and increase your wealth. Without money, a surplus of potatoes each month would go a long way towards smelling up your house, but it wouldn’t allow you to store any of the surplus production.

Our monetary authorities (the central bank) use a number of different measures to quantify the amount of money which exists in our economy. The central bank holds the member banks’ required reserves, loans money to the commercial banks, supervises them, and clears their checks. That is, the Central Bank controls the money supply.

The most common method the Central Bank applies to change reserves in the economy are open market operations. The term refers to the Central Bank’s activity of buying and selling government securities (bonds). Bonds are pieces of paper (certificates) which are proof that you have lent money to someone. Government bonds are first issued by Congress and the White House to help finance expenses on defense, roads, social security, etc. The Central Bank does not issue these bonds, but only trades them to fine tune the money supply. To put more money into circulation, the Central Bank buys bonds from people, businesses or banks who hold them. These groups would receive cash in exchange for the bond, which puts funds in circulation and increases the money supply. The reverse occurs when the Central Bank sells bonds. This takes funds out of circulation and decreases the money supply.

When the Central Bank increases the reserve requirement (the amount a bank is required to keep on hand as a percentage of its deposits) it forces banks to make fewer loans. This causes a drop in the money supply (and vice versa). The discount rate is the interest rate which a bank must pay the Central Bank when the bank borrows money from the Central Bank. The more money a bank borrows, the more it can loan out and the more it increases the money supply. If the Central Bank decreases the discount rate more banks
will want to borrow money, thus increasing the money supply. The reverse is true when the Central Bank decides to increase the discount rate.

**Inflation**

Inflation is a general rise in the prices across the economy. Individual prices rise and fall all the time in a market economy, reflecting consumers’ choices and preferences, and changing costs. Inflation means that the value/purchasing power of money is falling because prices keep rising. We often hear about the rate of inflation being 3% or 7% or some other number. The rate of inflation is a measure of the change in prices over a specified period, mostly 12 months (this is called the annual inflation rate). For example, if the annual inflation rate was 1.9% in any given month, this means that prices overall were 1.9% higher as compared to the previous year. Thus if a basket of goods and services cost 100 in July 2000 they would cost £101.9 in July 2001.

**What causes the inflation rate to Change?** The causes of inflation can be divided into two categories, but it is usually linked to the amount of money supplied in the economy:

1) The Cost-push inflation: This type of inflation occurs when a firm passes on an increase in production costs to the consumer. The inflationary effect of increased costs can be the result of: i) Increased wages leading to: a) Wage – price spiral, which occurs when price increases spark off a series of wage demands which lead to further price increases and so on. b) A wage-wage spiral, which occurs when one group of workers receive a wage increase which sparks off a series of wage demands from other workers ii) Increased import prices which can be the result of: a) A rise in world prices for imported raw materials b) A depreciation in local currency

2) Demand-Pull Inflation occurs when there is too much money chasing too few goods, because the demand for current output exceeds supply. Price changes like the ones described above can have other indirect effects on inflation but it should be noted that individual price changes in themselves do not have a lasting impact on the inflation rate.

Not everyone suffers from inflation. Some parts of the society might benefit: a) The governments find that people earn more and so they contribute more to income tax. b) Firms are able to increase prices profits before they pay out higher wages. c) The debtors (borrowers) gain because they have use of money now, when its purchasing power is greater.

**Inflation Rates Measures**
The most common measure of inflation is the CPI, or Consumer Price Index. This figure is a weighted average of price increases of a typical “basket” of consumer goods and services. The term “weighted” means that price increases of goods that are bought in large quantities, *i.e.* economic textbooks, increase the CPI more than goods which are not consumed as commonly (french fries) (joke).

To illustrate, let’s assume that an economy produces only tables and chips. Let’s say that in 1991 20 tables were produced and 5 bags of fries were made at respective prices of
$10 and $1 each. We will use 1991 as the base year in which the price index is set at 100 (100%). In 1998 the same output is produced, but at higher prices (inflation). Tables now cost $20 each (a 100% rise) and a bag of fries sells for $1.10 (a 10% rise). How much did inflation go up? If one would take an unweighted average, the answer would be 55% (average of 100% and 10%). But a weighted average takes into account that more tables were made than chips. The weighted average increase is \((20 \times 100 + 5 \times 10)/25 = 82\). The index thus increased by 82% to 182 between 1991 and 1998 (hypothetical example).

Other common measures of the inflation rate are the GDP deflator and the Producer Price Index (PPI). The PPI is similar to the CPI, but changes in (wholesale) prices which businesses, not consumers, must pay are measured. The GDP deflator is defined as nominal GDP divided by real GDP times 100. It gives a more accurate picture of the changes in prices of all goods and services in our economy.

**The Cause of Inflation**

The quantity theory of money simply and clearly illustrates that the only explanation for a long term rise in the general level of prices in an economy is a rise in the quantity of money in circulation. Thus the value of money, like the price of any good, is determined by its quantity supplied.

As an example, suppose that the level of aggregate spending in our economy is $1000 billion and that the volume of goods produced is 10 billion units. In this case, the average price of a good must be 100 dollars per unit. If the government increases the quantity of money by, say $200 billion, the total amount of spending (demand or Dc) in our economy would increase to $1200 billion. Without an increase in the supply of goods (Sc), the price level would rise to 120 (dollars per unit). In other words, inflation is 20 percent. The monetary (nominal) value of the goods purchased is determined by the quantity of money available to the purchasers.

Many economists believe that a greater quantity of money available to purchasers stimulates the economy and helps Sc (and therefore Dc) grow. However, in the long run the production and supply of goods is determined by the industriousness of entrepreneurs, wage earners, managers, etc. in our economy. The more they produce, the more economic activity we have, and the more our economy is stimulated. Factors which influence this industriousness deal with the inherent desires for workers to produce, better themselves economically and increase their wealth. A country which provides its producers with a good economic climate will stimulate the most economic activity.

Increasing the quantity of money by the government does not stimulate businesses to produce more. It only raises the prices at which goods are sold; *i.e.* it lowers the value of the existing money. In other words, it causes inflation. And because inflation causes businesses uncertainty, malinvestments, and other harmful effects, it actually discourages production of goods in the long run. The single most important reason why our economy has done so well the past 16 years is the fact that inflation has remained low. This has
been due to a more responsible Federal Reserve which has chosen to restrict the increase in the money supply since 1980.

However, there are relevant disadvantages of inflation: a) People on fixed incomes are unable to buy as many goods as they would love to. b) Creditors (savers) lose because the loan will have reduced its purchasing power when it is replaced. c) Domestic goods may become more expensive that foreign products. This way the balance of payments will suffer. d) Industrial disputes may occur if workers are unable secure wage increases to restore their standard of living. The poor people, because they have fewer possibilities to protect themselves from the increase in prices.

Inflation can lead to non productive investments. When prices rise, certain investments go up faster as compared to when prices are stable. For instance, prices of real estate and antiques rise faster if there is inflation. More money is invested in these goods therefore as compared to when there is no inflation. However, putting our borrowed money or savings into these non-producing types of commodities is not the most efficient way to increase the country’s wealth. Higher inflation which causes prices of housing to rise may help real estate owners increase their wealth, but it encourages money to flow into ventures which otherwise would not have been as attractive. Instead of funds flowing into ventures which produce additional wealth, it is being invested in consumption items which do not add to the country’s productive capacity. In addition, current buyers of property suffer. Current buyers pay for inflated houses and other inflated commodities. Some workers who could afford to purchase a house ten or fifteen years ago, can no longer do so.

Inflation encourages consumption instead of saving. Higher prices induce people to purchase more products now (before they become more expensive) and discourage people from saving, because money saved for future use will have less value. Too much consumption discourages savings needed for investments in capital goods and technology, the real causes of wealth in our economy.

Inflation leads to higher interest rates in the long run. Initially when the government increases the money supply, the increased availability of money may lower interest rates. However, the higher prices and lower value of the money leads banks and other financial institutions to raise rates in order to compensate for the loss of the purchasing power of their funds. Higher long term rates discourages business borrowing, which leads to less investment in capital goods and technology.

The most usual ways to combat inflation are: cost – Push Remedies a) Introduce a price and income policy to arrest inflation. b) Encourage an appreciation of domestic currency. c) Reduce indirect taxation (taxation goods) as opposed to income & corporate tax. ii) Demand – pull Remedies a) Reduce government spending. b) Reduce people’s ability to borrow money by increasing interest rates and tightening credit regulations. c) Control the supply of money through monetary policies.
Higher prices of goods means that other countries will find it less attractive to purchase our goods. This will lead to a decline in exports and lower production and higher unemployment in our country.

Higher prices lead to increases in taxes. Nominal (not real) incomes rise along with inflation and push income earners into higher percentage tax brackets. So even though purchasing power does not increase, a person pays a bigger chunk to the government.

If the funding of the increased social security spending came from newly printed money, it would, as we saw earlier, decrease the value of the money and produce the same harmful effects regarding people's loss of purchasing power as would occur if the government had raised taxes. Higher prices on goods and services will make these people demand less and this will offset any earlier benefits from the social security recipients' increase purchasing. In fact, overall economic activity can be expected to slow, because of the harmful effects of the inflation.

When the government finances its expenditures at least in part by printing more money, it acquires these funds “for free” (of course, it is not free to citizens who will be faced with significantly higher prices on goods and services later on). However, to the public it initially appears that these funds have been acquired without too much sacrifice. This encourages the public to accept the government programs more than if it had to pay taxes to finance them. This is a very serious form of inefficiency in our society.

Falling prices as a result of higher production is a vastly different situation though. It is desired in this case that production rises and prices fall. The greater production capacity and increased wealth enables businesses to lower their prices, because business owners and income earners all benefit from the increased purchasing power. Lower prices does not mean lower profits for businesses in this situation. The overall decrease in the price level benefits businesses because the goods that business owners purchase for their production as well as the goods the owners purchase as consumers are now less expensive and available in greater (and higher quality) amounts.

Monetary Policy

The aim of monetary policy is to ensure that the expansion in domestic liquidity is consistent with the government’s objectives, which are frequently GDP growth rate, inflation, and balance of payments. The monetary policy controls nominal variables, such as the price level, monetary aggregates, the exchange rate, and nominal GDP. For example, deviations from inflation target during the past month or so are made up in the immediate future such that on an average within a given year the desired inflation rate is more or less being achieved. Countries on gold standard and fixed exchange rate regime (Argentina in the 90s) are examples. Such targeting of inflation facilitates the country to have long-term nominal contracts and enhance credibility in government policy. Some other countries target inflation but when surprised by movements in the price level during any given month do not make any policy adjustments. This approach fails to correct for past mistakes in the price level and over time could “an inflation drift” and the
government’s credibility could be questioned. Government’s commitment could be very effective if it adhered to a rule, say fixed exchange rate regime or independence of Central Bank, or a monetary rule, say that money supply growth would equal the GDP growth.

**DEMAND FOR MONEY CURVE**

Monetary policy works through changes in the money supply and interest rates. For example, in the face of a recession and high unemployment, the central bank would use expansionary monetary policy to stimulate demand. The central bank would expand the money supply (M), this would bring down interest rates. We can think of the interest rate as the price of money. If the supply of money increases relative to the demand, the price (interest rate) falls. The lower interest rates means that it's cheaper to borrow money which stimulates business investment. As businesses invest more, they hire more workers, increasing employment. There are now more workers with a paycheck and their spending creates an increase in aggregate demand for goods and services. Businesses respond to the increased AD for their products by increasing investment and employment. This creates more AD and so on.

Rather than establish a direct relationship between the instruments of policy and the objectives to be achieved by the government, an indirect targets such as money or credit is often considered. Two types of monetary instruments exist:

- Direct instruments of control include credit ceilings on individual banks, control of interest rates, and use of capital/asset ratios. Most developing countries use these instruments. In some developing countries, credit controls or bank credit is directed for specific activities. In such circumstances, the government is said to be
picking winners. A minimum capital/asset ratio is often used by the central bank to force branches of foreign-owned banks to increase their capital.

- Indirect instruments attempt to influence the demand for and supply of reserve money to achieve the intermediate target. For example, open market operations involve the sale or purchase of government securities by the central bank to inject or withdraw excess money from the system.

Similarly, reserve requirements, which are cash in vault and deposits with the central bank, affect the demand for reserve or base money through the money multiplier and therefore assist in controlling the money supply and credit. Weak central banks cannot enforce the legal reserve requirements and as such the actual reserves are lower than the legal requirements. Reserve requirements sometimes vary with the bank liabilities. Time deposits may require lower reserve requirements. An increase in reserve requirements raises the cost of resources to the banking system and would increase interest rates on loans. Moreover, frequent changes in reserve requirements confuse the money markets and lead to excess holdings of reserves thereby thwarting the effectiveness of monetary policy.

In addition, by expanding or restricting access to the central bank credit and refinancing/rediscounting facilities, the credit expansion in the economy is influenced. But in some of the developing countries, political pressures have led to the use of this instrument to extend credit to commercial banks with inadequate reserves (such as state-owned banks) or to provide support to troubled financial firms. Reduction in central bank rediscount and credit is very effective as it curtails credit to the private sector through the banking system. The discount rate is generally high to discourage borrowing by the commercial banks which could offset the impact of open market operations.
After the Mexico debacle in December 1994, it became fashionable to argue in favor of a currency board. The suggestion is that the Mexico crisis of 1994 would not have occurred had Mexico introduced a currency board as in Argentina since April 1991. Under the currency board, the central bank would commit to a fixed exchange rate and to zero domestic credit expansion. In such a system, the central bank will not act as a lender of last resort to its domestic banks and as such will not be able to provide liquidity (change in net domestic assets would be zero) even if the domestic banks are faced with a depositor panic. If it does, the central bank's reputation is jeopardized and could exacerbate a financial crisis. For example, Argentina during early 1995 when faced with a bank panic, despite a balanced budget and zero inflation and with adequate international reserves at the central bank, was forced to seek the emergency financial help from the international financial institutions to support the domestic banks to the tune of about $11 billion dollars. Currency board also eliminates the flexibility of the nominal exchange rate and exchange rate devaluation or depreciation is not an option. For smaller and very open economies, such as the Eastern Caribbean States, Hong Kong and Lithuania, this is a good option for its ensures fiscal and monetary discipline.

**Financial sector policies**

Banks are intermediaries between savers and investors. With the deposits, banks create money through their loans. There is a close relationship between the real output sectors and the monetary sector. By regulating the financial markets (which includes banks, financial institutions, credit unions, stock market and so on), the monetary authorities try to maintain the solvency of deposit taking institutions and ensure the stability of the system. For this reason, the authorities establish requirements of capital and reserves and supervise the risk-taking of the banks by controlling the quality of loans and ensure certain set asides for the deteriorating loans, if any.

Developing countries rather than stabilizing the financial system expanded the role of this sector by state directed credit to promote industrialization, exports, and growth, and used the banking system to finance fiscal deficits by increasing reserve requirements and obligatory holdings of government debt and securities (to extract seignorage). The state also regulated interest rates to provide interest subsidies to favored industries and sectors and to keep domestic debt servicing costs low. When deposits are insured (through a state guaranteed scheme), banks have little or no incentive to be careful about their lending. These policies distorted the savings and investment behavior of the private sector and the performance of the financial system. As banks could not charge higher interest rates for more riskier projects, low risk and low profitable projects were financed in the past. As we can see in the graph below, financial deepening correlates positively with GDP per capita.
On the other hand, a move from these distortions and repression to financial liberalization during the 1980s by several developing countries had yielded mixed results. Lack of interest rate response of savings, the less than perfect nature of the financial markets, and inadequate supporting policies during and after such liberalization coupled with a large surge in capital inflows are the underlying causes of the financial crises of the 1990s.

Despite efforts to bring in internal competition, the financial markets by nature are imperfect because of the importance of inspiring confidence in the banking system with a few large banks operating along with several small ones. The fear of a collapse of a major bank or banks puts the owners of such institutions in a very privileged position vis-a-vis the public officials and the supervision and regulations of the financial institutions is therefore, never easy. The process is invariably secretive, intransparent to the Government and the masses, and involves some collusion and concentration of economic power in such oligopolistic markets. Private sector has misused banks and stock markets in several developing countries. It is also found that private savings are not sensitive to changes in real interest rates or inflation. As such, the investment has to be financed by external savings. Freeing up interest rates in an environment of high inflation, macro instability, and fiscal deficits due to large debt servicing costs leads to prohibitively high real interest rates. Financial openness at a time of high interest rates attracts capital inflows that could be destabilizing if not channeled for investment and would appreciate the real exchange rate. Such a phenomenon is occurring in several developing countries.
The mid-nineties financial crisis in Mexico and similar banking sector problems in Thailand, Argentina, Brazil, Bolivia, Colombia, Chile, Japan, Jamaica, and France among other countries, had made it clear that balance of payments crises are not only caused by external debt, current account deficits or fiscal deficits, but also by financial sector fragilities. A run on the banks could easily be translated into a run on the domestic currency. Commercial bank deposits are highly and positively associated with money demand. Thus a fall in money demand implies, other things remaining the same, a fall in the stock of bank loans and could have a negative impact on investment and growth. Commercial bank loans are usually the only source of funds for firms in most developing countries. Financial liberalization at a time of fiscal deficits and high domestic inflation brings in capital inflows and this when sterilized tends to increase domestic debt and raise domestic interest rates further, leading to more capital inflows. The financial sector growth in such conditions is divorced from the growth of the real economy Therefore, tight fiscal and monetary policies and flexible exchange rate policies are needed to ensure low inflation and macro stability, and could be conducive for financial liberalization. Since high costs of external and domestic debt servicing could be an underlying cause of fiscal deficits, financial sector reform is most likely to succeed with debt reduction strategies in place and with a mature stock market.
A country's exchange rate policy affects the overall level of domestic prices, the price of goods produced for the domestic market or non-tradables, and the goods which are traded with other countries or tradables. The economic structure of the country and the institutional capacity of the Central Bank and the financial markets, such as limited banks, are important factors in determining the exchange rate system and the exchange rate policy. Most developing countries rely on primary commodity production and exports, such as minerals and agricultural crops and depend on the external sector for imports, in particular for imports of intermediate goods and machinery, for foreign direct investment and private and official capital inflows. There are several approaches to determination of the exchange rate.

The absorption approach suggests that the excess of domestic absorption (i.e. gross domestic expenditure) over domestic income induces an increase in imports resulting in a deterioration of the external resource balance. To correct this situation exchange rate depreciation is needed. The monetary approach suggests that growth in domestic credit relative to changes in money demand will result in a decline in international reserves. This approach assumes that (i) nominal exchange rate is the relative price of two currencies of two countries and (ii) growth of money supply in the domestic economy will effect domestic prices and via the purchasing power parity (PPP) affects the exchange rate. Thus nominal devaluation will have no effect on the relative prices or on the real exchange rate. Since under PPP, domestic price level (P) is equal to nominal exchange rate (E) times the foreign price level (P*), devaluation will raise the domestic prices in a one-to-one effect.

The asset market approach is an extension of the monetary approach, and suggests that both the demand and supply of different currencies (viewed as assets) determine the exchange rate. Interest rates and expected movements in exchange rate affect the demand for a particular currency leading to changes in the exchange rate. The structural approach is of the view that changes in productivity and efficiency which affects unit costs, and the introduction or elimination of import tariffs or export subsidies, all have an effect on the exchange rate.

More and more developing countries have adopted floating or flexible exchange rate arrangements during the past fifteen years. This is because high domestic inflation made it necessary for continuing depreciation of the local currency to maintain international competitiveness and due to uncertainty on account of the fluctuations in major currencies since the mid-1980s. By changing the rate of the domestic currency, exchange rate actions impact upon the current account balance. A deterioration in current account position does not always imply that a devaluation or depreciation of the exchange rate can stem the deterioration. For example, domestic supply disruptions due to war or natural disaster would lead to balance of payments problems. Similarly, high external debt servicing due to a jump in international interest rates, as in early 1980s, or worsening terms of trade due to
an increase in import prices such as the oil shocks of the 1970s, may also lead to external imbalance. However, in the case of a decline in the export prices, say due to a recession in the Western countries, a country has the option of waiting out the cyclical downturn with the expectation that export prices would increase with recovery in the Western economies, or be proactive by devaluing the exchange rate to restore profitability to the export sector. The strongest case for devaluation exists when expansionary monetary and fiscal policies have resulted in excess aggregate demand and worsened the current account. Therefore, for the devaluation to work and for the current account to improve, there must be a reduction in aggregate spending in real terms and this may represent a cut in living standards of the people.

Flexible versus Fixed Exchange Rates

Flexible Rates
Countries can decide to allow their foreign exchange rates to increase or decrease, i.e. adopt flexible exchange rates. Exchange rates are nothing more than prices buyers face for purchasing foreign currency, similar to a price a buyer faces for purchasing a commodity like a car. Just like a car buyer can pay $20,000 for a car, he can pay $20,000 for 40,000 euros. Prices (rates) of currencies relative to other foreign currencies fluctuate according to their demand and supply relative to the demand and supply of other foreign currencies. For instance, if the United States government supplies many more dollars than the French government supplies Euro to the world economy, then there would be an increase in the relative supply of dollars and a decrease in the relative supply of Euro. Consequently, ceteris paribus (i.e. no other changes in say, demand), the price (value) of the dollar relative to the Euro would fall (called: depreciation) and the price of the Euro relative to the dollar would rise (appreciation).

An increase in relative demand can also cause the currency to fluctuate. Assuming other variables do not change, a relative (to the Euro) increase in demand for U.S. dollars (for example, because of an increase in demand for American goods) would increase the price (value) of the American dollar and would decrease the price of the Euro. The advantage of fluctuating exchange rates is that the rates always reflect the true value of the currency and create the most economically efficient (no long term shortages and surpluses) situation.

Fixed Rates
Some countries prefer to keep their currency value fixed relative to other foreign currencies. If two euros exchange for 1 dollar, then regardless of demand and supply forces, the countries choose to keep this exchange ratio constant. The advantage of this system is that businesses who engage in international trade and must frequently buy the foreign currency always know (and can therefore plan with more accuracy) what the currency values are and will be. The disadvantage is that surpluses and shortages of the currencies often occur because the relative demands and supplies of the currencies change. If for instance, many buyers demand euros, the market price of the mark goes up. However, the government fixed rate does not allow it to rise in actuality and as a result the euro is priced too low. This “cheap” price encourages many buyers to want to
buy euros, forcing the market price higher still. Eventually the demand can not be satisfied and more and severe shortages result (and surpluses of the dollar). Frequently in this situation the countries’ central banks intervene to try to "correct" the situation. The American and European central banks would purchase and dollars to try to raise the value of the pound and lower the value of the mark.

The banks have a limit as to how much foreign money they can purchase, however. When the pressures become too severe and unreasonable amounts need to be purchased to support a certain currency, a government can choose to devalue (lower the value) or revalue (raise the value) of its currency. Note that the devalued currency, which was purchased in large quantities by both central banks, is now worth less, and has caused both banks significant losses to their balance sheets.

The Balance of Payments
Countries trading with each other experience inflows and outflows of goods and services and accompanying flows of money used to pay for these goods and services. An accounting system, called the balance of payments, is kept to keep track of all of these flows. The balance consists of two major accounts, the current account and the capital account.

The Current Account
The current account is subdivided into four smaller accounts, the merchandise trade account, the services account, the investment income account, and the transfer payments account. The merchandise trade account includes imports and exports of tangible goods such as cars, computers, clothes, televisions, etc. If a country’s imports more than it exports in this category, then it is said to have a trade deficit.

The services account includes flows of payment in exchange for services countries provide to each other: transportation, insurance, banking, tourism, etc.

The investment income account reflects Americans’ investment earnings from foreign stocks, bonds, real estate, etc., minus foreigners’ investment earnings from American stocks, bonds, real estate, etc.

The fourth sub-account of the current account is the transfer payments account. This account includes gifts from American citizens to people living abroad or vice versa or payments (for example, a social security check) from the United States government to a person abroad (or from a foreign country’s government to an American citizen).

A negative balance on the current account means that the country is considered a “debtor nation.” The United States recently (mid 80s) turned into a debtor nation, primarily due to the fact that its merchandise trade (exports minus imports) account became negative.

The Capital Account
The capital account includes a variety of sub-accounts all dealing with purchases and sales of financial assets or real estate (stocks, bonds, land, buildings, businesses, etc.).
Additionally, a central bank’s trade in foreign exchange (German marks, French Euro, Brazilian reals, etc.) is also a flow of money which is reflected in the capital account.

The balance on the capital account is the sum of the changes in the above mentioned capital sub-accounts. This amount should equal the balance on the current account. However, if it does not, there is a statistical discrepancy, which given the size of the money flows and the difficulty in measuring the literally millions of international trade transactions, is sometimes a substantial number.

**Exchange rate and trade**

As we continue towards the next chapter on trade, experience of developing countries with exchange rate actions suggest that exports are significantly responsive to exchange rate changes. But, export diversification is only possible in the medium to longer term when exchange rate changes are accompanied by trade liberalization and favorable external environment, including financial support. The effectiveness of exchange rate actions on import substitution has been limited because a large share of imports are often tied to aid. Countries that followed expansionary domestic credit policies and large fiscal deficits after nominal devaluation found that there is a high erosion of the effect of devaluation.

Reform programs crucially depend on an external debt and borrowing strategy, especially after the debt crises of the 1980s. External borrowing supplements domestic savings and should therefore consider not only the stabilization and growth objectives of the country but also the rate of return of projects that these borrowings would be used for. One principle of debt management is that the growth rate of GDP would increase only if the marginal product of capital for which these funds are borrowed should exceed the interest rate applicable on these borrowings. Ability to service the debt through foreign exchange earned from exports of goods and services should be assessed. Other rules of thumb include limiting the external debt service to exports ratio of no more than say 20%. The domestic and external borrowing should be consistent with stabilization objectives and not increase aggregate demand or lead to external imbalance. The external borrowing should be consistent with the requirements and the capacity to implement the government’s public investment program. In addition, there is a need to manage the level and composition of both domestic and external debt, monitor the debt service profiles in terms of maturities, interest rate, currency composition, and risk management and also because of its implications on the budget and/or foreign exchange availability. Highly indebted countries need to have a debt and debt service reduction strategy that the external agencies could support. These would involve an economic reform program that external agencies could support with debt forgiveness, swaps, reschedulings, concessional financing and so on.

Several econometric studies dealing with the external debt overhang of the developing countries, especially the middle-income highly indebted countries and the low-income African countries, have found that investment is negatively correlated with external debt indicatros. High levels of both domestic and external debt impedes investment and policy reform, since investors fear that prospective returns could be taxed away the governments to repay creditors. However, Brady type operations for some middle-income countries such as Mexico have benefitted as indicated by the economic performance
immediately after the Brady plan was in effect. But, external debt and debt service reduction programs have to be preceded by a period of strong economic policy reforms. Otherwise, the uncertainty about governments credibility would continue to hamper private investment.
CHAPTER 10. TRADE POLICY AND THE POOR

International trade refers to the exchange of goods and services among countries. In any given economy it is not possible to produce all the goods that are required by the local consumers. It therefore becomes necessary to buy from other countries in order to satisfy needs of the local consumers.

The exchange takes place because of differences in costs of production between countries, and because it increases the economic welfare of each country by widening the variety of goods and services available for consumption. Differences in cost of production exist because countries are differently endowed with resources required. Normally, nations will sell products, which they produce cheaply and import those products, which are expensive to produce in their own countries. For example, Swaziland is able to produce sugar and also sell to other countries whose climates are not conducive for the growing of sugar cane. International trade can be used positively in a country to complement domestic production.

In agriculture for example, if the weather and other conditions are favourable there may even be surpluses in production, which can then be traded as exports with other countries. Proceeds obtained from export revenue can be used to finance a variety of social services thus increasing the choices available to poor sections of the economy. However trade, and especially trade of agricultural products, is controlled though the use of trade barriers such as quotas, tariffs or stringent regulations relating to health or safety standards. Trade barriers refer to any government limitation on the free international exchange of goods and services.

In the past, several developing countries following on the socialist path of self-reliance closed their economies to international trade. Quantitative restrictions, licensing requirements, and prohibitive tariffs kept import out of the domestic market. An overvalued exchange rate also made supported such policies. Open trade promotes competition in domestic markets, increases pressure on firms to be competitive and innovative, provides consumers with a wider choice and possibly at lower prices and allows firms to bring in new skills and technologies to fully exploit the comparative advantage.

Experience with trade liberalization suggests that attainment of complete free trade has to be phased in a realistic time table. Initially, elimination of trade bias through a realistic exchange rate and reduction in impediments to exports through elimination of quantitative restrictions on exports and imported inputs, and later move towards low, nondiscriminatory and transparent protection levels is more realistic and this could enhance growth prospects and improve balance of payments position in the medium term. There is a need to move from quantitative restrictions on imports, especially on non-competitive imports, through simplification/tariffication and later to low and uniform tariffs. Such a phased reduction will ensure that government revenues are not sharply reduced. It is observed that most developing countries have liberalized trade in conjunction with the global changes brought about by the Uruguay Round of trade negotiations. It may be preferable for smaller
economies to move towards hemispheric and regional trade integration. The potential gains from trade are substantial and trade has been an engine of growth for some developing countries, such as the East Asian countries, Sri Lanka, Mauritius, Eastern Caribbean states and so on.

**BOX 1**

*Trade and Inequality*

There is no evidence that trade openness—defined as the ratio of trade to GDP is associated with less or more income inequality (World Bank, 2003). At the same time, it is extremely difficult to ascertain whether trade reforms which may result in a net absolute benefit to the poor, will also result in the poor receiving a larger share of total income. Hard as it is to link trade reform to poverty reduction, it is even harder to determine the effect of trade reform on the overall distribution of income. There is evidence that trade liberalization in some cases, particularly in Latin America, has resulted in increased disparities in wages; and that while trade liberalization may benefit the poor, it benefits higher income groups even more. But overall distribution of income tends to change little over time and is affected by a variety of factors, including most importantly distribution of such assets as land. Nevertheless, it may be important from the social perspective to have some idea, however rough, if a specific set of trade reforms would tend to benefit primarily the non-poor, leaving the poor essentially unaffected, or marginally better off. If such an outcome appears likely, governments may wish to strengthen other policies and programs that are targeted to the poor so as to prevent a worsening of the overall income distribution.

Trade imbalances, when evaluated in terms of their momentary effects and their long-term economic consequences, can be either good, bad or immaterial, depending on the circumstances. Trade deficits may signal excessive borrowing which could in the future lead to possible default, or even worse, an excessive reduction in living standards needed to repay the accumulated debt. In this case the trade deficit is clearly bad for the nation. Alternatively, trade deficits may represent a country that is merely drawing down previously accumulated foreign savings or selling other productive assets, in which case, there is no potential for default or reduced living standards in the future. Here the trade deficit is either immaterial or even beneficial in that the nation is able to achieve a higher current living standard because of the deficit. Trade deficits might also make possible an expansion of domestic investment which could spur future economic growth sufficiently to make repayment consistent with growing living standards. In this case, trade deficits are clearly good as they stimulate future economic prosperity. Finally, in a free market economy, trade deficits may simply reflect the aggregated choices of numerous individuals to forgo future consumption in order to achieve more current consumption. In this case the trade deficit should be viewed as immaterial since it merely reflects the free choices of the nation's people.

On the other hand, a trade surplus may correspond to prudent foreign saving and purchases of foreign productive assets which may be used to support a growing retired population in the future. In this case the trade surplus is a good thing for the nation. The
Trade surplus might also represent a period of repayment of past debt. This outcome may be acceptable if achieved together with growing living standards. However, if the surplus arises in a period of slow growth or falling GDP, then the surplus would correspond to painful reductions in living standards, which is clearly a bad outcome for the country. Finally, the trade surplus may occur as a result of the aggregated choices of numerous individuals who have acquired greater past consumption by forgoing current consumption. In this case, the surplus should be viewed as immaterial to the nation as a whole.

**Understanding the Impact of Trade Policies on Growth**

Measuring the contribution of inputs to output growth is known as 'growth accounting'. GDP or output growth can be decomposed into growth of inputs (physical capital, land, labor or human capital). But invariably, the growth in output far exceeds the growth in all inputs; so there is an 'unexplained' remainder (residual) which economists attribute to growth in total factor productivity (TFP). TFP growth is interpreted as a measure of joint effectiveness of all inputs which were combined to produce output. The contribution of an input, say capital, is equal to the rate of growth of that input multiplied by that input’s share in GDP (output). Thus, the contribution of all inputs combined equals a weighted average (which is given by share of inputs in GDP) of the growth rate of inputs. As more and more units of inputs are accumulated, because of diminishing returns to scale, the inputs contributions to growth may become less and less.

While inputs explain about 50 per cent of growth variation across countries, TFP explains a lot more variation -- for example, higher TFP during 1960-85 explained much of the variation in per capita incomes across countries in 1990. Growth accounting does not mean that it reveals the causes of GDP growth in a country. For example, in the absence of productivity improvements no capital accumulation may have taken place. It is technological changes that improve productivity and facilitate increasing returns to scale and contribute to overall growth.

A proxy indicator for TFP or technological use is the stock of knowledge (which is each firm’s knowledge on their productive processes, accounting and financial practices, large and small innovations and inventions, adaptation and adoption of new technologies (e.g. computers), job training, skills building, spending on research and development etc). Some of the TFP may be attributed to human capital (education, job training).

One mode of technological changes in through interaction between countries. Interdependence among countries is increasing through flows of knowledge (e.g. spillovers from learning by doing), through terms of trade, through gains from research and development, primarily from industrial countries to developing countries (which includes new range of products, such as newer toys, batteries, etc but also stock of knowledge).

**Trade Policies, Growth and Poverty Reduction**
Smaller countries are likely to avoid the curse of diminishing returns than larger countries. For example, say Mauritius during earlier decades specialized in production of garments, which has low capital to labor ratio. It begins investment in garment-making machinery to increase garment production. But at some stage, as diminishing returns set in and each additional unit of machinery gives less and less unit of garments (yielding lower and lower income from garments), the country moves to tea or toy manufacturing as well as garment production because it is more profitable to do both. International Trade theory suggests that Mauritius will produce garments and tea or toys if and only if the capital to labor ratio of the country is between the capital-labor ratio used in these two industries. This argument can be expanded for many sectors and together with the fact that small countries do not affect the international price of that product (garments) explains why smaller countries can grow faster. On the other hand, larger countries such as China are prone to the curse of diminishing returns – as it expands its supply of products (say manufactured goods such as toys) it depresses the world/producer prices of those products on world markets. The value of output decreases and exacerbates the diminishing returns to input accumulation.

Recent evidence indicates that a one percent increase in trade (volume of exports plus imports) is likely to increase per capita income by about 2 percent through transmission channels of capital deepening, education, and TFP, with TFP having the largest impact. Also, among countries with similar degrees of trade openness, larger countries are likely to have higher income per capita (due to economies of scale effect) while smaller countries gain more in terms of market size, having a larger impact on their per capita income.

Trade volumes across countries depend on endowments, technologies, preferences, market structures and the interaction between these factors. Even if all countries engaged in free trade, trade volumes differ among countries, but correlations between trade volumes and growth rates is not fully explained by trade volumes. India, China and several countries followed restrictive trade practices (had lower trade volumes) until early 1980s and still managed to grow, while many African countries were much more open to trade and did not benefit in terms of growth.

There is no simple relationship between trade policies and income growth. For example, cross country evidence on the impact of trade policies on income growth is mixed. Openness (measured in terms of policy as in the Sachs-Warner, 1995, where average tariff rate, non-tariff barriers, black market exchange rate premium, absence of a socialist economic system and absence of an extractive state monopoly on major exports; and when it is measured as an outcome in terms of the ratio of exports plus imports to GDP) shows a strong correlation with higher incomes but there are several other studies that show a negative relationship between tariff reductions and income growth.

Also, trade policies are not truly exogenous and often complementary to other economic policies and cannot be represented by one variable or index. There is some evidence that trade policies impact on growth through the quality of macroeconomic policies, size of government, price distortions, factor accumulation, technological transmission and
foreign direct investment. Within-country inequality has changed little while between country globalization has risen during 1950-80, so globalization induced changes are small or negligible.

There is a growing recognition that trade liberalization could hurt the poorest segment of the society, who have fewer assets to draw on to protect themselves during harder times. Even a temporary loss in income is likely to throw the poor off and they tend to pull their children away from school or lose opportunities for health care and thereby bring them back into the vicious cycle of poverty.

Trade reform can affect the welfare of the poor by

(i) lowering the price of imports (e.g. basic foods, pharmaceuticals), keeping the prices of substitutes for imported goods low, thereby making them affordable to the poor, and opening to new technologies such as packaging perishable goods or improved seeds and fertilizers. The poor would also benefit if export taxes (e.g. on agricultural products that are generally produced by the poor) are removed

(ii) changing the relative wages of skilled and unskilled labor and the cost of capital, thereby impacting upon employment of the poor; if firms are constrained by labor regulations from reducing the workforce then most of the adjustment to changes in relative prices of outputs will result in changes in real wages. If minimum wage regulations restrict downward adjustment of wages then employment would be affected. In the informal sector (where businesses are not registered with governments) it is usually employment that is reduced. If high-tariffs are geared to protect, say agriculture and light manufacturing, then the workers of these sectors would be affected should the tariffs be lowered during liberalization

(iii) affecting government revenue from trade taxes as they are reduced and in an effort to balance the budgets the governments may cut social spending or introduce new taxes that could disproportionately impact upon the poor; however, lowering tariffs and non-tariff barriers is likely to increase transparency and simplify the tax and customs administration and reduce illegal trade and corruption at the customs, thereby increasing government revenues.

(iv) affecting economic growth – in the short term by removing export bias and in the long term by creating incentives and investment with openness attracting foreign direct investment; but the relationship between trade liberalization and growth is not very straightforward – it also needs complementary macroeconomic and structural policies such as removal of exchange rate controls and maintaining competitive exchange rate and roads to move exportables from the rural areas to the markets and ports

(v) affecting the vulnerability of an economy as it opens to external shocks such as abrupt changes in terms.
Different sectors could be liberalized at different speeds – where the poor are predominantly involved (say Maize in Mexico, cotton in Mali, etc) the phasing of reforms could be slower if the analysis indicates that liberalization is likely to reduce the producer prices for such commodities. Even a well-designed trade reforms creates winners and losers and transitory safety nets should be in place to mitigate the impact on the losers. Social infrastructure is an average of two components – government anti-diversion policies as estimated by Political Risk Services (a private firm) which takes into account law and order, bureaucratic quality, corruption, risk of expropriation, and government repudiation of contracts, and the fraction of years during 1950-94 that the country was open according to the Sachs-Warner measure of policy openness. The finding is that social infrastructure is very significant in explaining output per worker.

Globalization, Trade and Financial Liberalization

From time immemorial, economists argue for trade openness as one of the main tools for poverty reduction. Adam Smith recommended the repeal of the 1814 corn laws because they created unnecessary hardship for the Britons by causing the cost of food to increase and depressing consumption the market for manufactures, only to protect national agricultural production. After two centuries, agricultural export commodities are still subject to protectionist measures, with detrimental effects on the lives of those people in developing countries who earn their livelihoods from farming. Developed countries subsidize those agricultural products, which could be more efficiently produced by developing countries and thereby impair their ability to compete on world markets. In addition, they also encourage surpluses that depress international prices, thus lowering farmers’ revenues.

Among the most utilized trade-distorting measures, developed countries employ various forms of farm support, tariffs on farm products, export subsidies and industrial tariffs (for instance in the protection of textiles). In 2001, total support to agriculture in OECD countries was about $311 billion ($850 million/day) which equal six times the amount of total Official Development Assistance.

Basic economic models suggest that trade can benefit the majority of world citizens, because it allows each country to specialize in the production of the good where it enjoys a comparative advantage and export it while importing goods that other countries can produce at a lower cost. Data confirm that developing countries enjoy comparative advantages in many sectors including primary commodities.

For instance, the group known as West Africa 4 (Benin, Mali, Burkina Faso, Chad) can produce high quality cotton at the lowest cost in the world (around 50 ¢/lb). In spite of this, this group of countries is only the 3rd largest world producer, far behind the US (world’s biggest producer ), where the sector is heavily subsidized. This leads to paradoxical results: because of cotton subsidies, that cost the US up to US$ 4 Billion, Mali alone loses yearly US$43 million in Cotton earnings, but still receives US$ 37
Million in US Aid. As the production of cotton supports 10 million people in West African countries but only 25,000 farmers in the US, protectionist policies seriously impair poverty reduction strategies by depriving farmers in developing countries of their livelihood.

The potential benefits of agricultural liberalization are estimated by the World Bank at US$140 billion annually (Reaching the Rural Poor 2003). 60% of the estimated gains will go to developing countries and by 2015, agricultural trade liberalization would reduce the number of poor by 144 million. The collapse of the Doha round, which was exactly meant to integrate agriculture into the World Trade Organization (WTO) framework in order to eliminate unfair trade barriers and provide for a dispute resolution framework, has been a major setback. It is therefore of utmost importance for international organizations and NGOs in developing countries to advocate for trade liberalization by integrating agriculture under the multilateral trade rules of the WTO.

The potential benefits of what trade liberalization would imply are also confirmed by the positive experience in manufacturing. Trade liberalization has caused low income countries such as Bangladesh, China, Sri Lanka, India, Turkey, Morocco, Indonesia to have more than 80% share of manufacturing compared to only 20% in the 80’s. The slashing of tariffs goes a long way in explaining this success. The advances in technology, especially in transport and communications, also made it easier for LDC to impose their comparative advantage in manufacturing over industrialized economies.

This does not mean however that agricultural liberalization will automatically benefit all developing countries. A series of preparatory reforms are needed to ripe the full benefits of liberalization. Developing countries must implement policies stimulating agricultural exports, facilitate the formation of markets and avoiding to distort markets by introduction of price regulation. Moreover, some developing countries need to get rid of protectionist measures in the food sector themselves.

Another look on globalization

Globalization, defined as the increasingly free flow of ideas, people, goods, services, and capital that leads to the integration of economies and societies, has become a major force for global change, but much remains to be understood about the transmission channels and potential impacts. The developing countries commonly complain that the global system is a ‘creditor-run trade and financial system’ and as such, maintaining the stability of the trading and financial systems is more important for the advanced countries than the developing world. As interdependence between the developed (North) and developing countries (South) becomes greater, the economic policies of the North will probably become more and more important for the South.

More than merely the expansion of worldwide trade, globalization is based on improvements in the last two to three decades in telecommunications and information technology, and financial sector reform that has opened domestic markets to foreign investors, especially in services, and the differences between local and international
markets is blurred. These developments are impacting upon the structures of employment. Women's employment and income earning prospects must now take account of the globalization. For example, some developing countries which exported a rising proportion of their manufactured output to the developed countries tended to employ a rising proportion of females in their manufacturing sectors. In a series of articles Guy Standing details several aspects of globalization that have affected labor conditions and use of modern technologies, with direct consequences for male-female work patterns and labor regulations (Standing 1999).

**Financial Integration**

According to conventional economic theory the flow of capital takes place from the low-interest rate Northern countries to the high-interest rate emerging markets, and this is beneficial to both. While it is generally true, that emerging markets run larger current account deficits, which are financed by net capital inflows, in periods of crises, the inflows are cut off. For example, Asian countries had to switch from current account deficits to surpluses during 1997-99. Calvo et al (1993) were the first to warn about the reversal of external factors leading to capital outflows, two years before the Mexican crisis. Another example is that of the boom in investment in the new economy during the 1990s in the United States which led to large current account deficits of USA, which was far larger than those of all developing countries combined, thereby making less capital available for developing countries.

![International Financial Integration Diagram]

Apart from domestic policies (such as stock market liberalizations, privatization of state owned enterprises) that stimulate foreign inflows, the growing importance of depositary receipts and cross-listings and the emergence of institutional investors is driving capital
flows to emerging markets. For example, foreign owner restrictions have decreased dramatically in Asia (over 60%) and Latin America (over 70%) during the 1990s. Mergers and acquisitions resulting from privatization and easing of restrictions on foreign participation in banks in the emerging markets were an important factor in FDI flows. Institutional investors in the advanced countries, such as mutual funds, pension funds, hedge funds, and insurance companies have also become an important conduit for capital flows.

**North-South capital flows.** As shown in Chart 1, net flows to emerging markets during 1970-99 were, not surprisingly, considerably larger in real terms when the United States was in expansion than when it was in recession. This gap stems primarily from a surge in foreign direct investment (FDI) flows (which go up nearly threefold from recession to expansion) and in portfolio investment flows (which go up almost fivefold from recession to expansion).

![Chart 1](chart_url)

**Chart 1**

*How U.S. business cycles affect real capital flows to emerging market economies*

*Source: Authors' calculations using IMF, World Economic Outlook, October 2000 (Washington: International Monetary Fund). Note: Figures on top of each vertical bar show net private capital flows.*

The key offsetting category is other net inflows—mainly bank lending—which dried up when the United States was expanding. Apparently, banks tended to seek more lending opportunities (often short-term ones) abroad when the domestic demand for loans weakened and interest rates fell, as often happens during recessions. Demand for loans from industrial countries presumably picks up as well when FDI dries up. The U.S. bank lending boom to Latin America in the late 1970s and early 1980s and the surge in Japanese bank lending to emerging Asia in the mid-1990s are two examples of the cyclicality of other net inflows. Although a U.S. recession may not be all bad news for capital flows to emerging markets, those flows consist principally of less stable short-term financing rather than more stable FDI.
In years when U.S. monetary policy was easing, developing countries in all regions (with the exception of Africa, which was almost entirely shut out of international capital markets) received a markedly higher volume of capital inflows. Although FDI and portfolio investment flows do not change much during the interest rate cycle, other (short-term) flows fluctuate considerably during it.

**Volatility in exchange rates and interest rates.** Because there are multiple channels of influence from the North to the South working through capital markets, the net benefit of buying exchange rate stability at the cost of interest rate variability is an open question for empirical investigation. Chart 2 reports the results of thirty-year data on real capital flows according to whether G-3 real exchange rates were more (or less) volatile than the median experience and whether the U.S. real short-term interest rates were more (or less) volatile than the median.

In chart 2, first pair of bars indicate that the annual capital flows averaged about the same when G-3 exchange rates were volatile compared with when they were stable. However, exchange rate volatility apparently was associated with a move away from portfolio investment and toward direct investment. In contrast, when U.S. short-term interest rates fluctuated more than average the impact on various capital flows has been significant. Over the past thirty years, capital flows have been higher when interest rates have changed more. This is because of larger net portfolio and other capital flows, predominantly bank flows. On the other hand, private direct investment apparently suffered from interest rate volatility.

Generally FDI in developing countries is primarily in capital intensive oil, natural gas, mining activities (as in African countries and oil-exporting countries). These generate
few jobs, primarily for men. So from a women’s perspective FDI in capital intensive natural resource intensive companies is not beneficial.

**Trade and Financial Linkages between countries**

It may be useful to quickly review the transmission channels and the asymmetry and complexity of trade and financial relations between the developed and developing countries. To wit, a slowdown in developed countries (particularly G-7 countries) is normally associated with a reduction in export volumes from developing countries, a deterioration in terms of trade, and a slowdown in aid flows to most developing countries (see Table 1 below). An economic downturn in the North coincides with a weakening in South’s trade and current account balances. In addition, agricultural subsidies and protectionist policies distort trade. For example, in the high-income countries, subsidies of various sorts account for nearly one-third of agriculture revenue. Most of these subsidies are provided through mechanisms that artificially boost production and undercut the market for farmers in developing countries. For example, U.S. subsidies to cotton growers totaled $3.9 billion last year, three times U.S. foreign aid to Africa. This depresses world cotton prices, cutting the income of poor farmers in West Africa, Central and South Asia, and poor countries around the world. The same is true for E.U. sugar subsidies. While aid from developed to developing countries approximated at 75 billion per year, in comparison agricultural subsidies in developed countries amounted to $350 billion. Protection in industrial countries is costing $150 billion for poor farmers and implementing WTO agreements is costing $130 million for the developing world. There are some of the main reasons for slow progress in multilateral trade talks.

<table>
<thead>
<tr>
<th>Table 1 : North-South Linkages</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type of policy/shock</strong></td>
</tr>
<tr>
<td><strong>Growth Cycle: Recessions in G-3</strong></td>
</tr>
<tr>
<td>Income effects</td>
</tr>
<tr>
<td>Relative price effects</td>
</tr>
<tr>
<td>Import barriers (e.g. steel, textiles, restrictions against outsourcing)</td>
</tr>
<tr>
<td>Agri. Subsidies</td>
</tr>
<tr>
<td>Aid flows</td>
</tr>
<tr>
<td>Intl capital flows</td>
</tr>
</tbody>
</table>
Restrictions against labor tightened immigration in the North remittances? lower

**Interest rate cycle**
Easy monetary policy – lower interest rates in G-3

<table>
<thead>
<tr>
<th>Intl capital flows</th>
<th>higher portfolio flows to EMs</th>
<th>higher growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt servicing</td>
<td>lower cost</td>
<td>higher growth</td>
</tr>
<tr>
<td>Interest earnings</td>
<td>declining interest income</td>
<td>ambiguous?</td>
</tr>
</tbody>
</table>

**High volatility in G-3**

<table>
<thead>
<tr>
<th>Interest rates</th>
<th>complicates debt management in EMs</th>
<th>ambiguous</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uncertainty</td>
<td>tends to reduce investment</td>
<td>lower</td>
</tr>
</tbody>
</table>

| Bilateral exchange rate | reduces trade between North and South | lower growth |

Source: Chapter 2 of World Economic Outlook (2001); Reinhart and Reinhart (2001)

**Concluding Remarks on globalization**

From an economic point of view, globalization indicates the increasing global economic integration as exemplifies by international flows of Goods (Trade), People (Migration) Capital (FDI etc.) and Technology. Although sluggishly, trade and financial liberalizations have progressed significantly in the last decades. Since 1980, many developing countries have broken into world markets for manufacturing and services seeing their market shares in manufactures rise from 25% in 1980 to more than 80% in 2002. Likewise FDI flows have intensified. However, some developing countries, mostly in Africa, have become increasingly marginalized in the globalization process.

Growth may depend on much more than simple openness. There may be virtuous circle effects given by agglomeration and location in the same area, but also market size effects arising from high population density (ie demand). Those countries which are landlocked and suffer from infrastructure deficiency may therefore be in a permanent state of disadvantage.

Moreover, there seems to be no evidence that globalization is an equalizing force. For OECD and LDC globalizers as a whole, inequality has gone down between countries World Bank (2002). However, within countries, results are mixed and opinions diverge inequality has generally increased, particularly in China, which started with even base (Clark, Dollar, and Kraay, 2001) and other low-income countries (Ravallion, 2003). In general, there seems to be no positive relationship between change in openness and income equalization within countries (Dollar and Kraary, 2001).
Yet, when combined with existing growth, globalization understood as openness has reduced absolute poverty. From 1993 to 1998, there has been a 14% decline in absolute poverty (to 762 million), which can be quantified at 100 million from 1980 to 1992 (Bourguignon and Morrisson, 2001) and another 100 million from 1993 to 1998 (Chen and Ravallion, 2001). It therefore seem that globalization benefits countries which have already started growing and where people have already acquired some sort of skills (unskilled labor loses from globalization)

Exaggerated claims that globalization is unequivocally good distorts reality. What works for one country may not work for all. Overall, trade and financial openness may contribute to poverty reduction, but they are no panacea for poverty reduction. That is why they need to be implemented with complementary policies creating the underlying conditions for growth to happen.

Annex on Trade theory and policy

Rationale for trade: gains from trade

Trade is motivated by expectations of gain from countries. By engaging in trade, most countries expect to increase incomes for their producers and reduce costs of goods for their citizens. The global value of income and output is maximized if opportunity costs of producing everything in each country are minimized. Trade, therefore makes varied contributions to different sectors of the economy, such as being

➢ A source of revenue for government – licenses; and trade taxes
  Governments benefit directly from increased trade within their borders. Traders procure trading licenses from governments for which they pay taxes. Different countries also impose various trade taxes which will be discussed in more detail later in this chapter.

➢ A source of foreign exchange
  Through exports, trade also is a source of foreign exchange, which is of particular importance to developing countries.

➢ Exchange of goods and services
  Imports and exports represent the exchange of goods and services, which can also encourage better relationships with other countries. It has been suggested that countries that trade with each other are more likely to seek a peaceful solution for conflicts because the costs of a war to trade act as a deterrent.

➢ A source of livelihood for traders
  Whole communities are dependent on trade for a livelihood. From producers to retailers, to importers and exporters, trade is often the only source of revenue that enables people to make a living. Efficient trading patterns permit people everywhere to enjoy higher living standards.
The Theory of Absolute Advantage
The definition of the theory of absolute advantage asserts that nations gain by producing goods that require fewer domestic resources and exchanging their surplus for goods produced abroad with fewer resources. Therefore, absolute advantage emerges from differences in the abilities of individuals and nations to produce goods from given resources. Each country can benefit from specialized production, thus leading to trade. However, the theory is incomplete since it ignores the gains available through trade even when one party has the absolute advantage in the production of all goods, which leads to the theory of comparative advantage.

The Theory of Comparative Advantage
The definition of comparative advantage states that mutually beneficial trade is always possible between nations whose pre-trade relative costs and prices differ. The terms of trade refer to prices of exported goods relative to those of imported goods. The theory of comparative advantage justifies international trade as an instrument of growth that would benefit participating countries. It is the result of the exploration of benefits to two countries arising from trade. The theory basically advocates for specialization in production of goods and services by countries, based on comparative advantage. If trading countries concentrated on producing products in which they have a relative comparative advantage, they would all benefit and world output of goods and services would be maximized. Differences in endowment in natural resources, human resources and capital gives rise to comparative advantage. Even if a country has relative comparative advantage in producing several products, specialization would benefit that country more than if the country engaged in producing several commodities.

Characteristics of the Theory
- The theory of comparative advantage assumes free trade across countries. It assumes access by participating countries to markets of member countries.
- The theory assumes fair trade among countries.
- Policies can be trade-creating, such as outward-oriented policies which encourage production for export.
- Policies can also be trade diverting. This is when policies are inward oriented and do not encourage production for export.

Gains from trade
Most gains from trade are distributed between producers of exports and consumers of imports. They are realized internationally because of:

Specialization
Specialization gains arise from producing and selling goods in which a country enjoys a comparative advantage and buying other goods from countries that can produce them at a lower cost. Access to export markets thus increases the value of goods produced by people who are also able to buy goods at lower opportunity costs than if they relied solely on domestic production.
Uniqueness gains
In some regions, local sources of certain goods do not exist. Technology may also differ in countries, affecting the country’s capacity to exploit a resource. Uniqueness gains would thus arise from trading for goods that are not locally available.

Gains from Scale
In gains from scale, specialization is limited by the size of the market, therefore moving into the international market facilitates specialization, thus permitting expanded production. Gains from scale occur when access to export markets stimulates production of larger amounts of goods at lower average costs.

Gains from Trade
These are the long run, dynamic gains which occur when trade accelerates economic growth and development. These improvements can occur in cases where
- Trade spreads technology
- Higher income from trade accelerates capital formation
- Entrepreneurs are stimulated to innovate by profit opportunities in export markets.

International Political Stability
Political gains from trade arise when economic interdependency facilitates international political stability. Mutually beneficial trade is a powerful incentive for countries to avoid conflict by engaging in peaceful negotiations. The interdependency created by trade reduces the likelihood of war because the higher costs in economic terms reduce amounts demanded for any activity.

Free Trade
It is widely believed that free trade would maximize the value of the world’s production. However, it is still not used as widely as it should be, since countries have erected various barriers for a variety of reasons. Some countries use barriers to trade as a method of raising revenue, especially for states that have limited sources of revenue because of a narrow tax base. Trade barriers may also be attractive because they protect domestic industries, which may create a powerful political constituency, capable of lobbying effectively to protect their own interests. Some countries also prefer not to be dependent on other countries, as happens through trade, believing this will protect their sovereignty. Therefore the erection of trade barriers can be a rational response by countries to prevailing circumstances.

Trade barriers: tariff and non-tariff
Countries have a variety of reasons for creating barriers to trade. Two types of barriers are most commonly used: tariffs and non-tariff barriers.
**Tariffs**
A tariff is an excise tax that applies only to internationally traded goods. Its purpose is either revenue collection or protection of domestic firms. Protective tariffs put foreign producers at a competitive disadvantage when selling in local markets. Tariffs raise domestic prices of goods, thus stimulating domestic production. But when the tariff is very high, it becomes a disincentive to trade. High tariff could divert trade away from the country to other countries. Low tariffs could encourage trade, but at the cost of lower revenue for the state. Unlike non-tariff barriers, tariffs are usually transparent; they are of known magnitude.

**Quotas**
Quotas limit the amount of goods that may be imported or exported. They raise the price of imported goods so that potential gains from trade are not fully realized. A product might be imported in high quantities despite high tariffs if the demand exists but low import quotas completely prohibit imports once quotas have been filled. They have particularly pernicious side effects since profits from import licenses increase the potential for bribery and corruption in a country.

**Non-tariff barriers - key issues**
Non-tariff barriers are used to restrict imports into a country. could be licensing requirements, unreasonable standards pertaining to product quality and safety or unnecessary bureaucratic red tape which is used to restrict imports. Cumbersome documentation or administrative bottlenecks designed to discourage the potential imports also constitute non-tariff barriers. Recently the growing concern about the environment has led to countries introducing environmental requirements which in some instances may constitute non-tariff barriers.

**Voluntary Export Restrictions**
Voluntary export restrictions are trade barriers by which foreign firms “voluntarily” limit the amount of their exports to a particular country. VERs, having the effect of quotas are agreed to by exporters in the hope of avoiding more stringent trade barriers.

**Import Substitution**
For about 30 years after World War 2, trade policies in many developing countries were strongly influenced by the belief that the key to economic development was creating a strong manufacturing sector, best achieved by protecting domestic manufacturers from international competition.

**Infant Industry Argument**
According to the infant industry argument, developing countries have a potential comparative advantage in manufacturing, but new manufacturing industries in developing countries initially cannot cope with well-established manufacturing in developed countries. To allow manufacturing to develop, governments should temporarily support
new industries until they are strong enough to compete internationally. Tariffs and import quotas are used as temporary protective measures.

The argument for protecting an industry in its early growth must be related to a particular set of market failures that prevent private markets from developing the industry as rapidly as they should. Countries that have used protection as a method for developing their infant industries have usually found the method to be inefficient. In the case of Pakistan, which protected the heavy manufacturing sector, light manufacturing was the sector that grew to develop significant impact in the export market. Therefore the protection was actually a net cost to the economy, instead of the success they were expecting.

Export-oriented growth
From the 1960s, it conventional wisdom among developing countries became that exports of manufactured goods to advanced countries was a path to industrialization to be followed. Some countries in East Asia, most notably Japan and Singapore pursued this path to growth and today have joined the ranks of developed nations. However, on further consideration, other factors that contributed to the rapid economic development of these countries have become apparent, such as high savings rates, rapidly improving public education and openness to trade.

Annex on Gender and Trade

Impact of Trade Integration
The primary focus of this annex is whether or not trade in goods and services and financial flows across countries improves prospects for women’s employment and promote greater gender equality in wages? We know from trade theory that by opening up to trade, firms, industries and countries compete with rest of the world. By this process of competition, trade creation and diversion occurs to enhance people’s welfare in trading partners.

In other words, trade expands some activities and destroys or diminishes others. As a result of this, some firms/industries trading in new items may spring up while other firms/industries that cannot compete may phase out. If an individual works in an expanding sector or is able to switch to one, she or he is likely to benefit. Evidence shows that trade tends to increase the availability of paid jobs for women, particularly in export sectors. But certain factors, such as discrimination, lower skills, and gender inequalities in access to resources, may impede women’s ability to benefit from trade expansion.

Does trade create jobs for women?
Trade expansion appears to occur in labor-intensive exports from developing countries to developed countries, especially in women-dominated manufacturing of garments, shoes, jewelry, and electronics. Sometimes child labor is also in use in these sectors, which have witnessed significant gains in female employment. A study of 35 developing
countries found a strong positive correlation between the female intensity of manufacturing (the number of female workers per 100 male workers) and export growth (Wood 1991). In most of these countries, the female intensity of manufacturing increased between the early 1960s and mid-1980s. In some countries it increased dramatically—for example, by nearly five times. Egypt, Mauritius, Bangladesh, India, Madagascar are some examples of countries that benefited from such trade. In Bangladesh, about 2 million jobs had been created in the garment industry by 1998, of which two-thirds were held by women (Paul-Mazumdar and Begum 2000). In Madagascar, women accounted for three-quarters of the country's nearly 140,000 textile and apparel workers in 1999 (Nicita and Razzaz 2003).

Women employed in export-oriented manufacturing typically earn more than they would have in traditional sectors. Many of these women had never earned cash income before. In the above-mentioned study of Madagascar, 85 percent of the women who found new employment in the textile sector had never directly received any monetary income, compared with 15 percent of new male entrants. Women also experience other benefits when they earn cash income. For example, a study that followed 50 rural families in Mexico for 20 years found that a significant proportion of the women reported an improvement in their “quality of life,” due mainly to their income from working outside their homes, including in (export-oriented) factory jobs (Gladwin and Thompson 1995). Further, cash income earned by women may improve their status and bargaining power in the family. An example of this can be seen in Ecuador, where the development of the export-oriented flower industry provided paid employment to large numbers of rural women. A study comparing household time allocation patterns between a region that produces cut flowers and one that does not found that in the former region, married men with working wives spent twice as much time on housework as did similar men in the region that did not produce flowers (Newman 2002). The study tests and concludes that women gained bargaining power as a result of their access to regular wage employment and were thus able to influence the degree of their husbands’ contributions to household work.

How does trade affect gender wage gaps?

The impact of trade on the gender wage gap depends on the relative magnitude of several opposing effects. The gender wage gap may be reduced because trade, like domestic deregulation, can increase competition among firms. The resulting pressure to cut costs can result in less discrimination against women with comparable skills to men, and therefore greater equality in wages. This effect may be particularly strong in industries where market concentration was initially high—that is, in industries dominated by a few firms. Trade often results in a premium on skills. The resulting increase in the wage gap between skilled and unskilled workers may increase the gender wage gap, given that in most countries the average man has a higher level of labor market skills than does the average woman. Unskilled workers are often employed on a temporary basis. Women’s lack of skills relative to men increases the likelihood that they are employed as temporary workers, with little ability to negotiate wages or work conditions. A large influx of unskilled women workers into the labor force, caused by the expansion of export
industries, may exert downward pressure on their wages. The impact of trade on the gender wage gap depends on the relative magnitude of several opposing effects.

What is the evidence on gender wage gaps?

A cross-country study that investigated the impact of trade on the gender wage gap suggests that within occupations, increasing trade in most cases is associated with narrowing gender wage gaps (Oostendorp 2004). (An exception is found for high-skill occupations in poorer countries, where there is no evidence that trade has a narrowing impact.) Insofar as skills tend to be relatively homogeneous within narrowly defined occupations, the narrowing of the gender wage gap can be seen as evidence that there is less labor market discrimination as trade increases. Some country-level analyses support the hypothesis that trade reduces discrimination, while others do not. A study by Black and Brainerd (2002) used U.S. data to test whether increased openness in the period 1977–94 induced employers to reduce discrimination against women, by estimating the differential effect of increased imports on concentrated versus competitive industries. The results showed that, after controlling for skills, the gender wage gap narrowed more rapidly in concentrated industries than in competitive industries. Applying the same methodology, similar but less significant results were obtained by Artecona and Cunningham (2002) for Mexico for the period 1987–93. Berik and others (2003), on the other hand, found the opposite effect for the Republic of Korea and Taiwan (China), that is, an increase in international competitiveness between 1980 and 1999 in concentrated industries was associated with a widening of the gender wage gap. In Korea and Taiwan (China), discrimination actually increased in concentrated industries exposed to competition. These country-level studies also explore whether trade affects the gender wage gap unfavorably, by increasing the wage gap between skilled and unskilled workers. Although two of the studies find a negative (widening) effect on the gender wage gap, the results are not convincing because of methodological issues. Data from Madagascar illustrate the effects of skills and the nature of employment on women's wages relative to men's (Nicita and Razzaz 2003). In 1999, about 70 percent of male workers had permanent, skilled positions, while only about 50 percent of female workers did. Table 1 shows the estimated wage increases obtained by different gender/skill groups during 1997–99, a period when exports increased. Skilled male workers (constituting 18 percent of employees) and skilled female workers (37 percent) received significant wage increases; they were also likely to have held permanent positions. The wages of unskilled male workers (7 percent of employees) increased much less, and those of unskilled women (38 percent) did not increase at all. This last group is likely to have been comprised largely of temporary workers who were therefore unable to negotiate wage increases.

Women also experience more churning—that is, more frequent hiring, firing, and relocation from one job to another. A study of Chile covering a period of rapid adjustment, including trade liberalization, shows that firms tend to lay off a slightly higher proportion of female workers when business declines and to hire more women when business recovers (Levinsohn 1999). Female employees also had significantly higher job relocation rates, a result also found in a study of Turkey (Ozler 2001). These
studies illustrate the precarious nature of women’s jobs in the manufacturing sector, with frequent spells of unemployment and a reduced ability to negotiate wages and working conditions.

Policy Implications of Trade Integration

Policymakers need to consider a broad range of issues unrelated to trade if both women and men—and the economy as a whole—are to reap the full benefits of trade expansion. These include skills acquisition, a nondiscriminatory labor market, and unemployment benefits. Women’s education and skill accumulation are the most important factors determining the impact of trade on women’s employment and the gender wage gap. As long as women remain less qualified than men, they are likely to remain in lower paying, less secure jobs, even if better-paying jobs become available through trade expansion. Education and skills also provide greater Table 1 Estimated wage increases (percent) in Madagascar’s textile and apparel industry, 1997–99

<table>
<thead>
<tr>
<th>Type of employee</th>
<th>Share of labor force</th>
<th>Wage increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Skilled males</td>
<td>18</td>
<td>34</td>
</tr>
<tr>
<td>Skilled females</td>
<td>37</td>
<td>23</td>
</tr>
<tr>
<td>Unskilled males</td>
<td>7</td>
<td>11</td>
</tr>
<tr>
<td>Unskilled females</td>
<td>38</td>
<td>0</td>
</tr>
</tbody>
</table>


Impact of Financial Crises

International finance is inherently unstable and governments in both developed and developing countries resort to bailing out fragile banks and financial institutions. The cost of these bail-outs have been estimated by the World Bank, over the past 20 years, to amount to about 9 per cent of GDP in developing countries and 4 per cent of GDP in developed countries (Caprio and Honohan, 1999). One adverse affect of such bailouts is the ‘squeezing’ of public services, the burden of which is shifted to the people, mainly women, who provide the unpaid care that keeps families and communities going. “A gender perspective on a new international economic architecture would argue for a focus not only on the question of who is expected to be lender of last resort, but also on the question of who is expected to be provider of last resort.”

Those who have obligations that are not easily reversed, whose time horizons are measured in terms of the time it takes to rear a child rather than of the time it takes to buy a bond, and whose principal assets (kinship ties, for instance) cannot be marketed, are more likely to be risk averse. The gender division of labor and responsibilities means that women are less likely than men to be in the ‘liquid’ situation and more likely than men to be in the ‘locked-in’ situation. There is as yet only patchy evidence on gender differences in financial risk taking, but it tends to support the idea that women are more likely to be risk averse than men. For instance, research in the United States suggests that
women are more risk averse than men in investing their pension contributions (Bajtelsmit and Bernasek, 1996; Bajtelsmit and Van Derhei, 1997; Hinz, McCarthy and Turner, 1996).

A study of a group of poor women farmers in Malawi in 1987 found that one of the main factors limiting their use of credit (as compared to men farmers) was their aversion to the risks of being unable to repay in years when yield were low. The poorest did not want credit because they had no cash crop to sell (Gladwin, 1991). In relation to a similar setting of small holder agriculture, Arndt and Tarp (2000) suggest that responsibility for household food security is likely to lead to women farmers in Mozambique being more risk averse. Women are often reported to be unwilling to take on as large loans as men from micro finance institutions. Women tend to have liabilities in the form of obligations to children which cannot easily be liquidated. A gender perspective on new international economic architecture would certainly want to ask questions about arrangements for insuring those who are risk averse against the folly of those who are tempted to take excessive risks.

Singh and Zammit (2000:1255) argue that a liquidity problem was turned into a solvency crises with large output and employment loses by IMF fiscal tightening during the Asian crises. While studies on gender impact of such crises are lacking, survey data in both Indonesia and the Philippines show that as men became unemployed, the amount of work done by women increased, as women took up the role of provider of last resort. For Indonesia, relevant data is available from the Indonesia Family Life Surveys, which covered more than 30,000 people in 1997/early 1998 and a follow up survey of a 25 per cent sample in late 1998. Using this source, Frankenberg, Thomas and Beegle (1999) calculate the percentage of the labor force employed in paid work in 1997 and 1998 and show that for men it decreased by 1.3 per cent, while for women it increased by 1 per cent. When unpaid work is also included, there is an increase for both men and women, but for men the increase is only 1.3 per cent, while for women it is 7 per cent. A nationally representative survey conducted by the Indonesian statistical office sixteen months after the onset of the crisis reveals the household coping strategies underlying these figures - especially increasing the labor market participation of older married women with children and producing more goods for home consumption (de la Rocha, 2000).

In the case of the Philippines, Lim (2000) using data from the Labor Force Survey shows that both male and female unemployment rates rose between 1997 and 1998: for men from 7.5 per cent to 9.5 per cent and for women from 8.5 per cent to 9.9 per cent. However mean weekly work hours for those employed moved in opposite directions for men and women, with those of men falling while those of women rose. Among the factors that may explain the increase for women is an increase in the hours of work undertaken by home based women working on subcontract (Ofreneo, Lim and Gula, 1999). This increase in the average hours that women spend in paid work has occurred in a context in which women typically spend almost 8 hours a day on housekeeping and child care compared about 2 and a half hours for men (UNDP, 1997).
In S. Korea, it was women who lost jobs more than men. Between 1997 and 1998, data from the National Statistical Office show that employment declined by 3.8 per cent for men and 7.1 per cent for women (Lee and Rhee, 1999).

As detailed above, globalization is occurring at a rapid pace which means that there is heightened competition among developing countries for capital flows be it portfolio flows, FDI, multinational bank loans, workers remittances, official aid flows, or other flows. Each has a differential economic impact on societies, particularly on domestic investment, growth and employment and individual households. Understanding the role of gender wage inequality, and the labor market institutions that perpetuate that inequality, in economic growth specifies the circumstances under which capital flows can or cannot support a country’s overall development efforts.

**FDI and Feminization, 1975-99**

![Graph showing the relationship between change in feminization of the labor force and average net FDI/Gross Fixed Capital Formation.](image)

**Notes and Sources.** Figures based on author's calculations using data from World Development Indicators 2001. Change in feminization of the labor force equals female labor force/total labor force in 1999 minus the same figure in 1975. Average net FDI/gross fixed capital formation equals annual average FDI inflows minus outflows as a percent of gross fixed capital formation. All values taken in 1995 $US. Countries used include: Brazil, Chile, China, Colombia, Costa Rica, El Salvador, Greece, Hong Kong, India, Indonesia, Korea, Malaysia, Mexico, Paraguay, the Philippines, Portugal, Singapore, Sri Lanka, Thailand and Turkey.
GLOSSARY

Absolute advantage. The ability of an economic actor (an individual, a household or a firm) to produce some particular good or service with a smaller total input of economic resources (labor, capital, land, etc.) per unit of output than other economic actors. In international trade theory a country which has an absolute advantage in producing a good is able to produce that good more efficiently (more output per unit of input) than any other country. In trade, it is important to distinguish absolute from comparative advantage, since it is comparative advantage that determines the potential welfare gains from specialization and trade.

Accelerator principle. In macroeconomic models the accelerator principle relates changes in the rate of real output growth to the level of desired investment spending (investment demand) in the economy. A decline in the rate of real GDP growth, for example, will cause the amount of investment demand to decrease (the investment demand curve will shift to the left).

Aggregate demand. In macroeconomic theory the aggregate demand curve relates the level of real national income (GDP) demanded (the total quantity of goods and services demanded) to the price level (as measured by the GDP deflator).

Aggregate expenditure. The aggregate demand identity states that: \( Y = C + I + G + (X - M) \) which simply means that a single country's aggregate demand for national product (\( Y \)) is always equal to the total demands of its households for Consumer goods and services (\( C \)), plus the total demands of its firms for Investment goods (\( I \)), plus the total demands of its various Government agencies for goods and services (\( G \)), plus the net demands of foreign consumers, firms and governments for the country's goods and services (exports minus imports).

Aggregate supply curve. In macroeconomic theory the short run aggregate supply curve relates the total quantity of goods and services supplied and the price level (as measured by the GDP deflator) ceteris paribus. The long run aggregate supply curve is a vertical line at the full employment (capacity output) level of real national income (GDP).

Amortization. The process of fully paying off indebtedness by installments of principal and earned interest over a definite time.

Automatic stabilizer. Government spending programs which respond to changes in the level of national income in such a way as to offset those changes. For example, unemployment insurance benefits typically rise when the economy enters a recession, and decline when prosperity returns.

Axes. The fixed lines on a graph which carry the scales against which the coordinates are plotted.

Balance of payments An accounting statement of the money value of international transactions between one nation and the rest of the world over a specific time period. The accounting of a country's international position in terms of exports and imports of goods, services and income (the current account), and financial inflows and outflows (the capital account). In theory, the current account must balance the capital account, that is, money coming in must equal the money going out.

Balance of trade. A record of a country's exports and imports of goods and services. If exports of goods exceed imports, the trade balance is said to be favorable; if imports exceed exports, the trade balance is said to be unfavorable.

Base year. In calculating price indexes, values in the current year are compared to values in some arbitrarily chosen earlier or base year.

Bilateral Aid. The transfer of funds, goods or services from one government to another.

Bretton Woods. A town in New Hampshire, famous for a major international meeting in 1944 where world leaders mapped out a common strategy for the post-WWII economy. This led to the formation of the Bretton Woods institutions: the World Bank; the International Monetary Fund (IMF) and the General Agreement of Tariffs and Trade (GATT).

Budget deficit. The amount by which total government spending is more than government income during a specified period; the amount of money which the government has to raise by borrowing or currency emission in order to make up for the shortfall in tax revenues.

Budget surplus. The amount by which government revenues are more than government spending during a specified period.

Budget. A statement of a government's planned or expected financial position for a specified period of time (usually one year) based on estimates of the expenditures to be made by the
government's main subdivisions (wages and salaries of government employees; consultants' fees; purchases of equipment, supplies, real estate, etc.; money transferred to beneficiaries of various programs, and so on) during the specified period, along with estimates of the revenues to be realized from the various sources of income that will be available for paying for these expenditures. The budget of a government may be seen as a comprehensive plan of what the government will spend for its various programs during the next fiscal year and how it expects to raise the money to pay for them.

**Business Cycle.** The wave-like pattern of movements of national output, through expansions and recessions.

**Capital account.** That part of the balance of payments accounts which records a country's lending and borrowing transactions.

**Capital consumption.** The using up of real capital by not maintaining or replacing it as it wears out.

**Capital goods.** Unlike goods intended to be consumed, capital goods are used to produce other goods. Machinery in a factory would be an example of capital goods.

**Capital.** Usually used to refer to machinery and equipment, structures and inventories, that is, produced goods for use in further production. It can also design other kinds of capital (human social, etc).

**Central bank** The principal monetary authority of a nation, which performs several key functions, including issuing currency and regulating the supply of credit in the economy.

**Central bank intervention** The buying or selling of currency, foreign or domestic, by central banks in order to influence market conditions or exchange rate movements.

**Ceteris paribus.** The Latin for "other things being equal."

**Change in demand.** An increase or decrease in the quantity demanded over a range of prices. Shown by a shift of the demand curve.

**Comparative Advantage.** The ability to produce a tradable good or service at a lower opportunity cost than it could be produced at in another country. This concept underlies the justification for free trade.

**Competition.** In the general sense, a contest among sellers or buyers for control over the use of productive resources. Sometimes used as a shorthand way of referring to perfect competition, a market condition in which no individual buyer or seller has any significant influence over price.

**Competitive Devaluation.** A situation where countries devalue their currencies in sequence in a bid to wrest economic advantage through increased exports.

**Consumer Price Index (CPI).** A weighted index of prices of commodities commonly purchased by households. The CPI is typically used in calculation of the inflation rate.

**Consumer surplus.** The net benefit realized by consumers when they are able to buy a good at the prevailing market price. It is equivalent to the difference between the maximum amount consumers would be willing to pay and the amount they actually do pay for the units of the good purchased. Graphically it is the triangle above the market price and below the demand curve.

**Consumption function.** Generally, the relationship between consumer expenditures and all the influences that determine them. More specifically, the relationship between consumers' disposable incomes (personal income less taxes) and the amount they wish to spend on consumer goods and services.

**Consumption spending.** Spending on consumer goods and services.

**Coordinates.** Intersections of vertical and horizontal values plotted on a graph.

**Cross-elasticity of demand.** The (percentage) change in the quantity demanded of a good consequent upon a (one percent) change in the price of an associated good.

**Crowding out.** The possible tendency for government spending on goods and services to put upward pressure on interest rates, thereby discouraging private investment spending.

**Currency appreciation** An increase in the value of one currency relative to another currency. Appreciation occurs when, because of a change in exchange rates, a unit of one currency buys more units of another currency.

**Currency depreciation** A decline in the value of one currency relative to another currency. Depreciation occurs when, because of a change in exchange rates, a unit of one currency buys fewer units of another currency.

**Currency devaluation** A deliberate downward adjustment in the official exchange rate established, or pegged, by a government against a specified standard, such as another currency or gold.

**Currency revaluation** A deliberate upward adjustment in the official exchange rate established, or pegged, by a government against a specified standard, such as another currency or gold.
Current account. That part of a country's balance of payments accounts which records the value of goods and services exported minus the value of goods and services imported. Current account balance calculations exclude transactions in financial assets and liabilities.

Cyclical unemployment. Unemployment caused by a low level of aggregate demand associated with recession in the business cycle.

Debt Restructuring. A technique whereby debt service payments are deferred and the payback period of the original loan is stretched over a longer period.

Debt Service. The interest that must be paid on accumulated debt.

Debt, national. As usually defined, this denotes the total sum of the outstanding debt obligations of a country's central government. The national debt represents the accumulated total of all the government budget deficits of past years, less the accumulated total of all the government budget surpluses of past years.

Default. The failure to make debt service payments.

Deficit. The shortfall between a government's revenues from taxation and its expenditures, in any one year. It must then borrow money to meet its expenditures.

Deflation. A fall in the general level of all prices. The opposite of inflation.

Demand, law of. Other things being held constant, the lower the price of a good (or service), the greater the quantity of it that will be demanded by purchasers at any given time.

Demand. The willingness and ability of the people within a market area to purchase particular amounts of a good or service at a variety of alternative prices during a specified time period.

Depreciation. The using up or wearing out of capital goods.

Devaluation. A reduction in a country's official rate at which one currency is trade for another. A devaluation makes a country's exports cheaper abroad and makes imports more expensive.

Discount rate. The interest rate that banks pay on loans to them from Central Bank. An increase in the discount rate tends to cause a decrease in the money stock and higher short-term interest rates. In contrast, lowering the discount rate is expansionary. As the cost of borrowing from the Central Bank to meet a temporary emergency falls, bankers are more likely to reduce their excess reserves to a minimum, extending more loans and thus increasing the money stock and tending to lower interest rates in the short term.

Disposable income. The income a person or household has left to dispose of after income tax has been deducted from personal income. Disposable income may either be spent on consumption or saved.

Economics. The branch of the social sciences concerned primarily with analyzing and explaining human behavior in making decisions about the allocation of scarce resources.

Economic Growth. An increase in the quantity of goods and services produced in a nation, as traditionally measured by GDP.

Economies of Scale. A decrease in the per unit cost of production as a result of producing large numbers of the good.

Efficiency. A concept referring to making the most productive use of resources available.

Elasticity of supply. The (price) elasticity of supply is the percentage change in the quantity supplied of a good or service divided by the percentage change in its (own) price.

Elasticity. When used without a modifier (such as "cross", or "income"), elasticity usually refers to price elasticity which is the percentage change in quantity demanded of a good or service divided by the percentage change in its (own) price.

Employment rate. The percentage of the labor force that is employed. The employment rate is one of the economic indicators that economists examine to help understand the state of the economy. See also unemployment rate.

Equilibrium price. A price at which the quantity supplied equals the quantity demanded. At this price there is no excess of quantity demanded or supplied, nor is their any deficiency of either and consequently the price will remain at this level.

Equilibrium quantity. The quantity of a good demanded and supplied at the equilibrium price.

Equity. In the context of income distribution theory, refers to an objective, goal or principle implying "fairness". In a financial context may refer to a share or portion of ownership.

Exchange rate. The price of a country's currency in terms of another country's currency.

Externalities. A benefit or cost associated with an economic transaction which is not taken into account by those directly involved in making it. A beneficial or adverse side effect of production or consumption.

Fiscal policy. Use of the government's powers of taxation and spending to influence economic activity and employment.

Fixed exchange rate system. Exchange rates between currencies that are set at predetermined
levels and don't move in response to changes in supply and demand.

**Floating exchange rate system** The flexible exchange rate system in which the exchange rate is determined by the market forces of supply and demand without intervention.

**Foreign Direct Investment (FDI)**. Investment in one country by firms owned in another country.

**Free Trade**. Trade arrangements where tariffs or other barriers to the free flow of goods and services are eliminated.

**Frictional unemployment**. Unemployment caused by the loss of jobs due to technological change, the entry of new participants into a labour market, or other normal labour market adjustments.

**GINI Coefficient**. A measure of income inequality, which ranges from 0 (complete inequality) to 1 (complete equality). The ratio of the area between the 45 degree line depicting complete equality and a Lorenz curve to the entire area of the triangle below the 45 degree line.

**Government spending**. The total outlays by government on goods and services during some accounting period, usually a year. Government outlays such as welfare benefits to households, for example, are normally excluded from this amount on the grounds that they are merely transfers of income from taxpayers to the beneficiaries of such programs.

**Graph**. A visual representation of a relationship between two variables, usually drawn to some specific scale.

**Gross Domestic Product (GDP)**. A statistical measure of value of final goods and services produced by a nation's economy in a given period, usually a year.

**Gross Domestic Product (GDP) deflator**. Nominal GDP divided by real (constant dollar GDP) multiplied by 100. Nominal GDP is the value of output measured in terms of the prices prevailing in the accounting period in question. Real GDP is that output measured in terms of the prices prevailing in some base period. The value of the deflator in the base period is always 100.

**Gross investment**. Total investment during the accounting period. It includes both additions to the capital stock (net investment) and investment to replace worn out capital (to make up for depreciation).

**Gross National Expenditure (GNE)**. The sum of all spending on consumption and investment plus government spending on goods and services and net exports (total exports minus imports). It is equivalent in value to GDP.

**Growth theory**. The part of economic theory that seeks to explain (and hopes to predict) the rate at which a country's economy will grow over time.

**Human capital**. The stock of knowledge and acquired skills embodied in individuals.

**Income effect**. The effect of a change in income on the quantity of a good or service consumed.

**Indirect taxes**. Taxes levied on a producer which the producer then passes on to the consumer as part of the price of a good. Distinguished from direct taxes, such as sales taxes which are visible to the person who pays them.

**Infant Mortality Rate**. The number of deaths per 1000 live births before the first birthday.

**Inferior good**. A good for which the demand decreases when income increases. When a household's income goes up, it will buy a smaller quantity of such a good.

**Inflation**. A general rise in the average level of all prices.

**Interest group**. A group of people who share common traits, attitudes, beliefs, and/or objectives who have formed a formal organization to serve specific common interests of the membership.

**Interest Rate**. The going market rate for borrowing or lending money.

**International Financial Institutions (IFIs)**. The World Bank, the International Monetary Fund (IMF) and the Regional Development Banks.

**International Monetary Fund (IMF)**. An international organization with 146 members, including the United States. The main functions of the IMF are to lend funds to member nations to finance temporary balance of payments problems, to facilitate the expansion and balanced growth of international trade and to promote international monetary cooperation among nations. The IMF also creates special drawing rights (SDRs), which provide member nations with a source of additional reserves. Member nations are required to subscribe to a Fund quota, paid mainly in their own currency. The IMF grew out of the Bretton Woods Conference of 1944.

**Investment spending**. The total amount of spending during some period of time on capital goods.

**Labour Force**. The total number of people employed plus those actively looking for work.
Laissez Faire. Literally, "let do": a philosophy that advocates minimal government interference in the economy.

Land. All natural resources. The "gifts of nature" which are economically useful.

Law of demand. The inverse relationship between price and quantity of a good or service demanded.

Lender of last resort. The nation's central bank has the authority and financial resources to act as "lender of last resort" by extending credit to depository institutions or to other entities in unusual circumstances involving a national or regional emergency, where failure to obtain credit would have a severe adverse impact on the economy.

Lorenz curve. A curve showing the cumulative percentage of income plotted against the cumulative percentage of population.

Macroeconomics. The branch of economic theory concerned with the economy as a whole. It deals with large aggregates such as total output, rather than with the behaviour of individual consumers and firms.

Marginal benefit. The increase in total benefit consequent upon a one unit increase in the production of a good.

Marginal cost. The increase in total cost consequent upon a one unit increase in the production of a good.

Marginal propensity to consume. The part of the last dollar of disposable income that would be spent on additional consumption.

Marginal propensity to save. The part of the last dollar of disposable income that would be saved.

Market failure. Instances of a free market being unable to achieve an optimum allocation of resources.

Minority goods. Goods which have a very low elasticity of supply. That is, even large increases in their price can call forth little, if any, additional supply, which means that only the very wealthy can afford them. Large, secluded waterfront properties might be an example.

Monetarism. School of economic thought, led by Milton Friedman, that believes that inflation is caused by excessive growth in the money supply.

Monetary base. The same as "high-powered money": cash in commercial banks, plus cash in circulation and deposits of the commercial bank at the central bank.

Monetary Policy. A central bank's actions to influence the availability and cost of money and credit, as a means of helping to promote national economic goals. The use of the central bank's power to control the domestic money supply to influence the supply of credit, interest rates and ultimately the level of real economic activity. The policy which tries to control the size of the total stock of money (and other highly liquid financial assets that are close substitutes for money) available in the national economy in order to achieve policy objectives that are often partly contradictory: controlling the rate of increase in the general price level (inflation) speeding up or slowing the overall rate of economic growth (mainly by affecting the interest rates that constitute such a large share of suppliers' costs for new investment but partly by influencing consumer demand through the availability of consumer credit and mortgage money), managing the level of unemployment (stimulating or retarding total demand for goods and services by manipulating the amount of money in the hands of consumers and investors), or influencing the exchange rates at which the national currency trades for other foreign currencies.

Money. Anything that serves as a generally accepted medium of exchange, a standard of value and a means to save or store purchasing power.

Money supply. Total quantity of money available for transactions and investment (Also referred to as the money stock or simply money.)

Monopoly. Strictly defined as a market situation in which there is a single supplier of a good or service, but often used to suggest any situation in which a firm has considerable power over market price.

Monopsonistic firm. A firm which is the sole buyer of a good or service, most likely of labour in a particular market.

Moral hazard. The risk that a party to a transaction has not entered into a contract in good faith, has provided misleading information about its assets, liabilities or credit capacity, or has an incentive to take unusual risks in a desperate attempt to earn a profit before the contract settles.

Multiplier effect. The tendency for a change in aggregate spending to cause a more than proportionate change in the level of real national income.

National income (GDP) deflator. A general way of referring to the price index which measures the average level of the prices of all the goods and services comprising the national income or GDP.*
National income. The general term used to refer to the total value of a country's output of goods and services in some accounting period without specifying the formal accounting concept such as Gross Domestic Product.

Net exports. The total value of goods and services exported during the accounting period minus the total value of goods and services imported.

Net migration. The total number of people leaving the country to take up permanent residence abroad minus the number of people entering the country for the purpose of taking up permanent residence.

Net investment. Total investment during some accounting period minus the amount of depreciation during the same period.

Nominal interest rates. Current stated rates of interest paid or earned.

Non-accelerating Inflationary Rate of Unemployment (NAIRU). Also called the natural rate of unemployment. The theory behind the NAIRU is that if the unemployment rate falls too low, inflation will be triggered.

Normal good. Any good for which the demand increases as incomes increase.

Open market operations. Purchases and sales of government securities and certain other securities in the open market, done by the Central Bank. Purchases inject reserves into the banking system and stimulate growth of money and credit; sales do the opposite.

Opportunity cost. The best alternative sacrificed to have or to do something else.

Pareto optimality. The condition which exists when it is impossible to make any individual better off without making any other individual worse off.

Per capita income. Total income divided by the size of the population.

Perfect competition. A market situation in which there are so many sellers (and buyers) that no one seller (or buyer) can exert any influence on the price. All participants in such markets are "price takers".

Political economy. A branch of the social sciences that takes as its principal subject of study the interrelationships between political and economic institutions and processes. That is, political economists are interested in analyzing and explaining the ways in which various sorts of government affect the allocation of scarce resources in society through their laws and policies as well as the ways in which the nature of the economic system and the behavior of people acting on their economic interests affects the form of government and the kinds of laws and policies that get made.

Price discrimination. The selling of a good or service at different prices to different buyers or classes of buyers in the absence of any differences in the costs of supplying it.

Price elasticity of demand. The percentage change in the quantity of a good demanded by the percentage change in its own price. Price. What must be paid to acquire the right to possess and use a good or service.

Principle of diminishing marginal utility. The proposition that the satisfaction derived from consuming an additional unit of a good or service declines as additional units are acquired.

Principle of Diminishing Returns. The proposition that the marginal product of the last unit of labour employed declines as additional units of labour are employed.

Private goods. A good which cannot be consumed without paying for it and the supply of which is reduced when it is consumed by a particular user of it.

Privatization. The selling-off of publicly owned enterprises to private owners.

Production possibilities. Levels of output which are within the range of possibilities for a particular economy.

Production possibility curve. A graphical representation of the boundary between possible and unattainable levels of production in a particular economy.

Productivity. The amount of physical output for each unit of productive input.

Public goods. Public goods are those which can be enjoyed by an unlimited number of people (nonrival) without prejudice of each other and where one cannot exclude people from using them (nonexcludable).

Purchasing power parity theory. The exchange rate between any two currencies adjusts to reflect changes in the price levels within the two countries.

Quantity theory of money. The idea that there is a direct link between the quantity of money in the economy and the price level.

Quota. A limitation on the amount of a good that can be produced or offered for sale domestically or internationally.

Rational behaviour. Behaviour that is consistent with the attainment of an individual's perception of his or her own best interest.

Real balance effect. The influence a change in the quantity of real money has on the quantity of real national income demanded.
Real GDP. GDP (gross domestic product) adjusted for inflation. Real GDP provides the value of GDP in constant dollars, which is used as an indicator of the volume of the nation's output.

Real interest rates. Interest rates adjusted for the expected erosion of purchasing power resulting from inflation. Technically defined as nominal interest rates minus the expected rate of inflation.

Recession. A significant decline in general economic activity extending over a period of time.

Redistribution policy. Measures taken by government to transfer income from some individuals to others.

Relative prices. The relationship between the prices of different goods and services. May be thought of in terms of the amount of one good which can be had for a certain expenditure compared to the amount of another good which can be had for the same expenditure.

Rent-seeking. The activities of individuals or firms to obtain special privileges, such as monopoly power, which will enable them to increase their incomes. Using up resources to win such privileges from governments or their agencies.

Reserve requirements. Requirements set by the central Bank for the amounts that certain financial institutions must set aside in the form of reserves. Reserve requirements act as a control on the expansion of money and credit and may be raised or lowered within limits specified by law (lowering reserve requirements allows more bank lending and money growth; raising requirements, less lending and money growth).

Reserves. A depository institution's vault cash (up to the level of its required reserves) plus balances in its reserve account (not including funds applied to its required clearing balance).

Risk. Those undertaking investments or the production of goods and services for sale cannot know with certainty whether they will recover the outlays needed to conduct these activities. Although some risks can be insured against (the risk of fire losses for example) there is no way of insuring against the possibility of business losses due to the uncertainty of the market place.

Saving. The act of abstaining from consumption. In terms of the national accounts, the difference between personal income less taxes and total consumption spending.

Scarcity. The fact that human wants exceed the means of satisfying them.

Seigniorage. The profit which results from the difference between the cost of making coins and currency and the exchange value of coin and currency in the market.

Short run. In the theory of the firm, a period of time which is too short for changes to be made in all inputs. For example, a period not long enough to permit the size of the physical plant to be altered.

Social cost. The real cost to society of having a good or service produced, which may be greater than the private costs incorporated by the producer in its market price.

Substitute goods. Goods which may be used in place of other goods.

Substitution effect. The change in the quantity of a good demanded resulting from a change in its relative price, leaving aside any change in quantity demanded that can be attributable to the associated change in the consumer's real income. It may also be thought of as a change in the quantity demanded as a result of a movement along a single indifference curve.

Tariff. A tax imposed on an imported good.

Terms of Trade. The ratio of prices of exports to those of imports. Deteriorating terms of trade mean the price of exports has decreased relative to the price of imports.

Tobin Tax. A proposed tax, by Nobel laureate James Tobin, on international financial transactions. The tax would be set at a fraction of one percent, so as to discourage speculation, but not productive investment.

Total factor productivity. The growth of real output beyond what can be attributed to increases in the quantities of labour and capital employed.

Transfer payments. Social benefits paid to individuals or households by government.

Unemployment rate. The percentage of the labor force that is unemployed and actively seeking a job.

Unemployment. The non-utilization of labour resources; the condition in which members of the labour force are without jobs. Sometimes used more broadly to refer to the waste of resources when the economy is operating at less than its full potential.

Utility. An economic concept referring to the precise degree of personal satisfaction, pleasure, or sense of want-fulfillment an individual derives from consuming some quantity of a good or service at a particular point in time.

Velocity. The rate at which money balances turn over in a period for expenditures on goods and services (often measured as the ratio of GNP—gross national product—to the money stock). A larger
velocity means that a given quantity of money is associated with a greater dollar volume of transactions.

**Voluntary export restraint.** A restriction placed by an exporting country on the volume of exports it sends to a particular country.

**Wages.** The general term applied to the earnings of the factor of production, labour.

**Wants.** The apparently limitless desires or wishes people have for particular goods or services.

**World Bank.** Originally known as the International Bank for Reconstruction and Development, the World Bank was set up after WWII to facilitate the reconstruction of economies in Europe devastated by the war. In later years, it took on the role of providing loans to countries for economic development purposes. It is a sister organization to the IMF. Both organizations are based in Washington.

**World Trade Organization (WTO).** A Geneva-based free trade association with 128 member nations. Formed in 1995 to administer the GATT, as well as the trade in services and intellectual property. WTO panels rule on trade disputes among member nations.

**Yield.** The return on a loan or investment, stated as a percentage of price.
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