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TRENDS AND POLICIES IN THE WORLD ECONOMY

PART II: ECONOMIC POLICY AND POVERTY

Economic Policy and Poverty

UNITED NATIONS

PART TWO

ECONOMIC POLICY AND POVERTY

OVERVIEW

The United Nations Millennium Declaration,[1] adopted by all 189 States Members of the United Nations on 8 September 2000, presents a set of commitments aimed at improving the well-being of humanity in the twenty-first century. The development goals set out in the Millennium Declaration focus on poverty eradication through broad-based sustainable development. The Millennium Development Goals include the objective of halving, between 1990 and 2015, the proportion of the world's population that lives on one dollar per day or less (a measure of extreme poverty) and the proportion that suffers from hunger.

Poverty is intrinsically a difficult problem to analyse because it touches on many aspects of the human condition, ranging from the economic and social to the environmental, political and cultural. Reflecting its multifaceted aspects, poverty is variously defined and manifested in terms of income, consumption, deprivation of access to health and educational resources, vulnerability, voicelessness and powerlessness.[2] Even those who live in poverty have no easy way to describe the deprivation and hardship they experience. However, their voicelessness is being addressed. Part of the World Bank's efforts to understand and reduce poverty has involved gathering and publishing the views, experiences and aspirations of the poor.[3]

Understanding the causes of poverty, the interactions among those causes and the consequences of poverty for human lives is essential for formulating and implementing policies to achieve the poverty reduction goals established in the Millennium Declaration. Measuring the extent of poverty at the national and global levels in turn enables Governments and the international community to assess the impacts of policy actions. It is within this context that the Millennium Development Goals were formulated to include various poverty indicators to monitor progress towards the targets and to evaluate national and international actions.

The goal of reducing poverty by half by the year 2015 has prompted policy makers to increase the attention given to policies and measures that are targeted directly at achieving this goal. At the same time, it is necessary to also examine earlier policies aimed at achieving this same goal, possibly through different channels, as well as policies and measures with other, possibly related, goals, that are expected to have a bearing on poverty, even if they are not specifically directed at poverty reduction per se. Part two of the present *Survey* examines a number of areas in which policies are expected to have a beneficial effect on poverty over the medium or longer term, even if poverty reduction is not those policies' primary short-term goal.

1 See General Assembly resolution 55/2 of 8 September 2000. See also the report of the Secretary General entitled "Implementation of the United Nations Millennium Declaration" (A/57/270 and Corr.1), particularly the annex, entitled "Millennium development goals".

2 *Report on the World Social Situation, 2003* (United Nations publication, forthcoming) discusses the aspects of social vulnerability, voicelessness and powerlessness and examines several policies aimed at removing economic, social and cultural barriers that contribute to the vulnerability of the poor.

3 Part of the work undertaken for the World Bank *World Development Report, 2000/2001: Attacking Poverty* (New York, Oxford University Press, 2001) consisted in systematically seeking the views of more than 60,000 men and women living in poverty in 60 countries. These were published in three volumes: *Voices of the Poor: Can Anyone Hear Us?* (New York, Oxford University Press, 2000), *Voices of the Poor: Crying Out for Change* (New York, Oxford University Press, 2000) and *Voices of the Poor: From Many Lands* (New York, Oxford University Press, 2002).

In particular, Part two of this *Survey* examines the impact of economic policy in a number of areas on the material dimensions of poverty, such as income, consumption, employment and productivity, in the developing countries and economies in transition. The policies examined are monetary and fiscal policies (chap. V), trade policies (chap. VI), agricultural reforms (chap. VII) and the policies arising in the move from a planned to a market economy (chap. VIII). These policies are not specifically designed to combat poverty; their aim is rather to enhance the overall productivity of the economy and thus to reduce poverty in the long term. For example, macroeconomic and trade policies are considered to have a beneficial impact on poverty largely through economic growth: appropriate policies in these areas are expected to stimulate economic growth and growth, in turn, is expected to reduce poverty.[4] Agricultural reforms affect the incidence of poverty through increased efficiencies in agricultural production and distribution and more equitable patterns of rural development. Through various channels, these different policies affect the incidence of poverty, not just in the long term but also in the short and medium terms.

The primary importance given to poverty reduction by the international community is reflected in the fact that all World Bank and International Monetary Fund (IMF) lending to low-income countries requires the preparation of national Poverty Reduction Strategy Papers (PRSPs). These Papers not only focus on the consequences of macroeconomic policies for poverty reduction, but also include poverty-targeted microeconomic policies aimed at bringing employment and education to the poor in order to help them escape longer-term poverty, and such measures as income subsidies and food aid to help them overcome their present difficulties. This reflects the consideration that help should be provided to those who are poor but likely to find employment in the near future, as well as additional help to those who will remain poor without an improvement in their chances of obtaining employment. This distinction between transitory and chronic poverty is crucial, but is often disguised by the overall headcount figures for the poor, which do not distinguish between those who remained poor for longer than, say, a year, and those who had been poor at the time of the headcount but escaped poverty soon thereafter. This is of relevance to both the developing countries and the economies in transition. In the latter, Governments have combined macrolevel policies designed to ensure long-term employment-generating growth—and therefore the emergence from poverty of those who were plunged into it by the loss of employment during the transitional recession—with policies targeted at tackling chronic poverty (see chap. VIII).

There remains the question what is the impact on poverty of the economic policies available to Governments and the whole movement to liberalize economic activity. An examination of these different economic policies shows that, while they are effective instruments in reducing the incidence of poverty in the long term, they need to be complemented by micropolicies so as to achieve the greatest impact in reducing poverty in the short-to-medium term. A second consideration is that economic policies affect different groups of a society to varying degrees and, at least in the short and medium terms, some groups may be harmed if appropriate action is not taken. In particular, although trade liberalization nurtures the development of activities in which a country has a comparative advantage, it could lead to the longer-term decline—and even to

4 For a criticism of the assumed connection among good policies, growth and poverty reduction, see the Special Contribution (Poverty, globalization and growth: perspectives on some of the statistical links) by Joseph E. Stiglitz in United Nations Development Programme, *Human Development Report, 2003* (New York, Oxford University Press, 2003), p. 80.

the disappearance—of other activities without such an advantage. Similarly, while market-based agricultural reforms encourage the more efficient use of available resources in the public and private domains, a State-sponsored financing scheme would need to be put in place to ensure that the poorest of the poor who have no access to credit do not lose but actually benefit. An immediate implication of these two considerations is that several complementary policies must be pursued, simultaneously or sequentially.

It is difficult, however, to demonstrate the linkages among these policies and their combined impact on poverty. Part two aims to address these questions. One of the lessons that emerges is that increased discussion is required at the domestic and international levels on prioritizing policies, on the trade-offs among complementary policies, and on the correct sequencing. For example, the experience of some countries with economies in transition during the 1990s shows that economic policies need to be implemented with an awareness of the likely effects on poverty, that is to say, there needs to be a combination of complementary policies that provide a buffer against their possible adverse impacts and that target those most likely to fall into chronic poverty.

To clarify the links among economic policies and poverty and with a view to setting the framework for evaluating the policies examined in Part two, chapter IV argues that the impact of policies on poverty should be assessed from different aspects. Assessing the impacts of a policy on the evolution of poverty critically depends on (a) which aspect(s) of poverty—including income and/or non-income dimensions—the policy maker chooses to focus on; (b) the level of aggregation used—for example, national or subnational, urban or rural, tradable or non-tradable sectors, female or male; and (c) the time-horizon—short- or long-run—over which the impact of the policy is to be assessed.

Chapter IV examines growth-poverty relationships and demonstrates, based on cross-country evidence and case studies, the importance of using all three aspects in establishing a framework for evaluating policy. Economic growth and the reduction of income poverty usually go hand in hand, but increases in average income levels are not necessarily associated with improvements in health status and educational attainment, which constitute an important dimension of chronic poverty. When only the income dimension of poverty is considered, economic growth is generally found to be beneficial for the poor. This finding, however, is based upon an average of many countries' experiences; and the same degree of improvement in economic growth may affect the incidence of poverty in different countries differently, depending on the initial economic and social conditions and the sources of growth (for example, export-driven growth as opposed to increases in agricultural production for domestic consumption). Economic growth may thus affect some groups of people adversely, particularly in relative terms. Moreover, because even long-term growth is rarely steady but often consists of short-run fluctuations, during an economic downturn, poor people—who have few assets to smooth out consumption over such fluctuations—are more likely to be impoverished even further, compared with the non-poor.

Chapter V analyses the impacts of monetary and fiscal policies on poverty, in both the short and the long run. Special attention is given to these relationships during times of economic crisis, when the poor constitute the group that is most adversely affected. The experiences of East Asia and Latin America during the past 10 years are examined in order to elucidate some of the possible effects, especially on poverty, of periods of stop-and-go in macroeconomic policy. The importance of maintaining macroeconomic stability during times of growth, in order to have a greater degree of freedom to manoeuvre during crises and to be able to protect the poor, is emphasized. The focus is on the urban poor since they have been identified as more vulnerable in times of economic crises than the rural poor. The analysis concludes that macroeconomic policies alone are not sufficient to address the problems of the poor: complementary measures are necessary.

The analysis emphasizes that preventing or reducing economic shocks is essential, particularly in the context of poverty, since the protection of the poor is rarely a priority in the macroeconomic responses to crises when they do occur. Therefore, preventive measures should be put in place within a social protection scheme even before a crisis erupts, and curative measures must be undertaken when a crisis occurs, with the degree of intensiveness depending on need. Access to health, education and nutrition is usually better in urban areas than in rural areas, but since many of the poor are in the informal sector, such programmes are more likely to reach the middle- and higher-income families in the formal sector. Thus, in addition to formal social programmes, other forms of social assistance based on grass-roots involvement are necessary in order to reach all of the poor, especially those in the informal sector.

Chapter VI demonstrates how trade liberalization is conducive to poverty reduction because of its long-run effects on growth and focuses on the effect of short- and medium-term adjustment on the incidence of poverty. The chapter analyses various channels through which trade liberalization affects poverty. These include changes in prices and in the availability of goods and services, impacts on labour markets, changes in the incentives for investment and the transfer of technology, effects on government tax revenues, and changes in income distribution. Overall, trade liberalization is beneficial to the poor, although it should often be complemented by other policies. There is little evidence of a “race to the bottom” as countries lower standards to attract foreign investment. However, there do remain major impediments to the poorest countries’ taking full advantage of trade’s income-generating potential, particularly the protectionist and subsidizing policies of the developed countries.

Chapter VII addresses selected market-based policies intended to increase agricultural productivity. It identifies the impact of such policies on the achievement of more equitable patterns of rural development, particularly in sub-Saharan Africa. The chapter demonstrates that liberalization of staple food markets is especially important for the rural poor, who often generate the bulk of their income from producing staple foods. Particular attention should thus be paid to the role of food marketing reform in rural economic growth. The chapter also analyses how land redistribution policies can promote greater economic efficiency and more equitable patterns in rural growth.

The chapter shows that market-based policies, although not primarily aimed at reducing rural poverty, can still have an indirect positive impact on poverty alleviation. Greater emphasis on market-based approaches, aimed at improving the efficiency and cost-effectiveness of agricultural production and marketing, has produced mixed results in terms of rural poverty alleviation. The major challenge for the future is thus to implement corrective measures to deal with problems that occur as reforms are being implemented while maintaining the improvements in efficiency, reductions in marketing costs and fiscal savings that have resulted from market-based approaches to reform.

Chapter VIII deals with the effects on poverty of the economic dimensions of a unique shock: the end of the centrally planned system first in Eastern Europe and then over the Soviet Union, which broke up into independent States. It was widely believed that, after the collapse, the market system would be created within a short time and would lead to much higher standards of living than had been enjoyed before.

For the countries that will enter the European Union in 2004, this prediction has proved broadly correct, although after a longer time than many had expected. Poverty rose in the first years of transition, but has now fallen. However, especially among the members of the Commonwealth of Independent States, the collapse of central planning has given rise to a dramatic rise in poverty, to widening income inequalities and to chronic poverty. Various groups of the population—the unemployed, ethnic minorities, single mothers, those living in previously closed military towns—were hit particularly badly by the transition. Moreover, no longer can mass poverty be viewed as a transitory phenomenon, as was the case in much of Eastern Europe—it must now be regarded as chronic. These States had to confront, at a time of diminished government resources, the challenge of constructing social safety nets that target the most needy. This task should be easier now that their economic revival is under way, but it still requires action on many fronts, as the form of chronic poverty from which they suffer is not likely to be removed by economic revival alone.

The experience of the transition economies highlights dramatically the main conclusion of Part two of the *Survey*, namely, that there is no inherent contradiction between poverty reduction and the pursuit of optimum economic policies, including those in the macroeconomic sphere, and liberalization in trade and agriculture, for these policies should result in faster economic growth which will serve to reduce poverty. Growth will make possible the enactment of those microlevel policies that can address the needs of the poor. However, the enactment of macroeconomic policies should also be infused with an awareness of the likely effects on poverty, and, where necessary, complementary policies should be pursued to ensure that they result in even greater gains in terms of poverty reduction.[5]

5 For a discussion on how to achieve an equity-enhancing growth strategy and an analysis of the priorities of social policies in an integrated approach to growth, see the Report of the Executive Committee on Economic and Social Affairs of the United Nations entitled "Social dimensions of macroeconomic policy", New York, 22 June 2001 (ECESA/4).

IV GROWTH AND POVERTY: A FRAMEWORK FOR EVALUATING POLICY

It deserves to be remarked, perhaps, that it is in the progressive state, while the society is advancing to the further acquisition, rather than when it has acquired its full complement of riches, that the condition of the labouring poor, of the great body of the people, seems to be the happiest and the most comfortable. It is hard in the stationary, and miserable in the declining state. The progressive state is in reality the cheerful and the hearty state to all the different orders of the society. The stationary is dull: the declining melancholy.

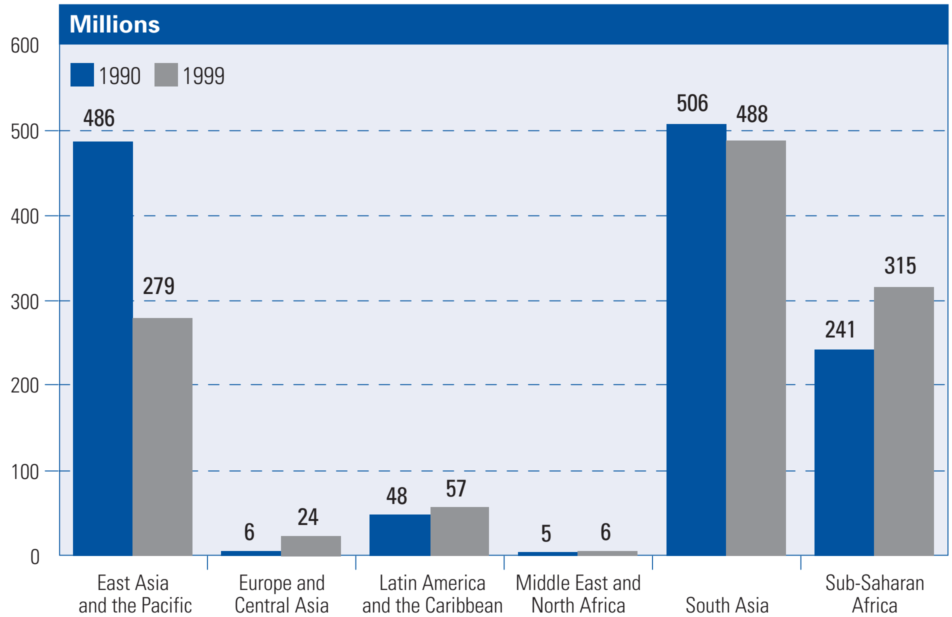
Adam Smith, *An Inquiry into the Nature and the Causes of the Wealth of Nations* Edwin Cannon, ed. (New York Modern Library, 1937), p. 81.

Concerns for poverty have been expressed for many years at the national and international levels, even if its priority in the political agenda has not always been high. The World Summit for Social Development, held in Copenhagen in 1995, produced new initiatives for the eradication of poverty and, subsequently, all countries in the United Nations endorsed, for the first time, in the United Nations Millennium Declaration (see General Assembly resolution 55/2 of 8 September 2000) the commitment to halve the proportion of people living in extreme poverty by 2015. Combating poverty has become a priority in the agenda for the international community and every organization of the United Nations system.

The number of people in the world whose income is less than one dollar per day, measured at purchasing power parity (PPP), was estimated in 1999 to be about 1.2 billion, the most recent available figure (see figure IV.1).[1] This number constitutes about 23 per cent of the total population of developing and transition economies, an improvement from 30 per cent in 1990. During the period 1990-1999, only Eastern and Southern Asia had reduced the proportion of the population living on one dollar or less per day. The rest of the developing world increased the proportions of that population, though the increments were marginal in Latin America and the Caribbean and the Middle East and North Africa. The proportion of people living in extreme poverty in sub-Saharan Africa increased from 47.4 per cent in 1990 to 49.0 per cent in 1999 and, owing to high population growth, the number of people below the poverty line increased from 241 million to 315 million during the same period. The proportion of people living in extreme poverty in the economies in transition also increased because of

1 Strictly speaking, this estimate is based on consumption/expenditure, not on income. Because it is now common to refer to this PPP per day figure as income, the present chapter follows the common usage. For details of the estimation method, see Shaohua Chen and Martin Ravallion, *How did the World's Poorest Fare in the 1990s?,* World Bank Policy Research Working Paper, No. 2409 (Washington, D.C., World Bank, August 2000).

Figure IV.1.
NUMBER OF PEOPLE LIVING IN EXTREME POVERTY IN DEVELOPING COUNTRIES, BY REGION, 1990 AND 1999[a]



Source: UN/DESA, based on World Bank, *Global Economic Prospects and the Developing Countries, 2003* (Washington, D.C., World Bank, 2002), p. 30.

Note: People living in extreme poverty, as defined, live on less than one dollar per day.

a Regions are defined by the World Bank. The country data necessary to compute these aggregates according to the country grouping used elsewhere in the *Survey* are not available.

difficulties associated with their economic transformation. The pace of poverty reduction experienced in the world as a whole during the 1990s was fast enough to achieve the target of halving the proportion of people living in extreme poverty by 2015,[2] but this success came largely from significant advances in Asia—particularly in China and, to a lesser extent, India.

The poor are found in all population groups—among the young and the old, among the employed and the unemployed, and among women and men. They live in the slums of central cities and areas of rural blight. Pockets of the poor are found in developed countries and eradicating their relative poverty is a major policy issue. Poverty in developed countries, however, is different from extreme poverty in developing countries, particularly the least developed countries, where the national poverty income threshold is often set at the equivalent of one or two dollars per day. At this level of income, the risks of death through hunger and the vulnerability to disease are far greater than those faced by people regarded as poor in the developed countries. The aim of alleviating mass extreme poverty in developing countries thus has priority in the global agenda.

Understanding the causes of poverty and the interactions among them is essential for formulating and implementing economic policies that affect poverty. Measuring the extent of poverty at the national and global levels and setting measurable targets, in turn, enable Governments and the international community to assess the impacts of policy actions. It is in this context that the international community has established the Millennium Development Goals to measure progress and to evaluate national and international actions.

Various economic, social and cultural policies have been formulated and undertaken to reduce poverty, explicitly or implicitly.[3] Policies that target poor people explicitly include income subsidy programmes, food aid schemes and

2 Report of the Secretary General entitled "Implementation of the United Nations Millennium Declaration" (A/57/270 and corr. 1), 31 July 2002, para. 40. The average annual rate of poverty reduction during the period was 2.7 per cent and if this rate prevails over the period of 1990–2015, the proportion of population living in poverty will be 15.1 per cent of the total population of developing countries, about 51 per cent of the 1990s level.

3 *Report on the World Social Situation, 2003* (United Nations publication, forthcoming) examines several social and cultural policies that help reduce social vulnerability, a source of poverty.

actions to provide employment and education. Because of the directedness of these policies, measuring their impacts on the people targeted and their effectiveness in relation to their intended goals is straightforward, at least in theory. However, many other policies do not place poverty reduction as their direct goal, even though their implementation may help eliminate poverty as part of the effort to improve the well-being of all. Macroeconomic policies, including structural adjustment programmes and trade policies, agricultural reforms, industrial policies, and national development plans are examples of such policies. They aim at strengthening or stabilizing activities within an economy, a sector or an industry in order to achieve sustained growth of the economy and, by doing so, improving the welfare of the population, including that of the poor. Their overall impacts on poverty are significant, and may sometimes surpass those of the direct policies because of the economy-wide effects that some of them have.

One distinction between the recent trends in policy-making and those formulated up until the mid-1980s (such as national development plans) lies in the current recognition of the roles that markets can play in economic development. Policy makers now formulate economic policies that nurture the development of markets and incorporate the working of existing markets in policy design. For example, instead of fixing the market interest rate at a predetermined level with little consideration of market conditions, more countries now adopt so-called inflation-targeting to stabilize the economy, with the monetary authorities communicating with the public through the money market so as to achieve the target.[4] Many countries have liberalized the external sector of their economies, instead of protecting certain industries with import tariffs and distorted foreign exchange rates. Prices of staple foods, water and electricity often used to be directly set by the Governments in many developing and transition economies, but these prices are now increasingly determined by market conditions, although in many cases some safeguard arrangements are still in place.

The linkages between each of these "market-friendly" policies and the incidence of poverty are complex because their effects on poverty are not direct: there are many channels through which each policy can affect poverty. In order to clarify the nature of the web of indirect links between policy and poverty and to set a framework for evaluating the policies examined in the following chapters of the present *Survey*, the present chapter argues that policies should be assessed from three different perspectives: that of the definition of poverty, that of the social and geographical level of aggregation of poverty, and that of the time-horizon.

As recognized in the Millennium Development Goals, poverty touches many aspects of the human condition, including the economic, social, environmental, political and cultural. As a reflection of its multifaceted aspects, poverty is defined in various ways. Which definition of poverty to adopt is not an issue of right or wrong: it depends on the objective of the policy, or the priority that policy makers set. For example, if the objective of a macroeconomic policy is to stabilize economic conditions, its effects on poverty should be judged in terms of income, consumption, employment or wages, but not in terms of health status or access to water. If, on the other hand, the goal of a health policy is to improve the general health status of women, that policy should be evaluated in terms of the health indicators of the women targeted, not in terms of the incomes that they earn.

4 See *World Economic and Social Survey, 2000* (United Nations publication, Sales No. E.00.II.C.1), box I.1.

The level of aggregation matters particularly when discussing the effectiveness of policy on individuals or on a certain group of people categorized by socio-economic or geographical attributes. A nationwide unemployment compensation scheme is an important tool with which to supplement income declines associated with job losses in the formal sector, but it is of little use to workers in the informal sector or those who are chronically impoverished because of the lack of productive employment. The effectiveness of such a scheme should not be judged on the basis of the number of poor people remaining in the informal sector.

Assessment of the impacts of a policy on poverty also critically depends on the time-horizon that policy assessors—policy makers, experts or civil society—choose to apply. While policies aimed at increasing the average level of educational attainment are conducive to reducing poverty over a long period of time, no one should expect to observe a measurable impact of such policies on poverty within a year or two.

The two extremes of a wide policy spectrum—anti-globalization groups and naive market liberalization groups—often oversimplify, in their own ways, the linkages between policy and poverty in order to justify their respective claims. This chapter argues that such oversimplifications do not capture the essence of the linkages and, in many instances, mislead policy debates; and that assessing growth-poverty relationships depends, instead, on the choice of the definition of poverty, the level of poverty aggregation and the time-horizon. Analysing the relationship between growth and poverty highlights several important issues that become critical when assessing the impacts on poverty incidence of the policies mentioned above.

RELATIONSHIPS BETWEEN DEVELOPMENT, POLICY AND POVERTY

Over the centuries, the world has witnessed many events and changes that have harmed people's lives and livelihoods. Man-made disasters, such as wars, civil strife and political instabilities associated with regime changes, have had adverse impacts on innumerable lives. Natural disasters, such as floods, droughts, earthquakes and volcanic eruptions, have affected them as well. Even in politically stable times, economic and political reforms, changes in the external environment, such as the oil shocks of the 1970s and 1980s and the currency and financial crises in the 1980s and 1990s, and serious epidemics, such as bubonic plague (the Black Death) which killed one quarter of Europe's population in the fourteenth century and human immunodeficiency virus/acquired immunodeficiency syndrome (HIV/AIDS), have all devastated not only human lives but many nations' economic vitality. In many cases, the poor have been affected most severely by these events and changes, owing to a lack of resources with which to address the situation.

At the World Summit for Social Development, held in Copenhagen in March 1995, the States Members of the United Nations recognized that poverty occurs in all countries—mass poverty in many developing countries, pockets of poverty amid wealth in developed countries, loss of livelihoods as a result of economic recession, and sudden poverty as a result of disaster or conflict. Member

States pledged to make the conquest of poverty, among other things, an overriding objective of sustainable development.[5]

The Programme of Action of the World Summit for Social Development recognizes that poverty has various causes, including structural and transitional ones, and that "poverty is a complex multidimensional problem with origins in both the national and international domains".[6] Poverty encompasses not only material deprivation (in terms of income, consumption and assets), but also poor health and inadequate education (human capital), vulnerability to adverse shocks, and a sense of voicelessness and powerlessness (lack of participation) in a society or State.[7] These facets are intertwined and often create a vicious circle: poor people's limited access to opportunities of earning adequate incomes reflects low levels of education and poor health, and their inadequate educational and health status, together with the lack of physical and political infrastructure, often results in the limited participation of the poor in national and local politics. Furthermore, low incomes, together with initial poor health, expose the poor to a higher risk of diseases, making it more difficult for them to participate fully in productive activities.

It is often misleading to focus on only one dimension of poverty because poverty manifests itself in various ways: even when one poverty-related indicator improves, others may worsen. For example, at various times in the 1990s, Ethiopia and Uganda showed improvement in all four aspects of well-being—poverty headcount, net primary school enrolment rates, child nutrition and mortality rates of children under age 5—and Ghana and Mauritania experienced similar trends (see table IV.1). Four other African countries, however, had mixed outcomes. While the poverty headcount increased slightly in

5 Documents related to the World Summit for Social Development are available at http://www.un.org/esa/socdev/wssd/indec.htm. See, in particular, the Programme Action of the World Summit for Social Development (*Report of the World Summit for Social Development, Copenhagen, 6-12 March 1995* (United Nations publication, Sales No. E.96.IV.8), chap. I, resolution 1, annex II), chap. II entitled "Eradication of poverty".

6 Programme of Action of the World Summit for Social Development, para. 23.

7 For discussions on the nature of poverty, see World Bank, *World Development Report 2000/2001: Attacking Poverty* (Washington, D.C., World Bank, 2001), chap. 1. For a vision of poverty coming from the poor themselves, see World Bank, *Voices of the Poor: Can Anyone Hear Us?* (New York, Oxford University Press, 2000); *Voices of the Poor: Crying out for Change* (New York, Oxford University Press, 2002); and *Voices of the Poor: From Many Lands* (New York, Oxford University Press, 2002).

Table IV.1.
EVOLUTION OF STANDARD POVERTY MEASURES IN SELECTED SUB-SAHARAN COUNTRIES

	Poverty headcount[a]		Net primary school enrolment rate		Child malnutrition[b]		Child mortality (per thousand)	
Country and period	Initial level	Percentage change	Initial level	Change in percentage points	Initial level	Change in percentage points	Intial level	Change
Ethiopia (1994-1997)	39	**-26**[c]	19	**6**	66	**-11**	190	**-15**
Ghana (1992-1998)	51	**-24**	70	**12**	26	0	119	**-15**
Madagascar (1993-1999)	70	1	48	**16**	50	**-1**	170	**-21**
Mauritania (1987-1995)	58	**-40**	28	**13**	48	**-25**	..	..
Nigeria (1992-1996)	46	56	94	**4**	38	..	136	11
Uganda (1992-1997)	56	**-21**	68	**18**	43	**-4**	165	**-3**
Zambia (1993-1998)	74	**-3**	73	-7	40	3	194	**-5**
Zimbabwe (1991-1996)	26	35	83	**3**	30	**-7**	77	31

Source: UN/DESA, based on Luc Christiensen, Lionel Demery and Stefano Paternostro, "Growth, distribution poverty in Africa: messages from the 1990s" World Bank, March 2002, tables 1 and 6.

Note: Bold face type indicates improvement.

a Consumption measured as regionally deflated real household expenditure per adult equivalent. Poverty lines are calculated according to the cost-of-basic-needs approach, which includes non-food needs (except Zimbabwe). Poverty line for Mauritania is based on a United States one-dollar-per-day equivalent.

b Referring to children under age 5 whose height for their age is less than minus two standard deviations from the median for the international reference population ages 0 to 59 months.

c Rural poverty only.

Madagascar, the other variables showed improvement. Nigeria and Zimbabwe experienced significant increases in the number of poor people and child mortality rates, but larger proportions of children attended school. In Zambia, on the other hand, the share of the population living below the poverty line and child mortality rates declined slightly, but a lower proportion of children attended school and the incidence of child malnutrition increased.

While the well-being of the poor in Ethiopia, Ghana, Mauritania and Uganda clearly improved on average during the periods specified—albeit from a very low level—it is not obvious how the changes in the poverty situation in the other countries can be summarized. Such complexity tends to make for extensive debate about the relationship among economic, social, political and other human development-related factors as causes and consequences of poverty.[8] Moreover, hard evidence is difficult to come by to support or refute arguments, because of the costs and technical difficulties associated with data collection. In the end, the complexity of the poverty issues and the lack of hard evidence "can overwhelm adequate understanding".[9] This situation poses a problem for policy makers, particularly when they design a policy that aims to improve the living standards of the poor and when they evaluate the outcome of this policy. A policy inevitably induces changes in economic, social and other variables in complicated ways; without adequate understanding, it is difficult, if not impossible, for policy makers to design and implement an appropriate policy with feasible targets.

Selecting a few poverty variables—depending on the policy goal established and on data availability—helps improve analytical capability and allows policy makers to examine more closely the relationship between poverty and policy actions. Given the current stock of knowledge about the relationships among poverty, development and policy, policy makers and experts in the field will gain practical insight, however incomplete, by focusing on a narrower range of manifestations of poverty, at the expense of a more in-depth description of the multifaceted experiences of the poor.[10]

Focusing on one or a few indicators that gauge material aspects of poverty (income, consumption and productivity) has additional advantages. One reason for this focus is the limited availability of internationally comparable data for analysing the impact of policy changes on consumption or income over time. Such data are indispensable because tracing the impacts of policy on poverty is inevitably required to track changes in poverty indicators over time (the so-called poverty dynamics). Second, there are well-established statistical definitions of the indicators related to the material dimensions of poverty, which is not the case for the sense of being powerless and voiceless, for example. Third, some indicators related to the material dimension of poverty are generally more responsive to economic policy changes than are such social variables as health, education and literacy rates. These indicators, particularly income and consumption, involve fewer measurement problems and are observed frequently enough to allow for the detection of the relationships between them and the changing socio-political environment, including policy changes. Fourth, and perhaps most importantly, the multidimensional definition of poverty tends to lead to a complex but static view of poverty—that is to say, a snapshot at one point in time—in which the focus of the anti-poverty strategy is on *what* people lack.[11] The narrower material definition of poverty, in contrast, makes more

8 One way to evaluate the status of the poor is to construct a "poverty index", which assigns weights to various poverty-related variables and sums them up to create a single number. However, the question remains what variables should be included and what weight should be attached to each variable.

9 United Nations Conference on Trade and Development (UNCTAD), *The Least Developed Countries Report, 2002: Escaping the Poverty Trap* (United Nations publication, Sales No. E.02.II.D.13), p. 40.

10 The theoretical links between growth, poverty reduction and social indicators are discussed in Lance Taylor, Santosh Mehrotra and Enrique Delamonica, "The links between economic growth, poverty reduction, and social development: theory and policy", in *Development with a Human Face: Experiences in Social Achievement and Economic Growth,* Santosh Mehrotra and Richard Jolly, eds. (New York, Oxford University Press, 1998).

11 See *the Least Developed Countries Report, 2002* …, part two, chap. 1.

tractable the relationship between policy changes and poverty dynamics and allows policy makers to focus on *why* people lack certain things.[12] Furthermore, this approach allows policy makers to distinguish chronic poverty from transient poverty (that is to say, those stuck in poverty over a long period in contrast with those who can be expected to escape from poverty after a short period), each requiring for its reduction, in many cases, its own unique set of policy prescriptions.

The following sections in this chapter focus on the relationship between economic variables, especially growth, and poverty indicators, and examine the impact of economic policies on those variables and indicators, with a view to drawing implications and proposing guidelines for poverty reduction in the context of a macroeconomic framework.

AVERAGE RELATIONSHIPS BETWEEN GROWTH AND POVERTY

History suggests that sustained economic growth over "the very long run" is the critical factor for reducing or even to eliminating extreme poverty.[13] Without sustained growth over the centuries, Western Europe, where until the mid-eighteenth century most social scientists were resigned to accepting the phenomenon of poverty as an inescapable fact of life,[14] could not have achieved the high living standards that the region enjoys at present. This is true for developed countries in other regions as well. While the developed countries experienced wars, economic depressions, social unrest and other setbacks during the course of their development, they undertook countermeasures to rectify these situations and maintained long-term sustained growth that has led to their current developed status.

In the current debate on policy and poverty, however, the issue is how national authorities in developing and transition economies, assisted by the international community, can enable the poor to escape from poverty as quickly and effectively as possible, in order to reach the Millennium Development Goals by 2015. The importance of sustained economic growth over the very long term in eliminating poverty is recognized, but policy makers need to identify, beyond the economic and social policies adopted by the now-developed countries over the course of their development, a new set of policies that allow economic growth to reduce the incidence of poverty more positively.

One of the major policy debates on poverty has centred on the relationship between poverty and macroeconomic policies—policies that aim at stabilizing, sustaining or enhancing economic growth. The main questions raised have been the following: Do macroeconomic reforms based on free-market discipline have positive impacts on the poor? Is liberalization of trade and finance beneficial for poor people and poor countries, or does it only further enrich already rich people and wealthy countries? Is economic growth in general pro-poor and, if not, what types of growth are pro-poor?[15] More generally, has globalization of the world economy in recent years had a positive impact on people in developing countries, particularly the poor?

These questions seem to assume that various linkages—direct or indirect—between poverty and globalization, poverty and economic growth, and poverty

12 Furthermore, as discussed later in this chapter, focusing on the dynamics of poverty narrowly defined sheds light on the issue of short- versus long-term impacts of a policy change, which has created disagreement on economic policy among policy makers, experts and non-governmental organizations. See Ravi Kanbur, "Economic policy, distribution and poverty: the nature of disagreements", *World Development*, vol. 29, No. 6 (June 2001), pp. 1083–1094.

13 While no clear definition of it has emerged, the very long run refers generally to periods longer than a century. For an example of such an analysis, see Charles I. Jones, *Was an Industrial Revolution Inevitable?: Economic Growth over the Very Long Run,* National Bureau of Economic Research Working Paper Series, No. 7375 (Cambridge, Massachusetts, October 1999).

14 *World Development Report, 2000/2001…*, chap. 3.

15 The term "pro-poor growth" is now frequently used in policy debates, but there is no consensus as to its meaning. See Howard White and Edward Anderson, "Growth versus distribution: does the pattern of growth matter?", *Development Policy Review*, vol. 19, No. 3 (September 2001), pp. 267–289.

and economic reforms exist over reasonably short periods of time. As argued previously, however, poverty has various causes and manifestations and thus does not display any straightforward relationship with global or macroeconomic phenomena. It is argued below that, while some relationship showing statistical regularity exists between growth and income or consumption poverty over the medium-to-long term across many developing and transition countries, the impacts of growth on poverty depend on the different socio-economic conditions in different countries, including the degree of initial income inequality. The assessment of impacts of growth on poverty also depends critically on the level of aggregation (national, regional, sectoral or individual) and the time-horizon chosen (short- versus long-run), which give rise to different pictures of poverty dynamics, often leading to different policy implications.

General relationship between growth and poverty in the long run

The World Bank estimates that 19 per cent of the world population lived on less than $1 per day and 46 per cent on less than $2 dollar per day in 1999.[16] The incidence of such poverty, however, exhibited a large variation among countries. The relationship between per capita income and poverty incidence, suggests some general tendencies related to income and poverty levels (see figure IV.2). First, on average, the higher the per capita income, the lower the incidence of poverty—which is not a surprising. Second, while poorer countries tend to have a higher incidence of poverty, the incidence varies widely among countries with similar annual per capita incomes. For example, among countries with per capita income less than $1,000 a year, the share of the population living on less than $1 per day varies between less than 20 and more than 70 per cent.[17] This variation reflects the degree of income inequality of the countries: for two countries with similar average income levels, the one with a higher income inequality tends to have a higher poverty rate.

The relationships between poverty and average income and the differences in the incidence of poverty among countries with similar per capita income level are subjects of much research. However, the large differences in the incidence of poverty between richer and poorer countries point to the importance of achieving sustained growth, and the wide variation in poverty incidence (and income inequality) among countries with similar income levels suggests the need to improve income equality as a means to reduce poverty.

The consensus, however, stops at this point, and debates arise on the issue of the evolution of poverty and economic growth, defined as a rise in the average living standard of a country, that is to say, in income per capita. While a redistribution of income at any point of time could reduce poverty in the short run, the long-run relationship between income distribution within a country and growth is the subject of considerable interest and debate (see box IV.1). Over long period of time, growth, an increase in inequality and a reduction of poverty have occurred in tandem. More recently, the debate has extended to the relationship between poverty reduction and the globalization of the world economy, which is presumed to affect, in one way or another, growth and living standards in the country. The issues in their simplest form are whether or not sustained economic growth is good for the poor, and whether globalization of the world economy has a positive or negative impact on the poor, possibly via its effects on the growth of the national economy.

16 World Bank, *Global Economic Prospects and the Developing Countries: Making Trade Work for the World's Poor* (Washington, D.C., World Bank, 2002), table1.8.

17 UNCTAD defines "generalized poverty" as a condition in which a major part of the population lives at or below income levels sufficient to meet their basic needs, and in which the available resources in the economy are barely sufficient to cater for the basic needs of the population on a sustainable basis. See *the Least Developed Countries, 2002* ...

Figure IV.2.
PER CAPITA INCOME AND EXTREME POVERTY IN THE 1990s[a]

Sources: UN/DESA, based on World Bank, *2002 World Development Indicators, CD-ROM* (Washington, D.C., World Bank, 2002); and World Bank, *World Development Report, 2002: Building Institutions for Markets* (Washington, D.C., World Bank, 2002), table 2.

[a] Data covering 78 developing and transition economies. Share of population living on less than one or two dollars a day referring to various years in the 1990s and the average annual per capita income is to average per capita GDP (purchasing power parity-based 1995 US dollars) during 1995-1998.

Box IV.1

EQUALITY, GROWTH AND POVERTY: ARE THERE TRADE-OFFS?

The connection between the income distribution that results from growth and economic progress has been at the forefront of much recent economic analysis. The most important hypothesis put forward in this area was that of Simon Kuznets.[a] He argued that the income distribution within a country was likely to change over time with its progress in changing from a poor agricultural society to a rich industrial society. The average per capita income of the rural population is usually lower than that of the urban population, whereas income distribution within the urban population is more unequal. In the urban population, savings are concentrated in the upper-income groups and the cumulative effects of such savings would be the concentration of an increasing proportion of income yielding assets in the upper-income groups. Thus, as the weight of the urban sector increases in the economy with industrialization, the country's overall income distribution will tend to deteriorate until such time as the urban sector dominates. After that time, the income distribution will tend to stabilize because of three factors—the slower growth in the population of the wealthier classes, the exploitation of the opportunities for wealth-creation offered by technology undertaken by those whose property assets are not in established industries, and the shift of workers away from lower-income to higher-income industries—which are all indicative of the "dynamism of a growing and free economic society".[b] In addition, progressive direct taxes and government benefits would tend to equalize post-tax incomes. As posited by Kuznets, this pattern of income equality that first worsens and then improves with growth is a long-run phenomenon: for example, Kuznets saw the phase in which income inequality widened as have taken place between 1780 and 1850 in England (the first country to industrialize), from 1840 (and especially from 1870 onward) in the United States of America, and from the 1840s to the 1890s in Germany. Narrowing income inequality is thought to have taken place eventually—beginning in around 1875 in England and after 1918 in Germany and the United States.

Figures for the world economy after the free enterprise system—what has been described as the "innovation machine"—first started to produce increases in productivity and new inventions at a rate unlike any previously seen in world history shed light on this long-run phenomenon in an interesting manner (see table 1).[c] These figures take into account the difference in incomes within countries and not just the differences between the mean incomes of each country. Whether measured by the Gini or Theil coefficients, both of which increase as inequality increases, income distribution in the world deteriorated substantially between 1820 and 1950, halting between 1910 and 1929. After 1950, the pattern became less clear, with the Gini coefficient having stabilized between 1980 and 1992.

For the purpose of this analysis, the world was divided into country groupings: (a) Africa, (b) Asia, (c) Japan, the Republic of Korea and Taiwan Province of China, (d) Eastern Europe (including the Russian Federation and Turkey) and (e) Western Europe, Australia, Canada, New Zealand and the United States. How much of the inequality of income was due to inequality within country groups or between country groups was then calculated. In 1820, because mean incomes in all parts of the world were considered to have been broadly similar before the Industrial Revolution caused Western Europe to pull sharply ahead, only 12 per cent of total inequality was due to differences in income levels between the country groupings. As the Revolution progressed and embraced more countries in Europe and North America, this proportion increased to reach nearly 40 per cent before the First World War, to 47 per cent in 1929 and to nearly 60 per cent in 1950. After 1950, the situation stabilized as more countries—first Japan, the Republic of Korea and Taiwan Province of China and later China, India, Indonesia and other Asian countries—achieved rapid growth and saw their mean incomes rise. This period of rapid growth in Asia followed the end of direct or indirect control by the European powers, during which period growth, and particularly industrial growth, was often held back by policies designed to help those powers.

The period of rising income inequality at the world level, and in particular of rising differences between the country groupings, had seen a massive reduction in extreme poverty (measured as consumption per capita of one dollar per day in 1985 purchasing power parity (PPP)), from 84 per cent of the world's population in 1820 to 66 per cent in 1910 and to 55 per cent in

[a] See Simon Kuznets, "Economic growth and income inequality", *American Economic Review*, vol. 46, No. 1 (March 1955), pp. 1-28.

[b] Ibid., p. 11.

[c] For an analysis of the wealth generating possibilities of the capitalist system, see *World Economic and Social Survey, 2002* (United Nations publication, Sales No. E.02.II.C.1), pp. 162-163; and William Baumol, *The Free Market Innovation Machine: Analyzing the Growth Miracle of Capitalism* (Princeton, New Jersey, and Oxford, United Kingdom, Princeton University Press, 2002).

Box IV.1 (continued)

Table 1.
POVERTY AND INCOME INEQUALITY AT THE GLOBAL LEVEL, 1820-1992

	1820	1850	1870	1890	1910	1929	1950	1960	1970	1980	1992
Gini coefficient	0.500	0.532	0.560	0.588	0.610	0.616	0.640	0.635	0.650	0.657	0.657
Theil index	0.522	0.598	0.672	0.745	0.797	0.777	0.805	0.776	0.808	0.829	0.855
Inequality within country groups	0.462	0.470	0.484	0.495	0.498	0.412	0.313	0.318	0.315	0.330	0.342
Inequality between country groups	0.061	0.128	0.188	0.250	0.299	0.365	0.482	0.458	0.492	0.499	0.513
Inequality between country groups as a percentage of total inequality	11.7	21.4	28.0	33.6	37.5	47.0	59.9	59.0	60.9	60.2	60.0
Mean world income PPP dollars, 1990	658.7	735.7	890.0	1 113.8	1 459.9	1 817.1	2 145.5	2 798.6	3 773.8	4 544	4 962
Extreme poverty (percentage of world population)	83.9	81.5	75.4	71.7	65.6	56.3	54.8	44.0	35.6	31.5	23.7
Mean life expectancy (years)	26.5	..	..	29.9	32.8	38.5	50.1	..	59.4	..	61.1

Source: François Bourguignon and Christian Morrisson "Inequality among world citizens: 1820-1992", *American Economic Review,* vol. 92, No. 4 (September 2002), pp. 731-732, table 1, and p. 734, table 2.

1950. This continued, with 24 per cent of the world's population, according to these calculations, having been in extreme poverty in 1992. Over the same period, mean life expectancy rose sharply, from 26 years in 1820, to 50 years in 1950 and to over 60 years in 1992.

At the global level, then, the pattern of rising inequality, especially between countries, rising incomes and declining poverty would appear to have held good. The overall figures show that global income distribution, which plots the number of people or proportion of world population against the income they receive, has shifted to the right over time, indicating a rise in incomes. In addition, particularly since 1970, the two peaks in the distribution, with one for the poor at between the $1 and $2 per day poverty lines and the other for the rich at about $9,000 a year, have levelled out, indicating the rise of the middle class at a global level.

Yet, over the period 1970-1992, the situation in different regions shifted dramatically. According to one study, the number of the poor (measured by the $2 per day poverty line) in Asia decreased sharply, largely as a result of the success of China and India in achieving sustained growth (see table 2). In China, income inequality increased over the period, with, as the Kuznets hypothesis would have predicted, the urban sector progressing faster than the rural sector. However, in India, there was little change in the income distribution, while in Indonesia, income inequality declined as the economy grew. In Latin America, the "lost decade" of the 1980s had reversed the gains in poverty reduction achieved in the 1970s, and in the 1990s the situation started to improve so that the numbers of the poor became lower than in 1970. In Africa, though, the situation deteriorated throughout the period. In Nigeria, the largest country, those living on less than $2 a day rose from 45 per cent of the population in 1970 to 70 per cent in 1998. However, as the income distribution shifted to the left as the economy declined, with private consumption per capita having declined by 4.1 per cent per year between 1980 and 1998, the upper tail of the distribution shifted to the right, indicating that the richest Nigerians had become better off as the average Nigerian became worse off. This situation was not uncommon in Africa.

Box IV.1 (continued)

This is not the phenomenon that the Kuznets hypothesis had set out to explain, as his analysis was based upon what happens during economic growth rather than during decline. Although the African experience was comparable with that in some of the transition economies where income distribution worsened as the economy declined (see chap. VIII), the effects of the shocks that pushed the transition economies into recession have now been overcome in that economic growth has resumed. The present income distribution in many African countries can be seen as the end result of the interplay of many of the different factors—such as poor governance, the misdirection of mineral rents and the lack of attention paid to the rural sector, especially the rural poor—that accounted for much of Africa's disappointing economic performance in the last decades.

Whether rapid progress is possible with such an unequal distribution as now obtains is a crucial question whose answer depends upon political and social as well as economic factors. Sustained growth will be achieved only if the fruits of any advance are shared more fairly, particularly among the poor, than were the losses during the decline, when an ever-expanding share of a declining income was appropriated by the richest members of society. In any event, with large numbers of the world's population, especially in Asia, continuing to make rapid progress, and with Africa's population continuing to grow rapidly—even after the effects of human immunodeficiency virus/acquired immunodeficiency syndrome (HIV/AIDS) and other diseases - unless the absolute decline in Africa's economic growth is halted and reversed, the distribution of income in the world will become more unequal. Rather than signal considerably faster progress in some parts of the world than in others, as was broadly the picture from 1820 to 1950, a rise in world income inequality will indicate the effects of an absolute decline in one part amid often rapid expansion in other parts.

Table 2.
PEOPLE LIVING WITH AN INCOME LEVEL OF LESS THAN TWO DOLLARS PER DAY, ASIA, LATIN AMERICA AND AFRICA, 1970-1998

Millions

	1970	1980	1990	1998	Total population in 1998
Asia (excluding Japan)	1 130.8	1 112.6	814.9	480.3	2 958
China	608.7	554.1	405.0	231.8	1 239
India	321.1	373.1	275.0	140.5	980
Indonesia	81.6	53.0	17.6	6.7	204
Pakistan	30.1	37.3	30.3	30.8	132
Bangladesh	39.3	55.6	54.1	42.8	126
Latin America	60.4	36.3	59.5	51.1	485
Brazil	29.8	18.7	24.3	21.4	166
Mexico	10.2	4.8	3.7	1.8	96
Colombia	5.7	4.6	6.0	7.0	41
Africa	141.2	193.0	270.9	368.4	579
Nigeria	24.2	37.6	60.7	84.4	121
Ethiopia	23.7	30.2	42.4	50.3	61
Congo	20.3	27.0	37.4	48.2	48
South Africa	4.5	4.7	6.4	7.7	41
United Republic of Tanzania	11.2	14.7	21.7	28.7	32
Kenya	8.5	10.3	14.9	18.5	29

Source: Xavier Sala-i-Martin, *The World Distribution of Income (Estimated from Individual Country Distributions),* National Bureau of Economic Research Working Paper, No. 8933 (Cambridge, Massachusetts, May 2002), tables 5-7 (available at www.nber.org/papers/w8933).

Note: These figures may differ from those from other sources that use different methodologies for their compilation.

It is important to distinguish logical considerations from empirical findings. The logical answer to the question concerning the growth-poverty relationship is rather straightforward if no consideration is paid to the differences in socio-economic conditions of countries that are observed in the real world. The economic growth of a nation—an increase in its production or per capita income—is neither a necessary, nor a sufficient condition for poverty reduction: there is no logical linkage running from sustained growth to poverty reduction. Growth is not necessary for poverty reduction because poverty can be reduced by redistributing incomes among all members of the country in the absence of economic growth. Growth is not sufficient for poverty reduction because economic growth does not necessarily have any distributional aspects: sustained growth may make the rich richer with no trickle-down effects to the poor at all. While logically possible, however, this is unlikely, as the rich will increasingly demand more and better goods and services, and will be in a position to pay more for them. In short, there is bound to be some trickle down, although this could be very limited. The impacts of growth or globalization of the world economy on the poor thus cannot be judged a priori because of this lack of a firm and consistent logical linkage between growth or globalization and poverty.

Actual observations of market-based economies seem to suggest, however, a correlation between growth and poverty, contrary to the preceding logical conjecture. The observed relation is a result of the political and socio-economic environment in these economies—a factor that the logical considerations completely ignore—which limits the range of observable combinations. For example, while an income-redistribution policy that eliminates extreme poverty may be politically feasible for high-income countries, where the fiscal transfers (such as taxes and subsidies) required to eliminate extreme poverty are small relative to national income, it is not feasible for low-income developing countries. In the latter group of countries, eliminating poverty would require massive fiscal transfers relative to their national incomes. There are likely to be severe political difficulties to implementing such a policy and the measures might themselves undermine growth prospects. On the other hand, economic growth that benefits the rich disproportionally for a long time cannot be pursued, because of the increasing dissatisfaction of the majority of the population with the unfair distribution of incomes and consequent likelihood of political instability or social unrest. A continued high degree of income inequality may also adversely affect the work incentives of the non-rich.

Studies of the growth-poverty relationship have given rise to disagreements with regard to the measurement of income poverty, the compatibility of cross-country and inter-temporal data and the methods of analysis employed (see box IV.2). Even where consensus is reached, the data often give no clear conclusions, or are not very informative. The rest of this section therefore focuses primarily on the points of common understanding among experts about the relationship between growth and poverty, in order to create a framework for the subsequent review of policy issues.

One point of consensus is that growth is generally beneficial for the poor, albeit not without exceptions. Growth has been found beneficial for the poor when growth-poverty experiences in various countries are “averaged out” and each growth period is sustained over a reasonably long period, typically five years or more. Countries’ experiences differ widely around the average, howev-

Box IV.2

DRAWING THE POVERTY LINE

The Millennium Development Goals for poverty reduction use an international absolute poverty line of one-dollar-per day in purchasing power parity.[a] The simplicity of the one dollar per day standard has been successful in promoting the concept of extreme poverty and has provided a useful reference mark for policy discussions. However, this line arouses controversy among experts with different professional points of view and experience.[b]

The one dollar-per-day line has been criticized on at least three grounds, namely, (a) the use of a single indicator as an international benchmark, (b) the calculation of purchasing power parity (PPP) conversion rates and, (c) the design of the household surveys used, and the sole reliance on them.[c]

With respect to (a), according to *some* researchers, the conception of poverty should refer to *minimum rights to resources,* and constitute a measure of the opportunities open to people to participate in the community's style of living with a salient set of elementary capabilities. The minimum resources (and thus income) required to participate in the community's lifestyle would depend on the community in which the individual/family resides, because lifestyles vary among countries. National poverty lines in many countries are constructed in a way that is consistent with this concept. "The notion of a fixed absolute poverty standard, applicable to all societies and at all times is therefore a chimera."[d] The international poverty line of one dollar-per-day is, on the other hand, based on the *standard-of-living approach* and is assumed to correspond to a specified level of consumption. It is designed to measure the number of very poor, most of whom live in the poorest countries, but not the community-dependent poverty in the rest of the world. It corresponds approximately to the national poverty lines of many low-income developing countries.[e]

With regard to (b) the purchasing power parity (PPP) conversion rate is a price index that is applied to convert the cost, measured in local currency, of a typical basket of goods that the average person consumes in a country to the cost in United States dollars. Besides the general problems associated with any index numbers,[f] there is a question about the relevance of the baskets of consumption used to calculate PPP rates. It is conceivable, and even likely, that the typical basket of goods consumed by the poor and the prices they pay are different from those relevant to the average person in the same country.[g] Furthermore, since some agricultural goods are available only in a particular local area and take a large share of local people's expenditure, it is difficult to find a relevant comparative price at the global level. In those cases, the cost of the basket relevant for poor people will not be accurately converted into dollars.[h] While these are important considerations, the current capacities of statistical offices in many countries do not allow for such detailed analysis.

As for (c), national household surveys are, in many cases, the source for constructing consumption or income distributions and estimating extreme poverty, but their designs are not standardized across countries and over time. Some experts use average consumption or personal income based on National Income

a Strictly speaking, the line is drawn at $1.08 per day in 1993 international purchasing power parity prices. See Shaohua Chen and Martin Ravallion, *How did the World's Poorest Fare in the 1990s?,* World Bank Policy Research Working Paper, No. 2409 (Washington, D.C., World Bank, August 2000).

b For more technical aspects of the following arguments, see Angus Deaton, "Data for monitoring the poverty MDG", mimeo, Research Program in Development Studies, Princeton University, January 2003.

c Another concern is connected with the unit of analysis (individual versus family), and is more technical in nature. See Deaton, loc. cit.

d A. B. Atkinson, "Poverty", in *The New Palgrave: A Dictionary of Economics*, John Eatwell, Murray Milgate and Peter Newman, eds. (London, MacMillan, 1987), p. 931. See also Food and Agriculture Organization of the United Nations (FAO), *World Agriculture: Towards 2015/2030: An FAO Perspective* (London, Earthscan Publications, 2003), p. 214, box 8.1.

e Deaton, loc. cit.

f Ibid.

g Some evidence is found in Christophe Muller, "Prices and living standards: evidence for Rwanda", *Journal of Development Economics*, vol. 68, No. 1 (June 2002), pp. 187-203.

h See Jeffrey G. Williamson, *Winners and Losers over two Centuries of Globalization,* National Bureau of Economic Research Working Paper Series, No. 9161 (Cambridge, Massachusetts, September 2002).

Box IV.2 (continued)

and Product Accounts (NIPA) to calculate poverty estimates because the conceptual framework of the NIPA is more standardized across countries and over time.[i] However, the NIPA framework does not necessarily produce more accurate information on consumption or income. Inasmuch as the NIPA framework demands much wider coverage of economic activities and more detailed estimation procedures, the chances are greater that the "residuals", that is to say, items that are unaccounted for by direct estimates, will become large and biased.

Another concern is how well a survey represents the population of a nation. It is often costly to travel to remote rural areas where the proportion of the extremely poor tends to be high, and in urban areas it is difficult to count and sample the homeless, or "street people". Moreover, rich people often refuse to participate in surveys or answer questionnaires dishonestly, because they fear that, based on answers they give, the tax authorities may discover their untaxed "informal" activities. While NIPA-based estimates are free from such problems, at least in concept, their estimates of consumption or income include items that do not represent actual expenditure of private persons, such as consumption by for- and non-profit organizations, imputed charges for financial intermediation (so as to remove double-counting) and imputed income from owner-occupied housing.[j]

Owing to the differences in design and methodology between household surveys and the NIPA framework, estimates of average consumption or personal income sometimes differ significantly. With NIPA-based numbers, estimated average consumption tends to be higher when economic growth is high, making poverty estimates lower than otherwise. When growth is stagnant, estimated consumption is lower and poverty higher. For example, using the NIPA method, the United Nations Conference on Trade and Development (UNCTAD) reports that the number of people in poverty in the least developed countries in Asia is found to be less than the number estimated by the World Bank, which is based on household surveys;[k] but UNCTAD also estimates that extreme poverty is much more widespread in sub-Saharan Africa than estimates by the Bank would indicate, owing to low growth in the region. Some researchers even claim, based on NIPA methods, that the Millennium Development Goals on poverty reduction has already been met, largely because of high growth in some developing regions outside sub-Saharan Africa.[l] These authors note, however, that, irrespective of their estimation procedures, mass poverty in sub-Saharan Africa should continue to be a major concern.

The construction and use of the one dollar-per-day poverty line entail several issues that are difficult to resolve. Resolving them would require actions by Governments, international organizations and experts to standardize household surveys across countries and over time and to improve the capabilities of national statistical authorities in developing countries.[m] Meanwhile, survey- and NIPA-based estimates should be considered complementary, rather than competing, sources of information.

i Examples include: UNCTAD, *The Least Developed Countries Report, 2002: Escaping the Poverty Trap* (United Nations publication, Sales No.E.02.II.D.13), part two; and Xavier Sala-i-Martin, *The Disturbing Rise of Global Income Inequality,* National Bureau of Economic Research Working Paper Series, No. 8904 (Cambridge, Massachusetts, April 2002).

j Average income or consumption and the distribution of either are also sensitive to the timing of visits of survey teams, particularly in agrarian communities, and the recall period.

k See the Least Developed Countries Report, 2002, ….

l See Sala-i-Martin, op. cit.; and Robert J. Barro, "The UN is dead wrong on poverty and inequality", *Business Week*, 6 May 2002, p. 24. Their poverty estimates are based on GDP. Their method takes into account government expenditure, such as health and education expenditure, that contributes to the living standard of the poor.

m The United Nations has initiated a project on the efficient design and implementation of household surveys in developing and transition countries. See United Nations Statistics Division, "An analysis of operating characteristics of household surveys in developing and transition countries: survey costs, design effects and non-sampling errors" (ESA/STAT/AC.85), 3 September 2002, draft submitted to an Expert Group Meeting, New York, 2-11 October 2002.

er, and shorter-run fluctuations in the growth and poverty relationship do not fit neatly within the long-run relationship. Furthermore, the extent to which growth is good for the poor depends on the definition of income poverty chosen, even when the same data set is used (see box IV.3). Overall, while economic growth tends to benefit the poor, this assertion must be understood relative to the analytical framework (including the time-horizon) and definitions used. These subjects are among the sources of disagreements among policy makers, researchers and civil society about economic policy aimed at poverty reduction.

At the regional level for the period 1990-1999, there was negative correlation between growth and extreme poverty—higher growth was associated with a lower poverty rate—but the responses of extreme poverty to growth varied among the regions (see figure IV.3). For example, each 1 percentage point

Box IV.3

GROWTH AND RELATIVE POVERTY

Poverty is defined in absolute terms in the Millennium Development Goals. Once poverty is defined in relative terms (as encompassing, first example, the lowest quintile of the income distribution), however, a different growth-poverty relationship emerges, creating multiple but sometimes conflicting visions of the nature of growth's impact on poverty.

The conceptual difference between the absolute and relative definitions of poverty is closely related to the difference between the standard-of-living and minimum resources approaches to defining poverty (see box IV.2). According to the former approach, an individual needs to attain a specific level of consumption and (thus to spend a certain amount of money), no matter where that person resides. This is one reason that levels of absolute poverty are often based on the consumption basket. The latter approach, on the other hand, emphasizes the importance, when identifying poverty, of the community to which the individual belongs. For example, the needs of an individual who lives in a least developed country with respect to participating in the local lifestyle are recognized to be different from the needs of an individual who lives in a developed country. In many instances, relatively poor people are defined either as individuals or households whose incomes (which are taken to represent the opportunities for participation in the community) are at or below a certain percentage of the national average income,[a] or as those who belong to the lowest bracket of income distribution. In order to enjoy a certain level of the local lifestyle, an individual living in a developed country needs to consume more varieties of goods and services in, possibly, larger quantities than an individual in a least developed country.

If the poor are defined as the people in the lowest bracket of a country's income distribution—typically the lowest income quintile (20 per cent) of the size distribution of income— *and* if the growth periods are at least five years long, cross-country regression analysis suggests that the poor benefit from economic growth and suffer from economic decline as much as the average income-earners do;[b] that is to say, when the national average per capita income rises (or falls), the average income of the poorest quintile rises (or falls) by the same proportion.[c]

While the cross-country-regression approach to analysing the growth-poverty relationship has been criticized on technical grounds,[d] similar results have been obtained by a different approach, based on observations of fluctuations in economic growth and income inequality and the correlation between the two. Because countries' income distributions over time have been observed to be more stable than economic fluctua-

a Nationally defined poverty used in figure IV.3 is such an example.

b The elasticity of average incomes in the bottom quintile with respect to overall average income is found to be unity, or very close to unity (see David Dollar and Aart Kraay, "Growth *is* good for the poor", Development Research Group, World Bank (March 2000)). It should be noted that this is equivalent to saying that the share of the lowest quintile is uncorrelated with GDP per capita. See Martin Ravallion, "Growth, inequality and poverty: looking beyond averages", *World Development*, vol. 29, No. 11 (November 2001), pp. 1803- 1815.

c This does not mean that growth raises the income of the poor by the same absolute amount as that by which it raises the income of the average income-earner. The continued inequality of income distribution makes the average gains to the poor smaller than the average gains to the non-poor.

d See, for example, T.N. Srinivasan and Jagdish Bhagwati, "Outward-orientation and development: are revisionists right?", September 1999, mimeo; and Steven N. Durlauf, "Manifesto for a growth econometrics", *Journal of Econometrics*, vol. 100, No. 3 (January 2001), pp. 65-69.

increase in per capita income was associated with a 1.2 percentage point decline in extreme poverty in East Asia, including China, but with only a 0.7 percentage point growth, but in a negative direction in South Asia. Europe and Central Asia saw the largest response in poverty to economic growth, but in a negative direction: each 1 percentage point decline in GDP led to a 5.9 percentage point increase in poverty incidence. Such a sharp increase in the poverty rate in response to economic contraction suggests that the collapse of the centrally planned economic system has affected the welfare of the population not only through economic decline, but also through the deterioration of social conditions, because of reductions in social expenditures by Governments.[18] Latin America and the Caribbean and the Middle East and North Africa experienced positive, albeit meagre, growth in per-capita GDP during the 1990s, but

18 United Nations, *World Economic and Social Survey, 2001* (United Nations publication, Sales No. E.01.II.C.1), chap. VI.

Box IV.3 (continued)

tions over the business cycle, it is empirically impossible to claim that the non-poor alone benefited disproportionally and that the poor did not benefit. If this were the case, the income distribution would have worsened to an extent are not compatible with any historical records.[e]

Through its impressive growth between 1990 and 1999, China reduced absolute poverty significantly, both in the number and in the proportion of the poor. However, the percentage share in the country's total income of the lowest quintile declined from 7 only to 5.9 per cent.[f] Burkina Faso, on the other hand, saw the poverty rate rise from 44.5 per cent in 1994 to 45.3 per cent in 1998 despite strong growth during that period, but the share in total income of the lowest quintile was almost unchanged, increasing from 4.4 to 4.5 per cent.[g] These cases demonstrate that the income shares of the poor change very little, even when the economy shows strong growth, and that different poverty definitions give rise to different perspectives on the impacts of growth on poverty.

Overall, both approaches have shown that growth is distribution-neutral when the poor are defined as the group at the bottom of a country's income distribution. Based on both types of analysis, the share of the lowest quintile in a country's total income is not affected much by economic growth, thus making gains from growth proportional to the existing incomes of the poor and non-poor. For example, if the average income of the richest quintile is 10 times higher than that of the poorest quintile, the absolute income gain to the richest is 10 times higher than the gain to poorest, thus leaving the income distribution unaltered. Thus, a political question is whether or not policy makers and the general public, including non-governmental organizations, should accept such growth as "pro-poor", on the grounds that it benefits everyone, including the poor, inasmuch as the same growth can be labelled "anti-poor", on the basis that it widens the absolute income gap between the poor and the rest of the population. An advantage of defining poverty based on an absolute level is that distributional considerations between the poor and the non-poor are not at issue; as long as the poor escape from one dollar-per-day poverty, or some other agreed poverty level in absolute terms, growth can be called pro-poor.

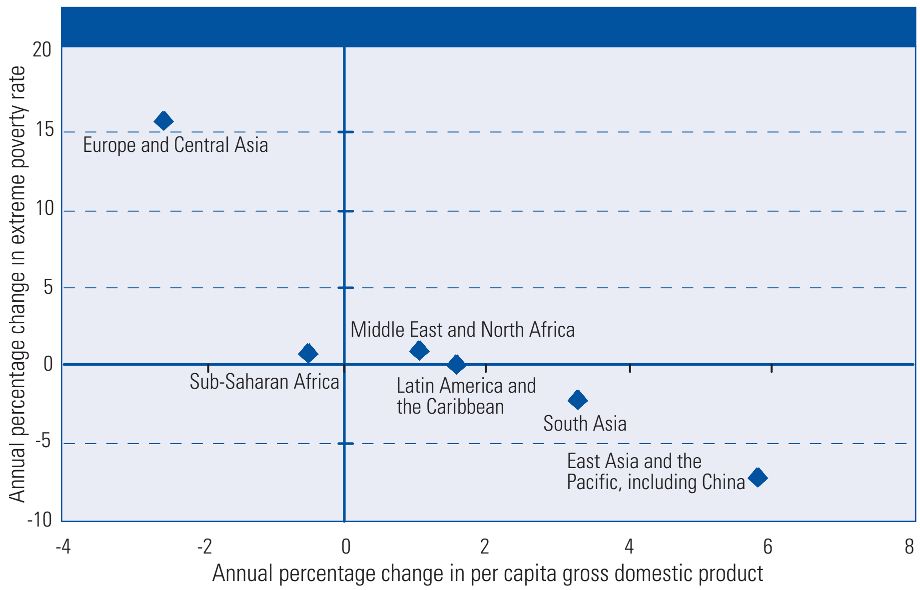
The choice of the definition of poverty depends on the purpose of the analysis or the policy objective. There is no universally accepted concept of poverty that can be applied to every conceivable situation in every country. Nevertheless, the one dollar-per-day poverty benchmark is useful for evaluating how economic and social development affects extreme poverty in the poorer countries (see box IV.2).

e This is the argument employed and calibrated in Danny Quah, "Some simple arithmetic on how income inequality and economic growth matter", London School of Economics, Economics Department (July 2001), and "One third of the world's growth and inequality", London School of Economics, Economics Department (April 2002).

f Based on World Bank, *2002 World Development Indicators, CD-ROM* (Washington, D.C., 2002), table 2.8; and "Deininger and Squire data set: a new data set measuring income inequality", available at http://www.worldbank.org/research/growth/dddeisqu.htm.

g Based on Hippolyte Fofack, Célestin Monga and Hasan Tuluy, "Household welfare and poverty dynamics in Burkina Faso: empirical evidence from household surveys", mimeo, World Bank, 2001, table 2 and annex 1.

Figure IV.3.
GROWTH AND THE EVOLUTION OF EXTREME POVERTY, 1990-1999



Source: UN/DESA, based on World Bank, *2002 World Development Indicators, CD-ROM* (Washington, D.C., World Bank, 2002); and World Bank, *2003 World Development Indicators* (Washington, D.C., World Bank, 2003), table 1c.

Note: Regional groupings are according to World Bank definitions, which are differerent from those adopted by the *Survey*. For the World Bank grouping, see World Bank, *World Development Report, 2002: Building Institutions for Markets* (Washington, D.C., World Bank, 2002), p. 241.

the incidence of extreme poverty increased slightly. In sub-Saharan Africa, where per capita GDP fell during the same decade, a 1 percentage point decline of per capita GDP was associated with a 0.8 percentage point increase in the proportion of people living in extreme poverty, a figure comparable with the one for South Asia in terms of the response of poverty change to economic growth/contraction.

Degrees of inequality in income distribution and the depth of extreme poverty are two important related factors that affect poverty incidence in relation to economic growth, as far as available statistics at the regional level show. Where the income distribution is highly unequal (as typically indicated by a higher Gini coefficient[19]), the poor receive, with other things being equal, little additional income from economic expansion, making it more difficult for them to escape from poverty. Higher income inequality in Latin America and sub-Saharan Africa (compared with East Asia) is a factor in the slowing down of poverty reduction in those regions.[20] In general, the growth-poverty relationship at the regional level (as well as at the national level) is sensitive to a region's degree of income inequality, which is considered to be a current snapshot of the economic, social, political and cultural processes inherited from the past. While it is beyond the scope of the present *Survey* to analyse the processes that have led to the current income inequalities in various regions, it should be noted that such processes are pervasive and that the way in which policies affect the incidence of poverty depends on the interactions between the processes and the policies chosen.

Where the depth of extreme poverty—typically expressed by the poverty gap ratio[21]—is high, very rapid economic growth is required to lift a large number of people out of poverty. The high degree of extreme poverty in sub-Saharan Africa means that particularly rapid economic growth is required to reduce poverty but weak links between the formal and subsistence sectors in the region

19 Intuitively speaking, the Gini coefficient indicates the average gain expected by an individual from the option of being someone else with a higher income in a population, divided by average income. For example, if average income is $1,000 a year and the Gini coefficient is 0.6, then the expected gain from being someone else with a higher income is $600, a substantial gain. See Nanak C. Kakwani, *Income Inequality and Poverty: Methods of Estimation and Policy Applications* (New York, Oxford University Press, 1980), chap. 5.

20 Douglas Smith, "International evidence on how income inequality and credit market imperfections affect private saving rates", *Journal of Development Economics*, vol. 64, No. 1 (February 2001), pp. 103-127, estimates that Gini coefficients of Latin America, sub-Saharan Africa, East Asia and developed countries are 0.472, 0.468, 0.427 and 0.322, respectively, based on a sample of countries.

21 The poverty gap ratio is defined by the product of the proportion of people who live below the poverty line and the difference between the poverty line and the average income of the population living under the poverty line, expressed as a percentage of the poverty line. If, for example, 50 per cent of the population live below the one-dollar-per-day line and the average income of these people is 40 per cent below the poverty line (that is to say, 60 cent a day), then the ratio is 20 per cent.

impede the channelling into the latter of the gains from growth in the former. On the other hand, low poverty gap ratios in Central and Eastern Europe and Central Asia should make it possible for the region to reduce extreme poverty rapidly, once the countries of this region achieve sustained growth.[22]

LOOKING BEHIND THE REGIONAL AVERAGE

The above analysis, which shows the critical role of growth for poverty reduction, at least in the medium-to-long run, overlooks some important aspects of poverty evolution over time. One is the variation of individual countries' experiences around the average in their region, and the other is the mobility of individuals in and out of poverty, which leads to short-run fluctuations in the incidence of poverty incidence.

Deviation from averages

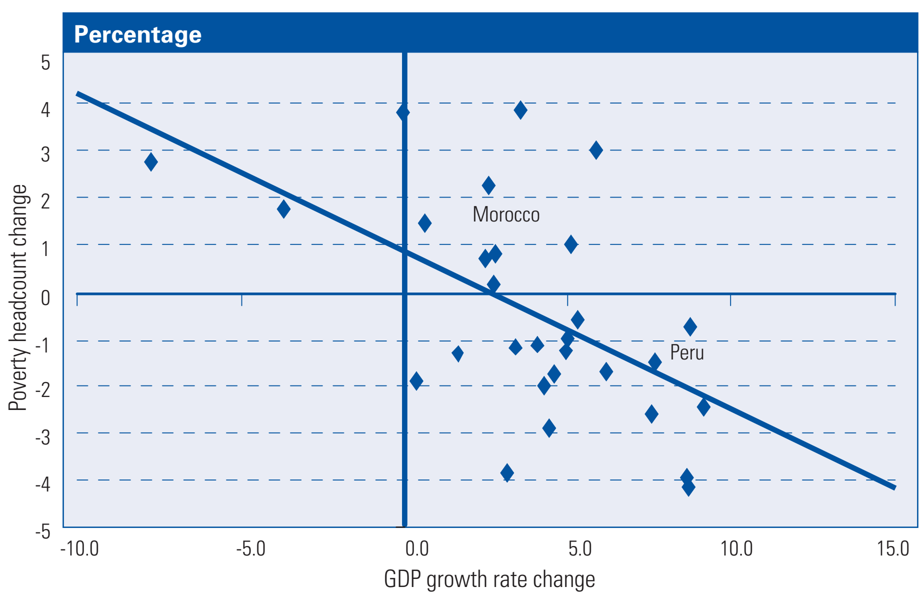
The above findings were based on regional experiences—the "average" experience of the countries in a region as a whole—and relatively long growth periods. As is often the case in statistical analyses, however, only a few countries fit the average figure, while many deviate from it considerably. Regional averages smooth out these deviations and may hide factors that systematically affect countries' performance.

Data on recent episodes of growth and changes in poverty incidence in 28 developing and transition economies[23], show a negative correlation between growth and poverty evolution, suggesting that growth tends to reduce poverty (see figure IV.4). However, there is wide variation. Many countries succeeded

22 The same low response of poverty incidence to growth when income inequality is wide or when the depth of extreme poverty is high, is found at the country level. See Anne Epaulard, *Macroeconomic Performance and Poverty Reduction,* IMF Working Paper, No. WO/03/72 (Washington, D.C., April, 2003).

23 Sample comprises countries for which at least two observations of poverty incidence over time are available.

Figure IV.4.
GROWTH AND THE EVOLUTION OF NATIONALLY DEFINED POVERTY DURING THE 1980s AND 1990s[a]



Source: UN/DESA, based on World Bank, *2002 World Development Indicators, CD-ROM* (Washington, D.C., World Bank, 2002).

a Nationally defined poverty is different from extreme poverty. The index is the percentage of the population living below the poverty line deemed appropriate for the country by its authorities.

in reducing nationally defined poverty headcounts with economic growth (indicated by the data points in lower right quadrant); but in eight countries, poverty, as measured by their poverty lines, did not fall even though their economies had grown (upper right quadrant), in some cases considerably. Three countries experienced negative growth with increased poverty (upper left quadrant).

At the country level, the evolution of poverty is further influenced by the situation where poverty incidence is being measured for the first time and by the policies that a Government adopts or abandons after that first measurement. This is particularly the case when the Government initiates a major economic reform, such as structural adjustment, liberalization or deregulation. For example, in cases where a country kept poverty (and income inequality) low in a pre-reform period by guaranteeing jobs for everyone, the introduction of market liberalization and greater openness to external trade would eliminate some jobs, at least temporarily, thus increasing poverty if no safety nets were in place. Countries with economies in transition fall into this category (see chap. VIII). On the other hand, in cases where a Government favoured the interests of the rich, where poverty was widespread and where inequality was high in a pre-reform era, market and trade reforms might have income-equalizing effects, benefiting the poor. For example, Peru cut its poverty rate and reduced income inequality during the mid-1990s while implementing reform policies that had been initiated in the mid-1980s.[24] Regional averages may cancel out such differing experiences, hiding the interactions between the initial conditions and the policies undertaken subsequently. While the reform policies helped alleviate poverty in Peru during the mid-1990s, some countries in Latin America and the Caribbean, which were slow to adopt such policies, experienced a rising incidence of poverty, even with positive growth.

The extent of differentials between urban and rural development, or economic dualism (which is often approximated by the relative productivity of the non-agricultural sector as compared with the agricultural sector), also influences the growth-poverty relationship at the country level.[25] Growth of the rural sector—farm yields plus non-farm incomes—matters for poverty reduction:[26] macroeconomic growth without development of the rural sector does not necessarily translate into poverty reduction as effectively as otherwise. Morocco, for example, experienced positive growth with rising poverty during the 1990s, mainly because of the deterioration in rural areas. Droughts in the second half of the decade were a major contributor, but widespread planting of crops that commanded higher prices in markets but were less resistant to drought aggravated the situation.[27] On the other hand, growth in many Asian countries, such as Japan, the Republic of Korea and Taiwan Province of China in the past and China and India at present, has led to significant poverty reduction. Strong productivity increases in agriculture and the transformation of the rural non-farm sector have come about as a result of reforms in land ownership or usage, the introduction of highly productive seeds combined with new technologies, and improvements in physical infrastructure.[28]

24 For the income distributions of Peru and other countries in Latin American and the Caribbean, see Barbara Stallings and Wilson Peres, *Growth, Employment, and Equity: The Impact of the Economic Reforms in Latin America and the Caribbean* (Washington, D.C., Brookings Institution/ECLAC, 2000), chap. 5.

25 François Bourguignon and Christian Morrisson, "Inequality and development: the role of dualism", *Journal of Development Economics*, vol. 57, No. 2 (December 1998), pp. 233-257.

26 Ibid. and Martin Ravallion and Gaurav Datt, "Why has economic growth been more pro-poor in some states of India than others?", *Journal of Development Economics*, vol. 68, No. 2 (August 2002), pp. 381– 400.

27 IMF, "Morocco; 2001 Article IV consultation: staff report; public information notice; and statement by the Executive Director for Morocco", Country Report, No. 01/205, 13 November 2001.

28 *World Economic and Social Survey, 2000 ...*, chap. V.

Mobility in and out of poverty

At a more fundamental level, averages hide not only countries' different initial conditions and sectoral characteristics, but also the movement of individual people or families in and out of poverty over time. Aggregate data collected at the national or regional level are useful for examining macroeconomic growth and poverty incidence and identifying a stylized, or general, relationship between the number and the average income of the poor. Among the poor covered by aggregate time-series data, however, there are some people who escape from poverty, while others become impoverished. This transient (or transitory) poverty has important implications for designing poverty reduction strategies. Even when an economy grows as a result of successful macroeconomic policies, not everyone benefits in the same manner; thus, complementary policies targeted at subnational regions or socio-economic groups are required to help the impoverished (see chap. VIII). Aggregate data are not informative when addressing the issues of transient poverty and relevant coping mechanisms at the household or individual level.

Such movements are illustrated by the experience of a region of Pakistan (not included in figure IV.4). Household surveys were conducted in 1996 and 1999 in rural areas of the North-West Frontier Province (Peshawar district)—a region with limited scope for agriculture-led growth, a low education level and a high infant mortality rate. Despite an average annual growth of 3.6 per cent for GDP and of 1.2 per cent for per capita GDP during the period 1996–1999, the region showed an increased incidence of poverty and the churning of people in and out of poverty.[29] During the period, the average income of the 299 households surveyed had declined by 23 per cent. The poor/non-poor status of three-quarters of the sample had remained unchanged,[30] but 33 households had escaped from poverty, while 46 non-poor families in 1996 had fallen into poverty by 1999. Income reductions were largely caused by job losses or significant drops in farm and non-farm wages (but not in crops harvested) which affected all the households. However, those who were severely constrained in respect of credit access had no means to smooth out consumption, making them impoverished in consumption.[31]

In general, transient poverty is as widespread a phenomenon as chronic poverty[32] and, in several cases, transient poverty is more prevalent than chronic poverty (see table IV.2).[33] An individual's or a household's income at any particular moment of time depends on its human and non-human capital endowments, its past perception of the returns to capital, idiosyncratic shocks (such as death, ill health and accidents) and common shocks (such as economic decline and natural disasters). Seasonal factors—more jobs at harvest time, for example—greatly contribute to income fluctuations within a year as well. The poor and people slightly above the poverty line, who typically have low human and non-human capital endowments, are always exposed to greater risks, not only of substantial income loss but also of hunger and even death, when adverse events affect them. Vulnerability—the risk of being negatively affected by shocks—is an important determinant of movements in and out of poverty.

Income fluctuation does not directly translate into consumption variability, because households or individuals can, to some extent, use coping mechanisms to smooth consumption. In many low-income developing countries that lack publicly managed programmes or market-based insurance schemes, the coping mechanisms are informal. They consist of reciprocal "gift" exchanges within local communities and extended families, self-insurance activities such as saving, asset accumulation and borrowing, and remittances from migrants living

29 Takashi Kurosaki, "Consumption vulnerability and dynamic poverty in the North-West Frontier Province, Pakistan", mimeo., Hitotsubashi University, Tokyo (July 2002).

30 Thirty-one households stayed above the poverty line (set at $189 per person per year in 1996) and 189 remained below the line, constituting cases of chronic poverty.

31 Those impoverished households also stopped sending their girls (but not their boys) to school. Parents thought that girls' education would be expensive relative to the expected private returns from it. See Kurosaki, loc. cit.

32 Some researchers define chronic poverty as a situation where average consumption over time is below the poverty line. This definition is less stringent than that in which the chronic poor are taken to be those whose consumption level is always below the poverty line. See Lawrence Haddad and Akhter Ahmed, "Chronic and transitory poverty: evidence from Egypt, 1997-1999", *World Development*, vol. 31, No. 1 (January 2003), pp. 71-85.

33 Bob Baulch and John Hoddinott, "Economic mobility and poverty dynamics in developing countries", *Journal of Development Studies*, vol. 30, No. 6 (August 2000), pp. 1–24.

Table IV.2.
PROPORTION OF HOUSEHOLDS IN CHRONIC AND TRANSITORY POVERTY, VARIOUS COUNTRIES

Country	Study period	Welfare measure	Percentage of households		
			Always poor	Sometimes poor	Never poor
South Africa	1993-1998	Expenditures per capita	22.7	31.5	45.8
Ethiopia	1994-1995	Expenditures per capita	24.8	30.1	45.1
India	1968/1969-1970/1971	Income per capita	33.3	36.7	30.0
India	1975/1976-1983/1984	Income per capita	21.8	65.8	12.4
Côte d'Ivoire	1985-1986	Expenditures per capita	14.5	20.2	65.3
Côte d'Ivoire	1986-1987	Expenditures per capita	13.0	22.9	64.1
Côte d'Ivoire	1987-1988	Expenditures per capita	25.0	22.0	53.0
Zimbabwe	1992/1993-1995/1996	Income per capita	10.6	59.6	29.8
China	1985-1990	Expenditures per capita	6.2	47.8	46.0
Pakistan	1986-1991	Income per adult equivalent	3.0	55.3	41.7
Russian Federation	1992-1993	Income per capita	12.6	30.2	57.2
Chile	1967/1968-1985/1986	Income per capita	54.1	31.5	14.4
Indonesia	1997-1998	Expenditures per capita	8.6	19.8	71.6

Source: Bob Baulch and John Hoddinott, "Economic mobility and poverty dynamics in developing countries", *Journal of Development Studies*, vol. 30, No. 6 (August 2000), table 1.

abroad or in another part of the country.[34] Such private mechanisms can help to buffer both common shocks to incomes and shocks that are specific to an individual. These mechanisms do not, however, completely protect people from falling into poverty. If a whole community was hit by a natural disaster, there would be no one who could provide an immediate "gift" exchange, as most assets in the community, such as land, crops, livestock and houses, would have been destroyed. In cases of long illness or the death of a main income-earner within the family, support from the community is lost eventually. Households or individuals who are detached from these mechanisms, and thus constrained in their access to credit, are at higher risk of becoming consumption-poor.

34 See chapter VIII of the present *Survey*; and Jonathan Morduch, "Between the state and the market: can informal insurance patch the safety net?", *World Bank Research Observer*, vol. 14, No. 2 (August 1999), pp. 187–207. According to the latter, these mechanisms are more prevalent in rural than in urban areas.

Evolution of poverty in the short run

Movements of people into and out of poverty cause short-run fluctuations in the incidence of poverty at the national or subnational level. Such short-run movements, however, are not captured by macroeconomic variables and household surveys in many developing countries because the former are estimated only once a year and the latter are conducted only once every few years. The lack of data for tracking poverty over short periods makes it difficult to analyse separately the shorter- and longer-run impacts on poverty of economy-wide policies, such as trade liberalization and macroeconomic adjustment.

Yet differences between the short-run and long-run effects of a particular policy are often at the core of controversies about the impact on poverty of macroeconomic policies, for example, between economists and policy makers in international financial institutions on the one hand and local authorities and fieldworkers in developing countries on the other.[35] Analyses by the former group are largely based on macroeconomic indicators and survey data and, because of the frequency of data collection, their time-horizon is usually a year or longer. They assert that growth and the policies that support it are beneficial for the poor in the longer term. The latter group of local authorities and fieldworkers (including non-governmental organizations) have day-to-day, hands-on experiences with poverty, and their time-horizon can be as short as a day.[36]

The impact of growth or policy changes on the poor within the short timeframe may not be captured by long-term macroeconomic and survey data. For example, consider a monetary contraction that aims at restraining high inflation, but also slows economic activity. Stable and low inflation is key for growth and thus for poverty reduction in the long run (see chap. V).[37] However, economic slowdowns may adversely affect the poor disproportionally through a rise in unemployment in the short run. Those who focus on a short time-horizon are concerned that the poor are on the edge of survival; to them, the possibility that the welfare of the poor will improve in a year or more is of little importance or relevance.

As discussed previously, there is strong evidence that growth is beneficial for the poor on average in the long run, but there is little systematic evidence regarding changes in the welfare status of the poor during short-run fluctuations, especially in developing countries. Most of the available evidence is confined to anecdotes. To make short-run analyses of poverty evolution that are comparable with longer-run analyses requires quarterly or semi-annual data on macroeconomic variables and poverty surveys conducted at least twice a year. Such data are generally unavailable in many developing countries because of the scarce human and fiscal resources of Governments.

One exception is Indonesia where the Asian financial crisis that erupted in August 1997 and affected the lives of many people in the country invited intensified research on economic crises, policy changes and poverty. The country, with the collaboration of the World Bank, tracked short-run changes in poverty over the course of the crisis (see figure IV.5). Its Government conducted a number of large-scale (but not necessarily nationally representative) household surveys covering between 10,000 and 65,000 households, starting in 1996.[38] While these different surveys used different sampling methods and poverty lines, researchers estimated a fairly consistent series of poverty rates for the period before and throughout the crisis.

Four findings emerge from a consideration of figure IV.5. First, changes in the level of economic activities have significant impacts on the evolution of poverty even in the short run: the poverty rate had declined steadily while the economy was growing, but the rate almost doubled in the six months after the third quarter in 1997, when the crisis hit the country.[39] Second, the response of the poverty rate to growth was asymmetric with respect to the boom and recession periods; during 1996 and the first three quarters of 1997, the economy is estimated to have grown by 6 per cent and the poverty rate to have declined from 9.8 to a low of 6.6 per cent, implying that each percentage point of growth had led to a 0.5 percentage point reduction in the poverty rate. After the crisis, however, the economy shrank by 13 per cent in 1998 and the poverty rate increased from a low of 6.6 per cent in the third quarter of 1997 to 17.4 per cent in the fourth quarter of 1998, implying that 1 percentage point of output decline had led to an almost

35 Such a sharp division oversimplifies a complex and wide spectrum of analytical and policy positions held by those who are concerned with poverty issues. The purpose of such a simple classification is to highlight disagreements in regard to the status of poor people and policy prescriptions. See Kanbur, loc. cit., sect. 2.

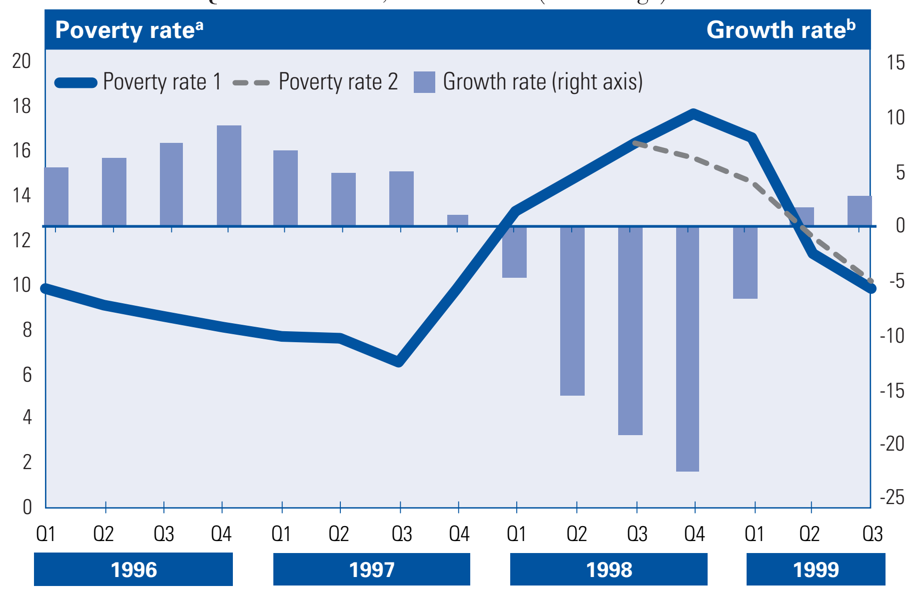
36 Ibid., sect. 5.

37 See, for example, William Easterly and Stanley Fischer, "Inflation and the poor", *Journal of Money, Credit and Banking*, vol. 33, No. 2 (May 2001, part 1), pp. 160-178.

38 For details, see Asep Suryahadi and others, "The evolution of poverty during the crisis in Indonesia, 1996 to 1999", Social Monitoring and Early Response Unit, Jakarta (September 2000). See also Menno Pradhan and others, "Measurements of poverty in Indonesia: 1996, 1999 and beyond", Social Monitoring and Early Response Unit, Jakarta (n.d.).

39 A survey conducted during August-October in 1997 suggests that the impacts of the crisis were not yet felt at that time.

Figure IV.5.
SHORT-TERM EVOLUTION OF POVERTY, FIRST QUARTER 1996-THIRD QUARTER 1999, INDONESIA (Percentage)



Source: UN/DESA, based on Asep Suryahadi and others, "The evolution of poverty during the crisis in Indonesia, 1996 to 1999", Social Monitoring and Early Response Unit, Jakarta (September 2000); and Statistics Indonesia, "Country paper: Indonesia: quarterly national accounts in Indonesia", paper presented at the OECD/Asian Development Bank/ESCAP Workshop on Quarterly National Accounts, 17-21 June 2002, Bangkok.

a Starting from the fourth quarter of 1998, there are two series. Series 1 is based on the surveys conducted by the Social Monitoring and Early Response Unit, Jakarta, and series 2 is based on the surveys conducted by the Central Bureau of Statistics of Indonesia.

b Based on changes in seasonally unadjusted quarterly GDP of the same quarter of two consecutive years.

0.8 percentage point increase in poverty, which was 1.6 times larger in absolute terms than the decrease in poverty when the economy had been growing. Thus, the downside risks to the poor were larger than the upside benefits: the poor were exposed to malnutrition and hunger during the downswing.

The third point is that the two different types of surveys show that the poverty rate had begun to decline in the first quarter of 1999, even before macroeconomic conditions improved in the second quarter. One explanation for this decline may be that the poor were not passive, but managed to find ways to secure a minimal consumption level by using some of the coping mechanisms discussed previously. Another explanation may lie in the underestimation of GDP: some economic activities might have become “informal”,—possibly, in part, to avoid taxes—with the result that the statistical agencies, which also faced fiscal retrenchment, did not capture these activities in the national accounts after the crisis. The fourth point is that while the poverty rate declined as economic growth resumed in 1999, the rate was still about 1.5 times higher in the third quarter of 1999 than just before the crisis.

The experience of Indonesia highlights some developments that may be applicable to other crisis situations. A negative shock seems to have a larger impact on poverty than a positive one, in absolute terms. The benefits of sustained growth appear to trickle down to the poor slowly, but negative shocks affect them almost instantly. However, the adverse effects of the crisis may not fall disproportionately on the poor. Between 1996 and 1999, the Gini coefficient in Indonesia decreased—from 0.36 to 0.33 (or 0.32 depending on the price deflator used)—indicating that the non-poor had been affected more adversely than the poor, in relative terms. Finally, it seems that the poor have “private mechanisms”, including self-help, to cope with negative shocks, at least in the short run. No evidence is available about the extent to which such coping mechanisms protect the poor, but the faster turnaround of the poverty rate than of GDP growth in Indonesia hints at the effectiveness of such mechanisms.

Although there exists a large volume of empirical studies on growth and the evolution of poverty in the long run, short-run analyses of how economic fluctuations affect poverty and to what extent coping mechanisms—public and private—influence the welfare of the poor are still scarce. More such analyses could help fill the void in respect of knowledge about the connections between short-run movements into and out of poverty and the long-run evolution of poverty. They also could help in assessing the immediate versus the long-lasting effects of policies on poverty.

CONCLUDING REMARKS

This chapter has argued that assessing the extent to which growth—which is generally desirable for poverty reduction—affects the incidence of poverty is influenced by the definition of poverty, the social and geographical level of aggregation of poverty, and the time-horizon employed for the assessment. As argued above, improvements in the material dimensions of poverty do not necessarily go hand in hand with improvements in the non-material dimensions of poverty. Even when poverty is defined solely in terms of its material dimensions, economic growth has been found not to affect all social or geographical groups uniformly and, in some cases, the same growth has affected two groups of people contrarily. Unsustainably high growth tends to reduce poverty incidence in the short run, but it eventually ignites high inflation, eroding the welfare of the population, particularly the poor with little stock of wealth. Furthermore, as noted in box IV.3, the choice of poverty line influences the general characterization of growth-poverty linkages: if the poor are defined as the people in the lowest bracket of a country's income distribution, then they benefit from growth as much as the average income-earner does but if, instead, the poor are defined in absolute terms (as in the Millennium Development Goals), such distributional neutrality disappears. In short, a simple statement such as "growth is beneficial for the poor" conveys a powerful message, but it can be misleading if not understood in the specific context of an assessment framework.

The extent to which growth affects the incidence of absolute poverty critically depends on various socio-economic conditions, such as initial distributions of income and physical and human capital, and the economic and political regimes that prevailed at the time of economic growth. In contrast with growth in East Asia, which led to a large decline in the poverty rate, economic growth in Latin America and the Caribbean during the 1990s did not reduce the poverty rate at all. While it is not easy to single out the most important determinants, an income distribution highly skewed against the poor and the large pool of chronic poverty, both rooted in the economic, social, political and cultural history of Latin America and the Caribbean, are factors that explain the weak linkages between growth and poverty reduction. In sub-Saharan Africa, income inequality aside, the presence of a large number of extremely poor people, who do not possess human and non-human capital, and the isolation of the subsistence sector from the formal sector of the economy, make it difficult for the benefits of growth to trickle down to the extreme poor, even when the economy grows.

The following chapters of the Survey examine the effects of policies on the incidence of poverty via their effects on the growth of a particular sector or the growth of an economy as a whole. They will argue that the complexity of the linkage between growth and poverty carries over to the relationship between policies and poverty. The policies to be examined are fiscal and monetary policies, trade policy and two key agricultural reforms, all conducted within the framework of a market-based economy. These policies are not necessarily designed to combat poverty directly, but they can have significant impacts on the incidence of poverty. The complexity of the linkage between policies and poverty stems from the complex reactions of the market to the policies implemented and from the economic, social, political and cultural conditions that underlie the state of poverty and income inequalities. Like the assessment of the relationship between growth and poverty, the determination by policy makers and researchers of the extent to which a policy is good for the poor needs to be undertaken in terms of three dimensions: the definition of poverty, the level of aggregation and the time-horizon employed.

V MACROECONOMIC POLICY AND POVERTY

Links between macroeconomic policies and poverty are complex. In theory, "good" macroeconomic policies are growth-enhancing,[1] and sustained growth reduces poverty in the long run; in practice, however, the extent to which growth affects poverty varies considerably among countries and over time, as was seen in chapter IV. In addition to the effects of growth, macroeconomic policies have their own direct effects on poverty. For this reason, it becomes a challenge to evaluate the overall effects of a particular macroeconomic policy on poverty.

Macroeconomic policy is used to manage aggregate demand in the short run and to bring the economy to a higher-growth trajectory in the long run. By these means, policy makers attempt to enhance the well-being of society as a whole, including the poor. In the short run, fiscal and monetary policies are used to balance aggregate demand and supply (see part one of the present *Survey* for a discussion of current practice). In the long run, structural changes are implemented to influence one or more of the three sources of growth:[2] growth in the factors of production, increased efficiency in the allocation of these factors across economic activities, and innovation that increases efficiency in the use of these factors or leads to new products or new uses for existing products. Trade liberalization, for example, can increase efficiency in the use of a country's resources, by exploiting comparative advantage, and introduces new products and technologies from abroad.[3] Deregulation of the economy and privatization of State-owned enterprises aim at improving allocation and production efficiency based on market mechanisms. However, the effects of macroeconomic policies, especially in the short run, do not always favour the condition of the poor. Therefore, other measures are necessary to protect the poor until favourable macroeconomic conditions are restored.

The present chapter will first analyse the theoretical relationships between macroeconomic policy and poverty in the short and long run. It will then focus on these relationships when changes in macroeconomic policy occur, especially during times of economic crises, when the poor are most vulnerable. The experiences of East Asia and Latin America during the past 10 years will help illustrate some of the possible effects on poverty of sudden changes in macroeconomic policies and conditions. The importance of maintaining stability during times of growth in order to have greater freedom to manoeuvre during times of crises and to be able to protect the socially and economically vulnerable will be examined. The focus will then be placed on the urban poor, since they have been identified as more vulnerable in times of economic crises (especially financial) than the rural poor. It will then be argued that, since macroeconomic policies

1 Stanley Fischer, "The role of macroeconomic factors in growth", *Journal of Monetary Economics*, vol. 32, No. 3 (December 1993), pp. 485-512.

2 T. N. Srinivasan, "Growth and poverty alleviation: lessons from development experience", mimeo, February 2001.

3 Trade and poverty are examined in chap. VI.

alone are not sufficient to address the problems of the poor, direct complementary measures are necessary. Examples from the two regions will be studied. Finally, based on the observations made, policy recommendations at different levels of actions will be presented.

MONETARY POLICY AND POVERTY

Monetary policy is utilized to affect aggregate demand, and price and employment levels, through a management of the monetary system that uses any or all of its main tools, namely, open-market operations, the setting of an official discount (or other) rate, and transactions in the foreign exchange market. The degree to which the monetary authorities depend on individual tools and the combination chosen will vary depending on the economic situation, the set of objectives and the exchange-rate regime. Each tool and combination of tools has an effect on prices (including interest rates and exchange rates), wages and employment. Each of these variables, in turn, has a different effect on poverty. Therefore, one cannot define one general relationship between monetary policy and poverty. However, one could simplify the analysis by examining the effects of monetary policy on poverty through observing two basic macroeconomic variables, namely, output and inflation.

Expansionary monetary policy tends to raise both output and inflation in the short run. This affects the poor in two main ways. First, high and unanticipated inflation induces an unintended redistribution of income. It can harm the poor by reducing the real value of wages and transfers (such as pension incomes and other government-sponsored schemes), but it can benefit the nominal debtor—a typical role assumed by the poor—at the expense of creditors. Second, and most importantly, the rise in total output can reduce poverty directly, as the experience of East Asian countries prior to the 1997 crisis shows (see below). A cyclical expansion creates jobs, the majority of which are likely to be low-skilled or to have low education requirements.

However, an expansionary monetary policy cannot continue indefinitely. It decreases unemployment and increases output above the trend capacity in the short run. On the other hand, low unemployment and high output, relative to the trend capacity, cause inflation to rise, in response to which the monetary authorities eventually have to contain inflation by shifting to a contractionary policy, which will harm the poor, along with other groups, in the short run. If not contained, inflation would accelerate further, leading to hyperinflation and, eventually, economic decline. Therefore, although expansionary policies, in general, may seem more beneficial towards the poor, restraining inflation and preventing abrupt output fluctuations would be of greater benefit to them in the long run.[4]

Prolonged high inflation has several effects on poverty. First, as in the short run, it causes a redistribution of income, whose net effects can be either positive or negative for the poor, depending on the combined effect on their wages, transfer payments and debt. Second, uncertainty associated with high inflation discourages physical investment in general, thus raising the marginal and average returns on capital and consequently lowering market-based wages; however, if the average return on capital rises and if the tax authorities capture this, the tax burden may shift away from labour and towards capital, partially off-

4 Christina D. Romer and David H. Romer, *Monetary policy and the well-being of the poor*, National Bureau of Economic Research Working Paper Series, No. 6793 (Cambridge, Massachusetts, November 1998).

setting the loss in wages. Third, economic uncertainty also discourages the poor from investing in their own human capital (for example, health and education), which is an important means for them to escape from poverty. Finally, high inflation may harm some industrial sectors more than others. For example, it is likely that inflation has adverse impacts on export-oriented sectors in many developing countries, such as agriculture and light manufacturing which are labour-intensive and employ the labour-abundant poor. On the other hand, these export sectors may become more competitive depending on the degree of depreciation of the currency.

Because these factors affect the poor in different directions and with different intensities, the net impact of prolonged high inflation on the poor cannot be determined a priori. To observe the actual effects, researchers have often used the so-called cross-country regression analysis, in which the statistical relationship between prolonged inflation and the incidence of poverty is estimated based on many countries' experiences. In those studies, higher inflation rates have been associated with lower average incomes of the poor.[5] While average inflation and the variability of nominal growth of gross domestic product (GDP) are highly correlated, making it difficult to isolate the effects of inflation on the income of the poor from those exerted by GDP growth, it is apparent that monetary policy—through lower inflation, less volatile growth or both—has contributed to the well-being of the poor.[6]

The strong inflation-aversion of the poor that has been revealed in international polling data substantiates this macrolevel observation:[7] the likelihood of mentioning inflation as a top concern increases as level of income and level of education decrease. Thus, while the rich or highly educated are more informed about the damage that inflation can cause, their physical, financial and human capital work as a hedge against inflation, making it less of a concern for them than for the poor or less well educated. With the least amount of human capital (education) and/or a negligible supply of non-human assets, the poor clearly do not have the means to buffer the shocks associated with inflation, and consequently make it a top concern.

The dilemma of policy makers, who are prone to choose expansionary policies to favour the poor, cannot be resolved within the framework of monetary policy alone. The poor prefer low inflation in the long run, but may accept high inflation in the short run if it is associated with expansionary policy and greater employment opportunities, provided that they have some source of income and have expectations of taking advantage of these new opportunities. However, expansionary policy must be abandoned sooner or later, to prevent inflation from accelerating.

FISCAL POLICY AND POVERTY

The macroeconomic policy that is most closely related to more direct poverty reduction strategies is fiscal policy, since it affects the amount to be spent on social needs. Social expenditures usually comprise expenditures for education, health and nutrition, housing, social security and welfare. Social security has relatively less relevance to poverty reduction since a larger percentage of the beneficiaries are typically at income levels above the poverty line.

5 Ibid.

6 William Easterly and Stanley Fischer, "Inflation and the poor", *Journal of Money, Credit and Banking*, vol. 33, No. 2 (May 2001, part 1), pp. 160-178.

7 Ibid.

The pursuit of the main objectives of fiscal policy, namely, allocation of resources, general stabilization and distribution, has an effect on poverty levels. Two types of analysis can be performed: at the aggregate level and by composition. The impact of changes in fiscal policy could be assessed by examining the impact on economic growth of changes in total expenditure or in the deficit, if these were the only variables that mattered in poverty reduction.[8] An increase of fiscal expenditure or reductions of taxes will tend to increase national income in the short run, when the supply constraint is slack. Such a rise in national income tends to reduce poverty, as discussed above. In the long run, however, continuing fiscal expansion without accompanying increases in tax revenue will lead to structural fiscal deficits—crowding out private investment, accelerating inflation and slowing growth—particularly if the deficits are financed by the monetary authorities. Furthermore, when domestic savings are not large enough to cover domestic investment plus the fiscal deficit (as is often the case in many developing countries), the current-account balance deteriorates, creating the so-called twin deficits—fiscal and external. Tax reductions, without reductions in fiscal expenditure, will lead to the same situation. Thus, persistent fiscal imbalances over the long run may have adverse impacts on the economy as a whole and on poverty, if these deficits accumulate and reach unsustainable debt levels. It should also be noted that, even if the balances are maintained, unproductive fiscal expenditures that do not facilitate the accumulation of capital and consequent productivity growth could lower potential economic growth over the long run.

8 For relationships between economic growth and the size of fiscal expenditures or the size of fiscal deficits, see Fischer, loc. cit.; and Robert J. Barro, *Determinants of Economic Growth: A Cross-Country Empirical Study* (Cambridge, Massachusetts, MIT Press, 1997), chap. 1.

However, the total impact of fiscal policy on poverty cannot be predicted accurately solely on the basis of total expenditure and revenue or the size of the fiscal deficit. The composition of the entire fiscal package—current and capital spending, the functional distribution of expenditure (for example, on education, health and nutrition, social security and welfare, defence, interest payments etc.) and the types and distribution of financing (taxes, fees and external assistance)—greatly influences the nature and outcome of the policy. When interest payments take a large share of total expenditure, the Government has less money to channel towards other objectives, including poverty reduction. On the revenue side, fees of health or educational services limit the opportunities of the poor to receive these services.[9] The burden of value-added (or consumption) taxes can be disproportionately high for poorer people. On the other hand, social expenditures may have a positive impact on the poor, if they are effectively targeted. In order for there to be funds available for the expansion of social programmes when required, the fiscal situation must be stable during times of growth. In the following sections, issues concerning social expenditures in different countries will be analysed.

9 See *World Economic and Social Survey, 2002* (United Nations publication, Sales No. E.02.II.C.1), chaps. VII and VIII.

In sum, because of the sensitivity of poverty outcomes to the composition of fiscal expenditure and taxes, it is not possible to establish a single general linkage between fiscal policy and poverty. In recognition of the complex relationship between policy and poverty reduction, Governments are agreeing to approach the challenge by means of the greater participation of civil society, partially basing their decision on positive experiences with the participation of, for example, non-governmental organizations during the process of decision-making on fiscal budgets in developing countries. This is reflected in the formulation and adoption of Poverty Reduction Strategy Papers (PRSPs) (See box V.1).

Box V.1

PARTICIPATION OF CIVIL SOCIETY IN STRENGTHENING POVERTY REDUCTION STRATEGIES

The international community's increasing awareness that the linkage between economic growth and poverty incidence is not clear-cut, together with the current domestic and international recognition of the need for national ownership of development programmes, has led to efforts to revise the roles of the State and civil society in formulating poverty reduction policies. In respect of the Poverty Reduction Strategy Papers (PRSPs)—the statements of recipient-government objectives, whose preparation is required for all International Monetary Fund (IMF) and World Bank lending to low-income countries—the new consensus is to invite wide, active participation by civil society and the private sector in formulating national public policy—including both macroeconomic and sectoral policies—for the reduction of poverty. The international financial institutions, in turn, have introduced new lending instruments designed to support the implementation of poverty reduction strategies.[a] Bilateral donors have increasingly reorganized their own aid programmes with reference to the national policies and goals set out in the PRSPs.[b] This signifies a fundamental shift, at the domestic and international levels, in the way in which Governments and international organizations formulate international development strategies.

In the PRSPs, it is recognized that macroeconomic stability could help the poor benefit from growth, if accompanied by structural adjustment, adequate social policies (on health, education, employment and social inclusion) and effective governance (including budgetary processes and monitoring systems). The PRSPs have strengthened the reform efforts of developing countries. The use of PRSPs has also expanded reform efforts beyond the social sector, which was the main area targeted by previous adjustment programmes. Ministries of finance are now central figures in coordinating countries' principal policy instruments, linking poverty reduction strategies to medium-term national budget processes for domestic and external resources. In these processes, poverty reduction is considered a goal of all sectors, cutting across most if not all macroeconomic and other policy areas.

The participation of civil society in the formulation of all policies that affect the incidence of poverty, including macroeconomic policy, is an underlying principle of the PRSPs, drawing on previous positive experiences at the national and local levels in some developing countries.

For example, Uganda's effort to devise a participatory national strategy for poverty reduction was a model both for the use of PRSPs by the World Bank and IMF, and for the enhanced Heavily Indebted Poor Countries (HIPC) Initiative. In formulating its Poverty Eradication Action Plan in 1996-1997, the Government sought participation from "central and local governments, the donor community, non-governmental organizations and civil society, and academia", and quickly used the results to reallocate public expenditure towards basic services in 1997.[c] Opportunities for local citizens and non-governmental organizations to participate in policy-making have increased since 1998, when responsibility for providing many services was devolved to local authorities and relevant budget data were presented to the public through the press.[d] Along these lines, when consulted by the Government in 1998, poor urban and rural communities pleaded for greater access to clean water, leading to greater priority for this in Uganda's central budget.[e]

If the PRSP initiative is not to be "ephemeral, a passing fashion in the ever-changing world of international development",[f] Governments, the international community and civil society have to strengthen their capabilities in various areas. These include gathering more accurate information on the poor, examining the conditions and causes of poverty, understanding better the links between poverty incidence and the policies considered in the PRSPs (including fiscal policy in general and allocation of budget funds) and establishing systems for tracking poverty-reducing public spending.[g] Such actions could greatly strengthen the participation of the civil society groups that represent the poor, and thus the ability of the entire development community to reduce poverty.

a Notably, the Poverty Reduction and Growth Facility of IMF and the Poverty Reduction Support Credit of the World Bank/International Development Association (IDA).

b David Booth, "Introduction and overview", *Development Policy Review*, vol. 21, No. 2 (Special issue on "Are PRSPs making a difference? The African experience") (March 2003), pp. 131-159.

c John Mackinnon and Ritva Reinikka, *Lessons from Uganda on Strategies to Fight Poverty*, Policy Research Working Paper, WPS 2440 (Washington, D.C., World Bank, 30 September 2000).

d Derick W. Brinkerhoff and Arthur A. Goldsmith, "How citizens participate in macroeconomic policy: international experience and implications for poverty reduction", *World Development*, vol. 31, No. 4 (April 2003), p. 696.

e Ibid., p. 690.

f David Booth, loc. cit., p. 135.

g IMF and International Development Association (IDA), "Tracking of poverty-reducing public spending in heavily indebted poor countries", 27 March 2001 (http://www.imf.org/External/np/hipc/2001/track/track.pdf); and IMF and IDA, "Actions to strengthen the tracking of poverty-reducing public spending in heavily indebted poor countries", 22 March 2002 (http://www.imf.org/External/np/hipc/2002/track/032202.htm).

MACROECONOMIC POLICY IN TIMES OF CRISIS

Shocks to the domestic economy can come in different shapes and sizes. They can be caused either by non-economic factors such as natural disasters, internal political turmoil and wars, or by economic factors like sudden changes in the prices of commodities, domestic banking crises or fiscal crises, which could create an outflow of capital leading to balance-of-payments crises. Additionally, a crisis in one country may be triggered by events in another: a flight of capital may assume regional dimensions, affecting other neighbouring countries and their currencies. Although both non-economic and economic shocks can have important effects on the economy and poverty, focus will be directed towards shocks caused by economic factors, since they are more closely related to economic policy.

Such economic shocks have become more commonplace as economies have become more open and thus more sensitive to changes in the international economy. On the one hand, without liberalization, capital flows would have been smaller and would have provided less support to the development process; on the other hand, liberalization also meant an increase in vulnerability, demanding greater care in both the macroeconomic and sectoral management of the economy in order for it to be able to reap the benefits of liberalization.[10]

10 For a further discussion on vulnerability, refer to the *World Economic and Social Survey, 2001* (United Nations publication, Sales No. E.01.II.C.1), part two.

Economic crises, which are often associated with sharp increases in poverty, induce Governments and international financial institutions to introduce various measures to reduce economic volatility. Given the importance and severity of the crises in the 1990s, more analysis is required on the extent to which increases in poverty have differed among crisis-affected countries and on why there have been such differences. An important policy question concerns the priority attached to reducing poverty, since measures to protect the poor (increasing social expenditure, for example) may worsen the fiscal balance in the short run. Policy makers have to consider the trade-offs between different policies and measures, for example, social and macroeconomic policies, when prioritizing objectives. Another important issue is whether any increase in poverty during a crisis will turn out to be just transitory or (in part or in its entirety) chronic.

While a review of recent country experiences can give policy makers some hints on the relationship between policy and poverty, more systematic and more comprehensive understanding is required to make the tolls of macroeconomic policy a more effective part of poverty reduction strategies.

Economic crises magnify the effects of changes in growth and short-term macroeconomic policy on poverty. The crises during the 1990s serve as recent case studies of this relationship and confirm the limitations of macroeconomic policy in reducing poverty in times of crises. Experiences on two continents, Asia and Latin America, in countries with different economic structures show both similarities and differences, but at the same time provide some insight into the prevention of future crises and their consequences. The following sections will briefly describe the macroeconomic responses to these crises, analyse the possible effects on poverty, and discuss the supplementary measures that had to be taken in light of the limitations of macroeconomic policies in times of shock.

Macroeconomic policy responses to crises in East Asia and Latin America

Several East Asian countries were directly affected by the financial crisis of 1997-1998. In five of those countries, Indonesia, the Republic of Korea, Malaysia, the Philippines and Thailand, an increase in poverty followed the crisis. All of these economies enjoyed high-sustained growth for most of the 1990s. In 1998, GDP fell 0.5 to 13 per cent. Inflation in these economies rose in 1998, but still within the single-digit range, except for Indonesia where it rose to 58 per cent.[11]

In response to the crisis, macroeconomic policy in these East Asian countries was initially restrictive in order to restore domestic stability; but as it became apparent that the magnitude of the crisis was greater than initially expected, macroeconomic policies became expansionary from the latter half of 1998.[12] In most countries, a general decline in revenues acted as an automatic stabilizer, while social expenditures increased along with the rise in total expenditures during the crisis as the need for emergency programmes grew.[13] As a result, fiscal balances deteriorated by between 2 and 4 per cent of GDP between 1997 and 1998 (see table V.1).

Monetary policy was geared to stabilize the exchange rates of the respective currencies, which quickly lost value as capital fled from the region. Interest rates, especially in the money market, had jumped, particularly during the latter half of 1997 and the first half of 1998, after which rates began to decrease in an attempt to prevent a further decline in economic activity and to support fiscal efforts.

Although the macroeconomic trends of the major economies of Latin America did not tend to converge as neatly as those of the East Asian countries, three shocks during the 1990s shaped to some degree the economic conditions of the region. The Mexican devaluation at the end of 1994 dragged down the

11 For a more detailed analysis of the macroeconomic effects of the crisis, see, for example, *World Economic and Social Survey, 1998* and *1999* (United Nations publications, Sales Nos. E.98.II.C.1 and E.99.II.C.1, respectively).

12 There has been much debate on the appropriateness of the policy responses after the East Asian crisis and the role of the international financial institutions. The present section will limit itself to referring to the results of these policies relevant to poverty.

13 *World Economic and Social Survey, 1999* ..., box III.2.

Table V.1.
MACROECONOMIC POLICY RESPONSES TO CRISES IN SELECTED COUNTRIES IN ASIA AND LATIN AMERICA

Country and year of reference	Fiscal balance (percentage of GDP)		Interest rate (lending)	
	Previous year	Reference year	Annual rate in the reference year (percentage)	Percentage change from previous year
Indonesia (1998)	-0.7	-2.9	32.1	47
Republic of Korea (1998)	-1.5	-4.2	15.3	29
Malaysia (1998)	2.4	-1.8	10.6	12
Philippines (1998)	0.1	-1.9	16.8	3
Thailand (1998)	-0.3	-2.8	14.4	6
Argentina (1995)	-0.7	-0.6	14.0	146
Brazil (1999)	-10.0	-4.6	49.1	-3
Mexico (1995)	0.0	-0.5	19.3	54

Sources: UN/DESA based on data from IMF, *International Financial Statistics;* and ECLAC, *Economic Survey of Latin America and the Caribbean* (various issues).

Argentine economy in 1995. Brazil had not been directly affected at that time, but the East Asian crisis followed by the Russian crisis of August 1998 put pressure on the Brazilian real, which had remained within a band since the beginning of the Real Plan in 1994 but had to be devalued in 1999. At the turn of the century, Argentina underwent its own crisis, while economic activity in Mexico and Brazil remained anaemic owing to the general global slowdown.

Inflation was rampant in the region during the first part of the 1990s; it surged in 1995 in Mexico, while Argentina managed to control its hyperinflation with the introduction of the Convertibility Plan, pegging the peso to the dollar one to one. The inflation situations in the three economies in the beginning of the new century had seemed to converge, although Brazil's inflation was slowly rising again in 2002. The Mexican peso had fallen in 1995, while the Argentine peso remained pegged until Argentina's abandonment of its Convertibility Plan in 2002, after which it plummeted. The real experienced more fluctuations during this period. Despite different exchange-rate paths, the current-account balances of the three largest economies in the region converged into deficits ranging between 1 and 5 per cent of GDP during the latter half of the 1990s. This meant a reduction in the current-account deficits of Argentina and Mexico compared with those of their pre-crisis period that was brought about by an increase in exports. Brazil's current-account deficit expanded between 1994 and 1999 and stabilized at about 4 per cent of GDP during the post-crisis years.

In general, macroeconomic policy in Latin America during the 1990s was largely conditioned by the swings in the economy. For example, on the fiscal side, since government revenues closely followed the trends in growth, and expenditures tended to follow revenues, Governments tended to spend more in times of growth and to cut down in times of trouble. Given the potential of fiscal policy to positively affect growth, this pro-cyclical tendency became counterproductive.[14]

14 Ricardo Martner, "Los estabilizadores fiscales automáticos", *Revista de la CEPAL* (Santiago), No. 70 (April 2000).

Similarly, monetary policy in Latin America in general has not been able to smooth the volatile tendencies of the economies of the region. Usually, after a sharp fall in GDP accompanied by a significant outflow of capital, domestic currencies quickly began to lose their value. In an attempt to adjust and to prevent the inflationary effects of the depreciation, monetary authorities were forced to raise interest rates. This, in turn, dampened investment and made indebtedness more expensive in the medium term, with particularly adverse effects on domestic financing. In consequence, this type of monetary policy could only exacerbate the contractionary effect of fiscal policy, at a time when the entire economy was shrinking from the effect of the shock.

In the absence of domestic and external finance, this policy combination may be the only means to return to price stability and eventually regain the path of growth. However, the impact on the economy and society may have long-lasting repercussions.

Of the three Latin American countries discussed here, Mexico had a relatively stable fiscal situation throughout the decade of the 1990s, even during the crisis of 1994-1995. In general, primary expenditures remained fairly stable and fiscal deficits did not experience visible increases during the crisis. At the beginning of the 1990s, Argentina's fiscal situation had been stable but, afflicted by problems in the real domestic economy, the external sector and provincial finances, it deteriorated during the latter part of the decade until 2002. This accumulation of problems ended up with the abandonment of the Convertibility Plan, and the cutting of expenditures during declines in economic activity. Brazil's public sector had suffered a large fiscal deficit fuelled by the increasing costs of servicing its debt in 1998. This was followed by a quick contraction in 1999, following recommendations of the international financial community to put limits on primary expenditures.[15]

Monetary policy in these three countries was attempting to ease the fall of the value of their currencies, to attract short-term capital and/or to attenuate the imminent sharp rise in prices. Interest rates had been raised to a much higher level in Argentina and Mexico during the crisis of 1995 and in Brazil in 1998 and 1999. The first two lowered their rates the following year, while Brazil was more hesitant in easing its monetary policy, given that the real value of its currency had dropped 36 per cent in 1999.

Comparing policy responses

While only one major economic shock, that of 1997-1998,[16] affected the East Asian region, Latin America and the Caribbean experienced the Tequila crisis at the end of 1994, the repercussions of the Asian and Russian crises in the 1990s, the devaluation of the Brazilian real in 1999 and the series of Argentine crises. This greater vulnerability of Latin America and the Caribbean also translated into the greater volatility of its economies during this period, not allowing much time or space for recovery. In addition to this constant short-term volatility, domestic savings in Latin America during the 1990s remained practically stagnant, partly owing to the lower savings of the public sector.[17] Furthermore, all five East Asian countries discussed here ended up with current-account surpluses, while each of the major Latin American countries still had to finance a deficit in its current account after the crises.[18]

Given these differences in the need for capital flows and degree of volatility, the macroeconomic policy responses varied among regions. As seen above, the Asian countries were able to pursue a fiscal policy that would help prevent a further fall in growth. Similarly, on the monetary side, interest rates were lowered to help reactivate the economy, except in Indonesia where inflationary pressure was much greater. In the case of Latin America, lack of financing obliged Governments to tighten their belts, putting off reactivation policies. Monetary authorities in Latin America were required to adopt contractionary policies and fiscal expansion was limited (see table V.1).

This delay in regaining the growth path had repercussions on poverty. Moreover, since the specific crises mentioned affected primarily urban activities, the urban poor were the most afflicted.

The channels of transmission to the poor will vary, depending on the policy responses taken and the effects on the economic sectors. Two of the most relevant variables for the poor are changes in wages and unemployment. The relative degree of adjustment of these variables will depend on inflation, which in turn is affected by the macroeconomic policies. For example, in Argentina, while the Convertibility Plan was still in effect, fiscal deficits had been kept under 2 per cent of GDP while interest rates were higher than in pre-crisis years. Thus, inflation was under control and real average wages (although fluc-

15 Total expenditures without including debt-servicing.

16 All five East Asian countries were growing at high sustained rates before the crisis. The Philippines was growing at a lower rate, but also experienced the smallest fall in growth. Although the shock in terms of the magnitude of the fall in growth in East Asia was larger than in the major Latin America countries, recovery came relatively quickly to the region.

17 Economic Commission for Latin America and the Caribbean (ECLAC), *Una Década de Luces y Sombras: América Latina y el Caribe en los Años Noventa*, Alfaomega and ECLAC (Bogotá and Santiago, 2001), p. 89.

18 Except for the 2002 Argentine crisis, which ended up with a current-account surplus owing to a contraction of its imports.

tuating) were maintained, but they plunged when Argentina abandoned the Plan and let the peso float freely (in January 2002). Hence, during the period of the Convertibility Plan, the adjustment was made mostly via unemployment, which remained consistently high after the initial shock in 1995. In 2002, unemployment also increased greatly but at a slower rate than after the crisis of the mid-1990s. During the Tequila crisis and at the end of the Brazilian Real Plan, the devaluation and consequent inflation also saw wages in Mexico and Brazil fall behind the rapid growth of prices. However, wages in Mexico recovered and unemployment was decreased under an expansionary macroeconomic policy, whereas wages in Brazil kept falling and unemployment remained high under strict contractionary measures.

In the aftermath of the Asian crisis, all five countries had experienced higher unemployment for a few years before it returned to pre-crisis levels, except for Indonesia and the Philippines where unemployment continued to rise. In these two countries, monetary policy during the post-crisis years was more restrictive than in the other countries (that is to say, official and lending interest rates remained at higher levels). However, all five countries pursued expansionary fiscal policies during the years immediately after the crisis. Of the main sectors with employment data, manufacturing had the biggest fall in employment in absolute terms in these countries during the crisis years. In contrast, employment in agriculture rose, despite the fall in output in the sector in 1998, except in Thailand where employment in all sectors fell.[19] Real average wages took a dive especially in Indonesia and the Republic of Korea, which also experienced large depreciation of their currencies and inflation.

POVERTY AFTER THE CRISES

It has been argued that the single most important cause of short-term increases in urban poverty (with possible medium- and long-term repercussions) is economic shocks that are typically produced by external or domestic imbalances and the policy responses to those imbalances.[20] Cities, given the nature of the activities, investments and industries that are usually concentrated in them are consequently more susceptible to certain types of shocks than other areas. Falls in investments are a first reaction to crises and as a result, unemployment, especially in the construction and manufacturing sectors, rises. Terms-of-trade shocks could affect rural or urban areas, depending on the location of the good's production. Whatever the shock, the first victims are usually low-skilled workers, who are also at the bottom of the income ladder and the most needy.

Although evidence is neither complete nor conclusive, in general, the rural sectors in East Asia seem to have been more resistant to the effects of the crisis in 1997 owing to their reliance on the agricultural sector which was largely unaffected by the crisis. In Latin America (see below), the majority of the population and the poor are concentrated in the urban areas. In addition, the agricultural sector in Latin America, similar to that of most of the East Asian countries, was much more resistant to the shocks than the urban-based sectors, and continued to grow throughout the crisis periods.[21] Therefore, the scope of the present discussion is limited to the effect of changes in the macroeconomic environment on the urban areas.[22]

19 Since mining does not employ large amounts of labour, its decrease was not significant in terms of the economically active population or the increase of poverty. See Asian Development Bank, "Key indicators of developing Asian and Pacific countries" (http://www.adb.org).

20 For further discussion of this argument, see, for example, Camilo Arriagada, *Pobreza en América Latina: Nuevos Escenarios y Desafíos de Políticas Para El Hábitat Urbano,* Serie Medio Ambiente y Desarrollo, No. 27 (Santiago, ECLAC, October 2000); and Nora Lustig, "Crises and the poor: socially responsible macroeconomics", presidential address given at the Fourth Annual Meeting of the Latin American and Caribbean Economic Association, Santiago, 22 October 1999.

21 Based on data from ECLAC, *Estudio Económico de América Latina y el Caribe* (Santiago, various issues).

22 Another factor, rapid demographic growth, affects the situation of urban poverty in the medium and long term in an important way. At the present growth rate, the urban population will soon surpass the rural population (*World Urbanization Prospects: The 2001 Revision* (United Nations publication, Sales No. E.02.XIII.16). Studies have also shown that if urban poverty continues its present rate of growth, it will surpass its rural counterpart. (Martin Ravallion, "On the urbanization of poverty," *Journal of Development Economics*, vol. 68 (2002), pp. 435-442; see also chap. VII of the present *Survey* for a discussion on rural poverty). Thus, urban poverty may become a problem if the appropriate policies are not implemented.

Disaggregated data on urban poverty are scarce, as they are not collected with much frequency, and pose problems of coverage and measurement. However, at least a partial description of urban poverty after the crises can be made. The highest proportions of urban population among the five East Asian countries discussed in this chapter are found in Malaysia, the Philippines and the Republic of Korea, where they are equivalent to between 57 and 82 per cent of the population.[23] In Indonesia, 42 per cent of the population live in urban areas, while in Thailand only one fifth do. As table V.2 shows, it was in Indonesia and the Republic of Korea that urban-dwellers were hardest hit by the crisis, with urban poverty rates doubling and almost tripling, respectively, during the crisis. About one fifth of all Indonesians were living in poverty, out of which one third lived in the urban areas. Urban poverty in the Philippines increased after the crisis to 25 per cent in 2000, eroding the progress made during the pre-crisis years (when poverty had been reduced from 28 to 21.5 per cent of the urban population between 1994 and 1997). Figures for Thailand before the crisis show that only about 10 per cent of urban-dwellers had lived under the poverty line. Although poverty in Thailand did increase during the crisis, most of this increase was concentrated in the rural areas, especially the north-eastern region.[24]

All three selected countries from Latin America suffered increases in urban poverty immediately after the economic shocks, reversing the progress made in

23 Data from World Bank, *World Development Indicators* (Washington, D.C., various issues).

24 For more details on the social impacts of the crisis, see for example, Michelle Gragnolati, "The social impact of financial crisis in East Asia: evidence from Philippines, Indonesia and Thailand", World Bank, East Asia Environment and Social Development Unit, EASES Discussion Paper Series, June 2001.

Table V.2.
EFFECTS OF ECONOMIC CRISES IN SELECTED COUNTRIES IN ASIA AND LATIN AMERICA

Country and year of reference	Macroeconomic indicators annual rate (percentage)				Other indicators					
	GDP per capita	Inflation	Exchange rate[a]	Current-account balance change[b]	Unemployment		Real Wages[c]	Urban poverty[d]		Most affected sectors[e]
					Rate	Percentage change	Percentage change	Rate	Percentage change	
Indonesia (1998)	-14.4	57.6	-70.9	6.0	5.5	36.2	-41.0	19.5	101.0	C, F
Republic of Korea (1998)	-7.4	7.5	-32.1	14.4	6.8	161.5	-9.3	19.2	180.0	C, T
Malaysia (1998)	-9.5	5.3	-28.3	19.1	3.2	41.7	-1.1	..	..	C, M
Philippines (1998)	-2.7	9.7	-27.9	7.7	9.6	21.5	-2.0	25.0	16.3	C, F
Thailand (1998)	-11.4	8.1	-24.2	14.7	3.4	277.8	-7.4	..	small increase	C, M
Argentina (1995)	-4.1	3.4	-0.1	2.3	17.5	52.2	-1.1	17.8	34.8	C, M
Brazil (1999)	-0.3	8.9	-33.6	-0.5	7.6	0.0	-4.4	26.4	7.5	M, S
Mexico (1995)	-7.8	35.0	-47.4	6.5	6.2	67.6	-13.0	37.5	29.3	C, S

Source: UN/DESA, based on data from Asian Development Bank, World Bank, ECLAC and other official sources.

a Percentage change in value of domestic currency per United States dollar. Negative sign denotes depreciation of the currency; positive numbers, appreciation of the currency.
b Change in percentage points of GDP.
c Data for Asian countries from Gordon Betcherman and Rizwanul Islam, eds, *East Asian Labor Markets and the Economic Crisis: Impacts, Responses and Lessons*, (Washington, D.C., and Geneva, World Bank and International Labour Office, 2001), p. 14.
d Percentage of urban population living under the national poverty line, pre- and post-crisis years of reference varying depending on availability of data.
e Sectors that had experienced the greatest fall in growth: C: construction; F: finance; M: manufacturing; S: services; T: trade.

terms of poverty reduction before the crises occurred, as was the case in East Asia. The majority of the population in these countries (75-88 per cent), as in most Latin American countries, live in urban areas, as do about 60-75 per cent of the total poor population.[25] Argentina and Mexico had managed to reduce urban poverty before 1994, especially the former, from almost 19 per cent of the total population in 1990 to a little over 11 per cent by 1994. After a sharp increase in urban poverty in Mexico in 1996, the level fell close to the pre-crisis level. However, the urban poverty level (29 per cent of the total population) remains high in Mexico. Argentina's urban poverty problem continued to worsen during the second half of the 1990s and into the new decade, along with the macroeconomic downturn. In the Greater Buenos Aires area alone, the population below the nationally established poverty line increased from about 30 to 50 per cent between October 2000 and May 2002.[26] The rate of poverty in urban areas of Brazil decreased from 36 to 24 per cent between 1990 and 1996[27], but this reduction was reversed during the crisis of 1999 when the poverty rate rose to over 26 per cent.

DIRECT MEASURES TO ADDRESS URBAN POVERTY

The degrees of freedom in the macroeconomic policy arena that authorities may earn during times of growth affect the availability of resources when they are most required to attend to social needs during times of crisis. The pre-crisis accumulation of surpluses in the East Asian countries allowed them to undertake fiscal expansion in times of crisis and create measures to protect the needy, since such measures had not existed before the crisis.[28] The Latin American examples illustrate how greater fiscal constraints even before the crisis and the unmet needs of the large number of the chronic poor limited the extension of existing social protection programmes when the crisis occurred.

In general, Governments in Latin America increase the amount directed towards social expenditures in times of growth. During the times of contraction and slower growth during the 1990s, many countries in the region found it difficult to protect the budgeted social expenditures. The degree of the adjustment differed among countries but, in general, its pro-cyclical pattern corresponded to the pattern of the Governments' total expenditures. Although attempts were made to protect funds budgeted towards social objectives, this could not always be achieved in the presence of financial constraints. Total expenditures are sensitive to the changes in revenues which, at the same time, are conditioned by the growth of the economy. As markets have become more open to foreign capital, fluctuations in the economy occur more often and more abruptly, making fiscal expenditures also volatile and thus hard to manage.[29]

Thus, the fiscal situation may affect the number and size of social protection schemes. There are two broad types of schemes which can be categorized by their objectives: those focused on assisting the affected people in generating income or compensating for its loss and those aimed at preserving human or physical capital and/or recuperating any such capital that was lost. The former include programmes such as workfare, unemployment insurance systems, severance payments and microcredit assistance. The latter includes programmes in education, health, nutrition and housing, sometimes referred to as livelihood protection.[30] Although the social service in the areas in the latter category could

25 World Bank, *World Development Indicators*, …

26 *World Economic Situation and Prospects 2003* (United Nations publication, Sales No. E.03.II.C.2), box III.1, entitled "Poverty in Argentina today".

27 ECLAC, *Social Panorama of Latin America, 2000-2001* (United Nations publication, Sales No. E.01.II.G.141).

28 Economic and Social Commission for Asia and the Pacific (ESCAP), *Protecting Marginalized Groups during Economic Downturns: Lessons from the Asian Experience* (United Nations publication, Sales No. E.03.II.F.2).

29 For a more detailed elaboration of this argument, refer to ECLAC, *Social Panorama of Latin America, 2000-2001* …; and ECLAC, *The Fiscal Covenant: Strengths, Weaknesses, Challenges* (United Nations publication, Sales No. E.98.II.G.5), pp.125-129

30 In public financing terms, both types of programmes are budgeted under social expenditures of the government. The income-related programmes are usually part of the social security expenditures, while livelihood protection pertains to the rest of the budget.

also be regarded as constituting monetary assistance, similar to that in the first group of programmes, the focus is nevertheless on investing in human capital and preventing permanent damage to it. Housing is physical capital, but at the same time it helps preserve the quality of human capital and the livelihood of people. Governments now see housing not merely as a spatial or physical issue, but as an integral part of efforts to reduce poverty and social isolation, as will be explained below. Since urban poverty presents multidimensional (income and non-income) challenges and each country faces specific problems and constraints, Governments have applied different measures according to their circumstances. These two types of programmes should complement each other, especially when the income generated by the poor alone is not sufficient to compensate for the human capital lost during a crisis or to provide access to services (see table V.3, which categories policies applied after crises).

Indonesia and the Republic of Korea experienced a much higher increase in the incidence of urban poverty than the Latin America countries (see table V.2). However, on average, poverty rates in Latin America have been higher than in East Asia. Much progress has been made in poverty reduction in East Asia during the sustained high-growth period before the crisis. This means that there was a greater surge in the number of people who became poor after the East Asian crisis. In addition, most of these "new poor" had been employed in the formal sector before they lost their jobs. Therefore, income-generating programmes were executed in the region to help these new poor return to their previous situations. In contrast, the proportion of the poor had been higher in Latin America before the crisis years, although progress was also made in poverty reduction in those years.[31] However, much of the poverty in Latin America is structural or chronic in nature, and existed even in times of growth. Hence, a variety of programmes have been in place in the region to attend to both income and non-income types of needs.

Several "income-type" programmes were implemented in South-East Asia to assist the population affected by the crisis of 1997.[32] The programmes included proactive measures, that is to say, measures aimed at generating

31 ECLAC, *Social Panorama of Latin America, 2000-2001 ...*

32 ESCAP, *Protecting Marginalized Groups during Economic Downturns ...*

Table V.3.
SOCIAL POLICY RESPONSES TO ECONOMIC CRISES

Types of policies	
Income generation/compensation	Livelihood protection
Active	Human capital
Workfare programmes	Health provision
Training programmes	Nutrition programmes
Micro credit programmes	Educational programmes
Passive	Physical capital
Unemployment insurance	Housing programmes
Severance payment	
Subsidies	

Source: UN/DESA.

income and creating employment, such as public works programmes, microcredit and small and medium-sized enterprise (SME) credit, and "passive" programmes such as unemployment insurance schemes. In general, these measures partially achieved their goal of alleviating the loss of income of the needy directly affected by the regional financial crisis. However, they all encountered problems of coverage and efficiency. Many of these programmes had to be created and implemented after the crisis began, since many of them had not existed or had been discontinued while the region was growing rapidly and did not have an urgent need for them. In addition, reliance on existing close-knit and strong family relations and support, that is to say, "social capital", often took the place of government protection, especially during good times, in the five East Asian countries discussed in this chapter. Thus, many of these programmes were ad hoc in nature and lacked the institutionalization and planning necessary to confront this sudden surge in poverty.

Public works programmes implemented in Indonesia and Thailand generated jobs and expanded necessary infrastructure at the same time. However, given the nature of the jobs offered, namely, heavy construction work, women and the elderly were not always able to participate in such activities. In addition, most of these programmes were located in the rural areas, and did not attract those who had lost their jobs in the formal sector in the urban areas. Indonesians found that the duration of such programmes was too short and left many people still jobless and in need. The arguments in favour of these programmes emphasized their easy execution, the good response from workers with low levels of education and the rise in income while the work lasted. In the Republic of Korea, the Government combined public works and job training with cash and in-kind transfers of food, clothing, housing, education and health care, for those eligible for its Livelihood Protection Programme.[33] In this way, the Programme served the dual purpose of providing income-generating capacity, and offering assistance in protecting human capital as needed.

Microcredit programmes executed in Indonesia and Thailand benefited, in particular, women with low education levels.[34] Through this credit, beneficiaries were able to finance income-generating activities with short gestation periods. However, like the public works programme, the microcredit failed to reach those most directly affected by the financial crisis—the unemployed in the formal urban sector. One of the reasons for this was the requirement of creating groups in order to receive credit. The urban unemployed were not able to form these groups in a short period of time. Another shortcoming of the programme was that credit was used by the recipients to finance consumption rather than productive investment, reflecting their difficulties in meeting basic requirements.

The unemployment insurance schemes in the Republic of Korea managed to give just enough relief to the beneficiaries in the formal sector to cover their basic needs[35] but, as with most insurance schemes, they failed to cover the informal sector. In the other countries, unemployment insurance was not developed at the time of the crisis.

An important problem with the SME credit programme applied in the Republic of Korea was that the SMEs most afflicted by the crisis received the least amount of assistance, while those in better financial standing were approved for larger loans. Because standard credit criteria were used to select the beneficiaries,[36] the most vulnerable had the least access.

33 World Bank, International Monetary Fund (IMF), Asian Development Bank and Inter-American Development Bank (IDB), "Social safety nets in response to crisis: lessons and guidelines from Asia and Latin America," submitted to the Asia-Pacific Economic Cooperation (APEC) Finance Ministers, February 2001, pp. 13-14.

34 ESCAP, *Protecting Marginalized Groups during Economic Downturns …*, pp. 44-45.

35 Ibid., p. 52.

36 Ibid., p. 59.

Social protection schemes of the income-generating type have also been executed in Latin America. As in East Asia, targeting is a major challenge in the region, but for a different reason. Unlike the South-East Asian new poor, many of the poor in Latin America were not part of the formal sector even before the crises. Therefore, these programmes, which are closely related to the formal sector, often failed to reach them. Indonesia and the Philippines have relatively small informal sectors, accounting for about a fifth of total employment.[37] Data for Thailand vary but indicate that the informal sector in the cities is small, accounting for less than one tenth of total employment. In contrast, the informal sector in cities of Argentina, Brazil and Mexico accounts for from 45 per cent to over half of total urban employment.

Some Governments in Latin America and the Caribbean have thus undertaken various programmes that target workers in the informal sector and address long-term structural problems.[38] Examples of long-term solutions for unskilled poor workers are training programmes such as the Retraining Programme on Employment and Wages (Programa de Becas de Capacitación para los Desempleados (Probecat)) in Mexico, which has trained nearly half a million urban workers per year since the late 1980s. However, each training programme, owing to its brevity, does not seem to have provided the required long-term skills. In Brazil, the Government is implementing an innovative professional training programme called the National Worker Qualification Plan (Programa Nacional de Qualificação do Trabalhador (PLANFOR), which is not linked to the formal sector. With the participation of local government and non-governmental organizations, the programme aims to target the poor who are mostly engaged in the informal sector.[39]

Unemployment insurance programmes are rarer in Latin America, although severance payments are implemented. However, the high level of informality of the labour market limits the coverage of such programmes, especially among the poor. A case in point is Brazil's unemployment insurance programme, funded by earmarked contributions from the employers, which benefits mostly the unemployed at higher-income levels.[40]

The credit programmes in Brazil try to combine two objectives: to support small enterprises, and also to generate employment for the poor through these enterprises, which are administered and staffed by the poor. The same fund that has been reserved for the unemployment insurance schemes, the Workers' Assistance Fund (Fundo de Amparo ao Trabalhador (FAT)), established in 1990, supports these employment-generation programmes.[41]

Standards of living are also affected during times of crisis, and their decline may have long-term effects. A decrease in funding for livelihood protection can make access to basic services more difficult. Livelihood protection programmes in education, health, nutrition and housing, like income-related social protection schemes, have experienced coverage problems. Many of these are targeted at the entire population and miss the really needy. Thus, often the better-off benefit more from these programmes since they have more direct access to them. This can be a problem in times of crisis, when deterioration in human capital may cause permanent damage to the livelihood of the poor. For example, a decision to drop out of school in order to start working early because of loss of income in the household may have lasting repercussions in the future for the individual and his/her future household. Newly poor tenants may be

37 International Labour Organization (ILO), *Key Indicators of the Labour Market, 2001-2002* (Geneva, 2002).

38 There are also work programmes that target workers in the formal sector. For example, "workfare" programmes, such as Trabajar in Argentina, offered construction jobs for public infrastructure at wages set not higher than 90 per cent of the market rate in order to attract only the needy and to encourage a return to the market when the demand recovered. The advantage of this type of programme is the ability to expand quickly in times of crisis, target poor areas and attract the poor. However, the cost assumed by the Government could be high. See Norman Hicks and Quentin Wodon, "Social protection for the poor in Latin America", *Revista de la CEPAL*, No. 73 (April 2001); and Jyotsna Jalan and Martin Ravallion, *Income Gains to the Poor from Workfare: Estimates for Argentina's Trabajar program*, World Bank Policy Research Working Paper, No. 2149 (Washington, D.C., July 1999).

39 For a review of poverty reduction policies in Brazil, see World Bank, *Attacking Brazil's Poverty: A Poverty Report with a Focus on Urban Poverty Reduction Policies,* vols. 1 and 2, Report No. 20475-BR (Washington, D.C., World Bank, 31 March 2001).

40 Ibid., pp. 78-79.

41 Ibid., p. 39.

forced to leave their dwellings and live in more precarious conditions. In the medium to long term, social expenditures can create positive externalities that may permeate other sectors of society. However, a regressive or poorly targeted programme would not be able to address the post-crisis needs of the lower deciles of the population.

The recent experience of Mexico in education and health programmes is illustrative of some of these problems of appropriately reaching the poor. Studies have shown that public education expenditures in Mexico have favoured the better-off and are highly concentrated in the urban areas, although this distribution became less skewed during the period 1994-2000. Expenditures per student at higher levels of education were disproportionately higher than expenditures at the primary level. In addition, the higher the levels of education, the more regressive the expenditures. Only at the primary level was it found that the poorest 40 per cent of the households were receiving more than 40 per cent of total public expenditures. Similarly, lower-income deciles have little access to health services, since they do not have medical insurance. Under reform programmes, the Government is attempting to increase access by offering medical insurance to workers outside the formal sector.[42]

42 Ana Corbacho and Gerd Schwartz, *Mexico: Experiences with Pro-Poor Expenditure Policies*, IMF Working Paper WP/02/12 (Washington, D.C., January 2002).

Strategies with multiple objectives, that is to say, incentives to encourage the poor to try to protect or build various aspects of their "human capital" simultaneously, have also faced targeting problems. For example, food subsidies have been implemented to encourage school attendance and health treatment. However, lack of access to education and health facilities still impedes the poor's participation despite the incentives. Conditional cash transfers are instruments with similar problems in respect of targeting and reaching the appropriate groups.

Housing problems are probably the most visible result of urban poverty. Insufficient income and lack of access to credit force the poor to illegally claim land and build their living quarters with whatever means they have available. These large slums, well known in cities of Brazil (favelas) and Mexico *(colonias populares)*, not only pose urban policy problems to the authorities, but can also perpetuate the precarious conditions of the poor living in them. Since land is claimed haphazardly, appropriate infrastructure is not in place, creating unhealthy, unsanitary, crowded and even dangerous conditions (such as steep hillsides vulnerable to landslides) for the inhabitants. In addition, such living quarters create physical and social isolation from the rest of the urban area and community. The mere provision of housing does not reduce urban poverty although it does improve living conditions.

In Brazil, several different approaches have been taken to address the housing problem of the urban poor.[43] One approach is offering credit to either households or communities. The credit programmmes for households target groups with different income levels under different conditions. Programmes covering communities include many non-poor households, but some municipalities are not eligible for credit at all owing to their low creditworthiness. Thus, the truly needy communities still remain without access to credit, while some non-poor households in eligible communities receive benefits.

43 Further analysis of these programmes can be found in World Bank, *Attacking Brazil's Poverty …*, vol. 2.

A second type of programme is geared to the general improvement of the conditions of slums. These programmes provide the infrastructure necessary for basic services to be received and also provide support and advice in order to enhance the livelihoods of the dwellers in the favelas. One multisector favela improvement project in Rio de Janeiro has the objective of enabling the dwellers to integrate socially and physically with the rest of the neighbourhoods of the city covering all medium-sized settlements. The Favela Bairro is an ambitious project, which includes the construction of infrastructure, schools, training centres, commercial establishments, sports facilities, provision of basic services etc. Although this project reflects a new type of approach to the housing problem of the poor by attempting to improve not only their living conditions but also their social integration, the complexity in respect of achieving these objectives has caused the project to fall short of its objectives.[44]

A third means of addressing the housing problem of the poor in Brazilian cities is to reform land regulations by either legalizing illegally claimed land or easing up on land-use regulation.[45] According to the World Bank, strict land-use regulations in Brazil's urban areas promote the growth of informal neighbourhoods, since the poor cannot meet the requirements and conditions for using legal land.[46]

In sum, programmes for both income-generation and the protection of poor people's livelihoods have encountered problems in reaching their target population, particularly in cases where the informal section is large. Many of the problems arise from the lack of access to formal institutions. While many of the newly poor can be aided through programmes related to the formal sector, the chronic poor remain neglected and are more difficult to mobilize. Programmes that target workers in the informal sector or long-term structural problems are required to address chronic poverty. Such programmes provide a "safety net" for the poor in times of crisis.

44 Elizabeth Riley and others, "Favela Bairro and a new generation of housing programmes for the urban poor", *Geoforum*, No. 32 (2001), pp. 521-531.

45 Hernando de Soto would also argue, as he has in *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York, Basic Books, 2000), that the poor not only need property rights but also the access to the market mechanisms that would allow them to increase the value of their acquired assets.

46 World Bank, *Attacking Brazil's Poverty ...*

POLICY IMPLICATIONS AND RECOMMENDATIONS

As can be seen, economic shocks can be very detrimental to the urban poor and recovery can be slow and costly. Therefore, the best macroeconomic policy is one that can soften or prevent these shocks. In times of crisis, the immediate and primary goal of economic policy is macroeconomic stabilization, and the direct results may or may not coincide with a reduction in poverty. Furthermore, financial constraints can also limit the space for manoeuvre for fiscal policy and determine the course of the subset of policies at the social level. Hence, measures to prevent crises at the macrolevel can and should be taken during times of growth, when constraints are fewer and space for manoeuvre is more ample.

The principle motivation behind taking preventive measures is to avoid excesses during both good and bad times by "saving for a rainy day". There has been greater consensus in this respect, especially after the experiences during the crises of the 1990s. However, it is also recognized that one set of measures is not sufficient to prevent crises and that policies must adjust to the specific economic situation. Applying sound macroeconomic policies is a necessary but not a sufficient condition for preventing crises. For example, regulation and supervision of the domestic banking system and appropriate capital controls can complement the macroeconomic policies in their efforts directed towards, crisis prevention.[47]

47 For a discussion on financial vulnerability in a globalizing world, see chap. IV, entitled *"Financial vulnerability in a globalizing world", World Economic and Social Survey, 2001* (United Nations publication, Sales No. E.01.II.C.I).

Ideally, such preventive measures would allow Governments to continuously pursue policies that resulted in relatively smooth and uninterrupted growth. In other words, counter-cyclical policies in periods of growth should allow for expansionary policies when they are required unexpectedly.[48] This is essential for an effective process of poverty reduction, since this process requires long-term stability and an interruption would mean losing ground in respect of the progress already made.[49]

Such policies would help attenuate the volatility of the economy, which makes policy response more difficult in times of crisis. Fiscal constraints during recessions usually directly reduce the budget assigned for social purposes, thereby impeding assistance to the needy. Hence macroeconomic policy can also directly affect the efficacy of social protection schemes, and the social impact of changes in macroeconomic policy in times of crisis should also be an important consideration for policy makers.

Social protection schemes are necessary to assist the vulnerable sectors of the population in case preventive measures, that is to say, macroeconomic policies, fail to protect the overall economy from either an internal or an external shock, and to help the chronically poor eventually escape their situation. Ideally, curative measures should not be necessary. Moreover, if structural problems (such as the pro-cyclical tendencies of fiscal policies) were reduced, especially during periods of growth, there would be more resources available during times of slow or negative growth for social protection schemes. Although such schemes do not guarantee complete shelter from economic fallout, they may help soften the shock.

Governments have faced many challenges in their pursuit of the reduction of urban poverty. The gap between the efforts made through policies and the results demonstrate the complexity of the problem. Problems exist at all stages of the process: from the design, planning, funding and targeting to the execution and monitoring.

One general difference between the Asian and Latin American economies concerns those who became poor as a result of the crises. In Asia, the newly poor were predominantly those in the formal sector who suddenly faced poverty as a result of losing their employment, but who could expect to escape poverty as a result of re-employment when the crisis subsided. In Latin America, the newly poor were often in the informal sector and joined the ranks of the chronically poor. This structural difference can determine the effectiveness of policies. For example, some policies directed at the poor who are or who were working in the formal sector may not reach the rest of the urban poor, who may not have access to formal sector institutions. To reach the chronically poor, other types of programmes may be needed.

East Asian countries had to resort to new ad hoc measures, since many social protection programmes were either discontinued or non-existent in the region. These were deemed unnecessary since the region had enjoyed more than a decade of high growth and relied more on family relationships in times of trouble—so-called social capital. In contrast, Latin American countries relied on extending existing programmes, since the countries had always had poverty problems, even during periods of high growth.[50]

Social expenditures in Latin American countries have followed the cycles of economic activity, which have been very volatile in nature, causing social

48 For a discussion on such policies, see J. A. Ocampo, *Developing Countries' Anti-cyclical Policies in a Globalized World*, Serie Informes y Estudios Especiales, No. 4 (United Nations publication, Sales No. E.00.II.G.115).

49 Some studies have calculated the cost of crises in terms of an increase in urban poverty. For some recent examples and further discussion on the social impact of economic crises, see Nora Lustig, loc. cit.

50 World Bank, IMF, Asian Development Bank and IDB, "Social safety nets in response to crisis ...

expenditures to decrease in times of recession.[51] Hence, as is the case for preventive measures at the macrolevel, social protection programmes should be set up during times of growth when resources are available.

Besides all of the above-mentioned problems of implementation, the major challenge is to reach the most needy through programmes funded by social expenditures. Even though access to health, education and nutrition facilities is usually greater in urban areas than in rural areas owing to the population dispersion and the difficulties of reaching distant locations in rural areas, these urban-based programmes often reach only the middle—and higher-income individuals in the cities. Most programmes can reach only those who are already in the formal sector, while the extreme poor are often in the informal sector with little access to educational and health facilities.[52] In addition, the social structure of many cities in developing countries, especially those with a more uneven distribution of income, creates segregation of different types. Large slums are an example of spatial or residential segregation (or concentration, depending on the viewpoint). The schools near these areas tend to be of a lower standard than the average. The informal sector creates its own dynamic away from the formal labour market, perpetuating a system of isolation.[53] Thus, conventional programmes are not sufficient for reaching the entire targeted population.

Grass-roots activities have been organized to try to fill this gap and bring needed services to the urban poor. Given the isolation of the urban poor from the formal sector, including institutions and local government, non-governmental organizations serve as a natural bridge. Non-governmental organizations have shown that they can build social capital among low-income neighbourhoods and obtain financial capital to invest locally.[54]

The reduction of urban poverty requires the participation of many actors at all levels of society and is as complex a process as economic development itself, as well as an essential part of that process. At the highest macrolevel, prevention of shocks is essential, but macroeconomic responses to crises do not always favour the protection of the poor, particularly since financial constraints can limit the degrees of freedom of macroeconomic policy. Therefore, at a second level, preventive and curative measures within a social protection scheme should be in place at all times with varying degrees of intensity depending on the need. In theory, social programmes would be able to cover the needs of the poor if they were integrated in the formal sector. However, since the informal sector is very large in most developing countries, grass-roots-level involvement is also necessary to facilitate the access to services of the whole community.

51 ECLAC, *Social Panorama of Latin America, 2000-2001* ...

52 For a study on the case of Mexico, see for example, Ana Corbacho, and Gerd Schwartz, op. cit.

53 For a sociological discussion of this phenomenon of isolation of the poor in Latin America, see for example, Rubén Kaztman, "Seducidos y abandonados: el aislamiento social de los pobres urbanos", *Revista de la CEPAL* (Santiago), No. 75 (December 2001).

54 For a review of grass-roots activities for the urban poor, see for example, Diana Mitlin, "Addressing urban poverty through strengthening assets", *Habitat International* (forthcoming).

VI TRADE POLICIES, GROWTH AND POVERTY

John Stuart Mill, writing in the middle of the nineteenth century, noted the crucial role that trade can play in the process of development, maintaining that "the opening of foreign trade … sometimes works as a sort of industrial revolution in a country whose resources were previously underdeveloped".[1] At the beginning of the twenty-first century, this link has taken on a slightly different emphasis. The current focus is heavily on the impact of trade policy on an economy and, specifically, on the potential role of trade policy in poverty reduction. A variety of factors have conspired to bring this connection to the forefront in recent decades. First, there has been the strong export performance of a number of East Asian economies, commencing in the 1970s, and the vigorous economic growth that came in the wake of their export drives.[2] Moreover, beginning in the 1990s, concern with the process of globalization began to capture the attention of policy makers and the public. In particular, a great deal of attention has been directed at the question whether income gaps are widening between those countries that are successfully integrating themselves into the world economy via their trading patterns and those that are falling by the wayside. Increasing concern is being expressed at the lack of progress of these poorest economies and their possible marginalization. The need to include the poorest has been articulated in the United Nations Millennium Declaration.[3] The Millennium Declaration emphasizes the need for poverty eradication and underscores the need for an open trading system that is "rule-based, predictable and non-discriminatory" (para. 13) as one means to this end. Finally, the Monterrey Consensus of the International Conference on Financing for Development,[4] noting that international trade is "an engine of growth", stated that a "universal, rule-based, open, non-discriminatory and equitable multilateral trading system, as well as meaningful trade liberalization, can substantially stimulate development worldwide, benefiting countries at all stages of development"(para. 26).

The present chapter will examine the role of trade and trade policies in stimulating growth and thereby contributing to poverty reduction. Trade policies are government policies that directly influence the quantity of goods and services that a country imports or exports. Such policies can take various forms. For example, liberal trade policies are geared towards allowing a nation's residents to trade internationally with a minimum of government interference, whereas strategic trade policy is intended to

1 John Stuart Mill, *Principles of Political Economy* (London, Taylor and Francis Books, Ltd., 1996), book III, chap. VII. Originally published in 1848.

2 For example, between 1969 and 1999, the share of world exports of goods and services of Hong Kong SAR of China, China, Malaysia, the Republic of Korea and Thailand increased from under 2 to over 8 per cent.

3 See General Assembly resolution 55/2 of 8 September 2000.

4 *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (United Nations publication, Sales No. E. 02.II.A.7), chap. I, resolution 1, annex.

influence the trade policies of partner countries. Such policies are beneficial only if other countries respond by changing their trade policies, as anticipated. Trade policy liberalization entails such measures as tariff reductions, relaxing or removing import quotas (quantitative restrictions), reducing import taxes and dropping export subsidies. All such policies can be carried out to a greater or lesser degree so that trade liberalization does not imply a shift to complete laissez-faire.

The basic contention of this chapter is that trade liberalization is a necessary, but not sufficient, condition for economic growth and that it is via such growth that poverty can be reduced. The chapter will argue that trade effects—and the policies that instigate them—operate in the short, medium and long run. Moreover, trade can impact on poverty via a variety of channels—for example, changing the prices and availability of goods and services or influencing the distribution of income within a country. Many of the changes brought about by trade and trade policies incur adjustment costs. In the longer run, however, the benefits of expanded trade tend to outweigh the costs. Moreover, avoiding trade expansion because of a concern with potential adjustment costs would be a recipe for stagnation. Yet, trade policies have to be thought out, since trade is but one—sometimes a small—variable in the growth equation, and policies suited to one country cannot be easily translated for use by other countries because conditions are as individualistic as are individual economies. Thus, the trade policy experiences of one country cannot be used to produce a generally valid "policy prescription".

TRADE AND THE ECONOMY

The potential of trade to serve as a catalyst for development can be put into sharp relief by looking at the ratio of trade to gross domestic product (GDP) in a variety of country groups (see table VI.1). Exports—which are conventionally viewed as contributing to, rather than subtracting from, GDP—had grown over the course of the 1990s by 29 per cent. By 2000, the ratio of exports to world GDP was almost 26 per cent. The importance of exports is further documented by noting that the ratio of exports to GDP was almost 30 per cent in both low-income and low- and middle-income countries, and over 20 per cent in least developed countries. Moreover, in each case, exports had risen substantially during the decade, at least at double the rate for the developed countries. With figures such as these, the focus has to be not on whether trade can serve the interests of growth and poverty reduction, but rather on putting the policies in place to ensure that it does so.

There are a variety of difficulties inherent in trying to pinpoint the economic consequences of specific trade policies, as well as in ascertaining the effects of changes in such policies. The greatest problem lies in the fact that trade policies are variable, shifting as circumstances demand. In part, this is because such policies are a useful tool and often easier to implement than changes in either monetary or fiscal policies. For example, raising government revenue by levying an import duty may be politically more palatable than raising revenue by increasing taxes, since the former may hurt a much smaller subset of the population. Similarly, non-tariff barriers to trade, while economically ineffi-

Table VI.1.
RATIO OF TRADE TO GROSS DOMESTIC PRODUCT IN DIFFERENT COUNTRY GROUPS, 1990 AND 2000

Percentage

	1990	2000
Least developed countries		
Exports of goods and services	13.6	21.6
Imports of goods and services	22.7	29.6
Total trade	36.3	51.3
Low-income countries		
Exports of goods and services	17.8	28.7
Imports of goods and services	20.7	28.1
Total trade	38.5	56.8
Low- and middle-income countries		
Exports of goods and services	20.1	29.9
Imports of goods and services	19.6	27.8
Total trade	39.7	57.8
High-income countries (OECD)		
Exports of goods and services	18.0	22.6
Imports of goods and services	18.0	22.9
Total trade	36.0	45.5
World		
Exports of goods and services	19.9	25.6
Imports of goods and services	19.8	25.3
Total trade	39.7	50.8

Source: World Bank, *World Development Indicators* web site, Washington, D.C.

cient inasmuch as they incur a variety of costs especially for consumers, might be politically desirable since they protect domestic producers. Or, confronted by a balance-of-trade deficit, policy makers may see export subsidies and import tariffs as the easiest way to rectify the problem, especially if monetary policy is not an option. The latter may be the case for economies whose exchange rates are tied to another country's currency, rendering monetary policy or devaluation an impotent policy device. In all such instances, falling back on trade policies to steer economic changes, while not a first-best solution, may be the most practical—and most practised—option.[5]

A second major complication in trying to identify the results of specific trade policies on the economy arises from the fact that it is difficult—if not impossible—to pin down causality (as opposed to correlation). This is because trade policies are never implemented in a vacuum. There are always a large number of macroeconomic policies being pursued in addition to the trade policy stance. Consequently, it is extremely difficult to disentangle the effects of trade policies from other economic policies and events. For instance, a partner country's tariff reductions may spur exports. However, increased exports may also be due to a better product or to increased income, and hence greater demand, in the partner country.

5 For example, the drive to expand exports may be driven by export subsidies and may result in subsequent charges of dumping by virtue of the importer's being brought before the World Trade Organization.

Attributing results to trade policies is also problematic because trade policy shifts are usually gradual (except in dire situations), hence their impact is correspondingly minor. For example, countries often switch between various forms of protection, instead of eliminating or raising the level of protection in one fell swoop. It is often feared that trade reforms, such as removing import quotas or reducing import tariffs, will have devastating effects on import-competing industries, while causing a boom in other sectors of the economy. Although experience indicates that the benefits of the expansion will outweigh the costs associated with the demise of any protected sectors, those who are more cautious voice the concern that the contraction of the import-competing sector will lead to a deep and prolonged recession. In practice, however, once trade reforms are implemented, the overall impact is often surprisingly small.[6] For example, several estimates of the impact of trade liberalization have found welfare increases of only ½ to 1 per cent of GDP, or relatively small gains compared with expectations.[7] However, incorporating dynamic impacts yields far larger welfare gains. Thus, going beyond the immediate, or static, situation, the potential gains from trade and trade reform, together with the growth-inducing impact of liberalization, can be quite significant for a country in the medium or longer run. Trade and trade policies can thus be a powerful tool in the poverty alleviation arsenal.

Openness and trade liberalization (which is synonymous with increasing openness) have increasingly become customary tenets of economic policy advice over the past two decades. While there is broad acceptance that openness is ultimately beneficial, examining and dissecting the effects of such policies can be complex. With the caveats noted above, trade impacts—to the extent that they can indeed be tracked—manifest themselves on three time-horizons. First, trade will have a bearing on overall growth in the long run. In addition, trade can impinge on the distribution of income and the welfare of the poor. Both of these are medium-run effects. However, trade policies can also have a variety of shorter-run consequences, producing adjustment problems and costs, and perhaps even economy-wide shocks.

Since neither trade liberalization nor poverty is easily measured and since there is only a limited number of historical instances in which liberalization could be singled out as the dominant economic shock, it is difficult to derive empirical relationships between the two.[8] Nonetheless, countries that trade more—as a proportion of their GDP—tend to have higher incomes, other things being equal. A perennial concern in interpreting this assertion is that countries may trade more because they are wealthier; that is to say, the trade share may be endogenous. However, countries that have traded more have had higher incomes over the course of the twentieth century.[9]

There are two aspects to the question of "openness". There is the issue of the extent to which a country's own economy is unfettered by protection, such as export subsidies or import tariffs or quotas. Countries have control over the policy choices they make in this regard, though such choices may sometimes be difficult to make. Increased openness—via its effects on imports and welfare—has consequences for poverty. These work through a variety of routes, such as changing the prices and availability of goods and services and the demand for labour, altering the incentives for investment and innovation, influencing government revenue, and affecting income distribution. Additionally,

6 Rui Albuquerque and Sergio Rebelo, "On the dynamics of trade reform", *Journal of International Economics*, vol. 51 (2000), pp. 21-47.

7 Thomas F. Rutherford and David G. Tarr, *Trade Liberalization and Endogenous Growth in a Small Open Economy: A Quantitative Assessment*, World Bank Policy Research Working Paper, No. 1970 (Washington, D.C., World Bank, 1998).

8 See, for example, L. Alan Winters, "Trade and poverty: is there a connection?" in *Special Studies, No. 5: Trade, Income Disparity and Poverty* (Geneva, World Trade Organization, 2000).

9 Douglas A. Irwin and Marko Terviö, "Does trade raise income? evidence from the twentieth century", *Journal of International Economics*, vol. 58 (2002), pp. 1-18.

there is the issue of access to markets and the degree to which potential partner economies resort to protectionist measures of various sorts, such as quotas, tariffs and non-tariff barriers to trade. Here the role of exports in generating GDP growth becomes relevant. To recoup gains from trade, foreign markets have to be open. Nevertheless, this is something concerning which individual countries have very little leverage. It falls, rather, upon the partners themselves, the World Trade Organization and the international community to ensure that the multilateral trading system is open and equitable.

TRADE AND GROWTH

Economic growth is acknowledged as a key to permanent poverty alleviation. The first fundamental question, therefore, is whether opening an economy to trade is an important determinant of growth.[10] This trade opening-growth relationship must be examined before exploring whether the growth that is associated with trade liberalization is particularly pro- or anti-poor.

Liberalization and growth in theory and practice

The theoretical links between liberalization and growth are ambiguous. Robert Solow's 1956 neoclassical growth model is the standard-bearer in this regard. The implication of this model is that openness, by allowing for a more efficient allocation of resources, can—under specified conditions—raise the steady-state level of income and the growth rate. Over the past two decades, endogenous growth theory has built on this foundation, suggesting that openness may promote long-run growth in a variety of ways, such as through the diffusion of technology or learning-by-doing.

To assess the empirical evidence of the liberalization-growth link, it is first of all necessary to recognize the difference between the active opening up—or liberalization—of an economy and the existing state of openness. It is logical to seek a relationship between two dynamic variables, such as liberalization and growth. It is equally logical to look for a relationship between two static variables, namely, the degree of openness and the level of incomes. However, it would generally be a mistake to seek an association between the level of trade openness and growth.[11] The benefit of free trade—or openness—is a static efficiency benefit. Dynamic benefits, which emanate from liberalization, impact on growth.[12]

Casual empiricism attests to an association between export growth and GDP growth (see figure VI.1). Nevertheless, there are at least two problems that arise when examining the relationship from a policy perspective. It can be difficult to assess accurately the trade stance of a country, particularly when it is relatively closed. This is a definitional issue. In addition, the difficulty of establishing an empirical link is complicated by the fact that trade policies are usually part of a policy package.[13]

While the domestic impacts of liberalization or, conversely, the costs of protection, can be difficult to gauge, there is a great deal of cross-country and sometimes controversial evidence that documents a positive relationship between a liberal trade regime and GDP growth. This finding has been con-

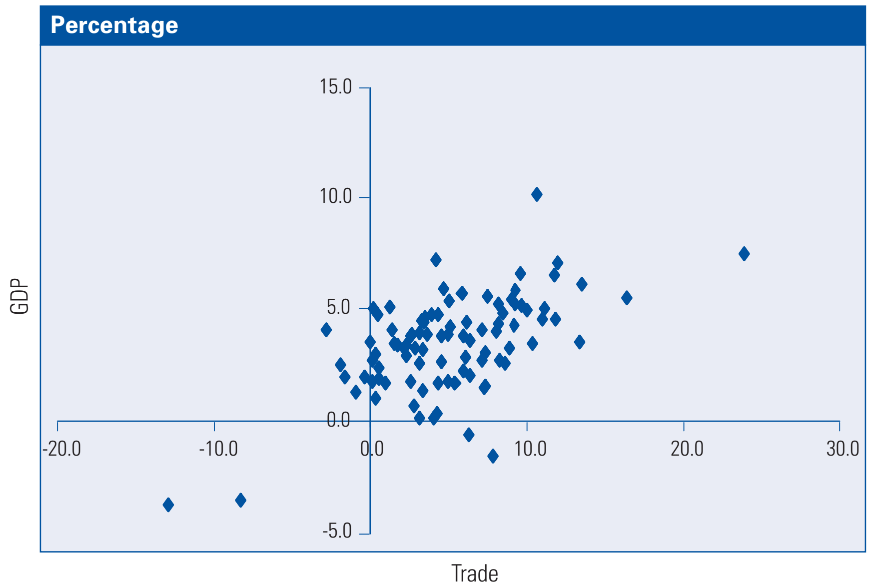
10 For a cogent exposition of these relationships, see Jagdish Bhagwati and T.N. Srinivasan, "Trade and poverty in the poor countries", *American Economic Review: Papers and Proceedings*, vol. 92 (2002), pp. 180-183.

11 Andrew Berg and Anne Krueger, "Lifting all boats: why openness helps curb poverty", *Finance and Development*, vol. 39, No. 3 (September 2002).

12 T. N. Srinivasan and Jagdish Bhagwati, "Outward-orientation and development: are revisions right?", Economic Growth Center, Yale University, New Haven, Connecticut, 1999.

13 Neil McCulloch, L. Alan Winters and Xavier Ciera, *Trade Liberalization and Poverty: A Handbook* (London, United Kingdom Department for International Development and Centre for Economic Policy Research, 2001).

Figure VI.1.
RELATIONSHIP BETWEEN THE AVERAGE ANNUAL RATES OF GROWTH OF GDP AND TRADE, 1990-2000



Source: World Bank, *World Development Indicators, 2002* (Washington, D.C., World Bank, 2002).

firmed for a diverse set of countries, including a number of sub-Saharan African economies.[14] Looked at from the reverse perspective, findings suggest that trade barriers for agricultural and industrial goods impose major costs, both in developed and in developing economies.[15] High protection and large consumer costs are usually concentrated in a handful of industries in each country. Some sectors appear with regularity on inventories of highly protected activities. Agriculture, apparel and textiles are on practically every developed country's list, while automobiles and parts feature prominently on the protection schedules of developing countries. Transport, communications and finance are severely protected by many developed and developing countries.

A positive empirical association between openness and economic growth has been established, with evidence accumulating that outward-oriented countries grow faster. Some of these investigations have focused exclusively on developing countries.[16] Others have cast their net wider. A survey of 57 developed and developing countries over the period 1970-1989 concluded that openness supports growth.[17] Some analyses take the next logical step, looking at openness in more dynamic terms—that is to say, as synonymous with opening up or liberalization. One examination of the effects of liberalization focused on over 100 developed and developing economies from the post-Second World War period to the mid-1990s.[18] A strong relationship between liberalization and growth was evident. Within the group of developing countries, the more open economies grew at a rate of 4.5 per cent per year, whereas the relatively closed economies grew at a rate of 0.7 per cent per year. Within the group of developed countries, the results were a growth rate of 2.3 per cent per year for the "open" economies and a rate of 0.7 per cent per year for the "closed" ones. These findings also extend to the economies of Central and Eastern Europe that have been undertaking market reforms, including trade liberalization, since 1990: the strong trade reformers achieved positive economic growth by 1994.

14 Kazi Matin, *Openness and Economic Performance in Sub-Saharan Africa: Evidence from Time-Series Cross-Country Analysis*, World Bank Working Paper, No. 1025; and Ann Harrison, *Openness and Growth: A Time Series, Cross-Country Analysis for Developing Countries*, NBER Working Paper No. 5221 (Cambridge, Massachusetts, National Bureau of Economic Research, 1995).

15 Gary Clyde Hufbauer, "Surveying the costs of protection: a partial equilibrium approach" in *The World Trading System: Challenges Ahead*, Jeffrey J. Schott, ed. (Washington, D.C., Institute for International Economics, 1996).

16 See, for example, Michael Michaely, "Exports and growth: an empirical investigation", *Journal of Development Economics*, vol. 4, No. 1, 1977, pp. 49-53.

17 Romain Wacziarg, "Measuring the dynamic gains from trade", Graduate School of Business, Stanford University, Palo Alto, California, 1998; and *The World Bank Economic Review*, vol. 15, No. 3 (2001), pp. 393-429.

18 Jeffrey D. Sachs and Andrew Warner, "Economic reform and the process of global integration", *Brookings Papers on Economic Activity*, No. 1 (Washington, D.C., Brookings Institution, 1995). The authors classify the developing economies into one of three sets: those that have always been open; those that had opened by 1994 after initial closure; and those that were closed as of the end of 1994.

These studies rarely differentiate between degrees of openness. Further results for a cross section of over 100 developed and developing countries over the last three decades, using two groups of trade openness measures, demonstrated that "trade liberalization does not have a simple and straightforward relationship with growth…".[19] Nevertheless, trade volume measures are found to be significantly and positively correlated with growth, while a second set of proxies for openness support the view that trade promotes growth through a variety of channels, such as technology transfers, scale economies and comparative advantage. An analysis of 93 developed and developing countries during 1980-1990, using nine different estimates of "openness", yielded similar results. Regardless of how openness is defined, "more open countries have indeed experienced faster … growth".[20] Moreover, while openness alone seems to be no guarantee of faster growth, the conclusions of most researchers involved in these studies is that lower trade barriers, in combination with a stable and non-discriminatory exchange-rate system, and prudent monetary and fiscal policies, as well as other elements of good governance, promote economic growth.[21]

Caveats concerning the trade-poverty link

A link exists between trade reform and the efficiency gains necessary for growth. Reduced average tariff levels, as well as lower quantitative restrictions on imports, are associated with increased output growth—even for given levels of investment and capacity use. However, the extent to which trade reform benefits a country reflects the initial conditions prevailing in that country. Countries with well-functioning markets and a better human capital base benefit more from trade reforms. For example, Ghana, Indonesia and Turkey had begun their respective trade reform programmes in the 1980s under different conditions. While all three carried out extensive reforms, Indonesia and Turkey benefited more because, at that time, they had more diversified production structures and better-functioning markets than had Ghana.[22] Initial conditions are thus extremely important.

Moreover, a concomitant of "initial conditions" is the considerable variation that can exist between countries depending on what is and can be exported. The impact of manufacturing exports on economic growth is likely to be greater than the impact of primary commodity exports because the former typically generate greater externalities and learning effects. Such external effects in commodity-exporting economies tend to be small. Furthermore, the export growth-economic growth relationship has often been fragile for mineral-exporting economies. Several explanations have been proffered for this, including the "Dutch disease" phenomenon, where surges in mineral export revenues lead to an appreciation of the real exchange rate and consequently to reduced competitiveness in other tradables.[23]

Another qualification is that the correlations between trade openness and a variety of other variables are frequently high. For example, the quality of a country's institutions, sustained long-run growth and high levels of trade often go together. There are findings that suggest "an important joint role for both trade and institutions in the very long run…".[24] Thus, liberalization is but one element in an array of variables important for growth, and its relative importance may vary depending on the time-horizon.

19 Halit Yanikkaya, "Trade openness and economic growth: a cross-country empirical investigation", *Journal of Development Economics*, vol. X (2003).

20 Sebastian Edwards, *Openness, Productivity and Growth: What Do We Really Know?,* National Bureau of Economic Research Working Paper, No. 5978 (Cambridge, Massachusetts, NBER, 1997); and *The Economist*, 21 March 1998.

21 Robert E. Baldwin, *Openness and Growth: What's the Empirical Relationship?*, National Bureau of Economic Research Working Paper, No. 9578, (Cambridge, Massachusetts, NBER, 2003).

22 Ejaz Ghani and Carl Jayarajah, *Trade Reform, Efficiency and Growth*, World Bank Policy Working Paper, No. 1438 (Washington, D.C., World Bank, 1995).

23 United Nations Conference on Trade and Development, *The Least Developed Countries Report, 2002: Escaping the Poverty Trap* (United Nations publication, Sales No. E.02.II.D.13), box 11.

24 David Dollar and Aart Kray, "Institutions, trade and growth", *Journal of Monetary Economics*, vol. 50X, No. 1 (2003), pp. 133-162.

Finally, trade policies are but a single element in the policy makers' arsenal of macroeconomic policy tools. More significantly, there are objectives that trade policy cannot—and should not be expected—to achieve. For example, an examination of the relationship between trade policies and macroeconomic adjustment in Argentina, Brazil, Chile, Colombia, Costa Rica and Mexico over the period 1965-95 confirmed the inability of trade policies to solve those countries' current-account difficulties. Other means had to be found to deal with this problem.[25]

ASSESSING THE EVIDENCE

One of the major problems in determining the trade growth-poverty reduction relationship is the fragility of the various statistical techniques that can be applied to an examination of this issue.[26] Although trade liberalization is generally viewed as a positive contributor to poverty alleviation, the evidence as regards the trade-poverty linkage is usually both fragmentary and often incomplete. Liberalization allows productive potential to be exploited, assists with economic growth and curtails arbitrary policy interventions. However, most reforms will create some losers—even in the longer run—and some reforms may temporarily exacerbate poverty.[27]

Moreover, while poverty reduction typically comes hand in hand with economic growth (see chap. IV), there is considerable variation in the impact of a given rate of growth on poverty.[28] One explanation is that differences in the impact of growth on poverty are a function of the initial level of inequality. Higher inequality results in the poor's receiving a lower share of the gains from growth.

Numerous investigations have found that the poor gain as trade expands. For a set of "post-1980 globalizers", which includes China and India, no systematic relationship was found between large increases in trade volumes and small changes in household income inequality. The conclusion was that the increase in growth rates that had accompanied expanded trade on average translated into more or less proportionate increases in the incomes of the poor.[29]

Comparable results have also been established for individual countries. For example, simulations for Cameroon, the Gambia, Madagascar and the Niger suggested that trade (and exchange-rate) liberalization tended to benefit poor households in both rural and urban areas, as rents on foreign exchange were eliminated, demand for labour increased and returns to the production of agricultural tradables rose.[30]

A further example is provided by a study of India in the 1990s. This suggested that economic growth in India had typically reduced poverty prior to the 1990s and that the 1980s rate of poverty reduction was most likely maintained through the last decade. At the same time, however, achieving higher aggregate economic growth was only one element of an effective poverty reduction strategy for India. Had the sectoral and geographical composition of growth been more balanced, and had existing inequalities in human resource development and between urban and rural areas been better redressed, the rate of poverty reduction would have been considerably higher.[31]

Overall, therefore, while trade liberalization alone cannot be linked incontrovertibly to poverty reduction, the general tendency of the evidence, comprising both cross-sectional and case studies, is strongly in the direction of such a linkage.[32]

25 Sarath Rajapatirana, *Trade Policies, Macroeconomic Adjustment, and Manufactured Exports: The Latin American Experience*, World Bank Policy Research Working Paper, No. 1492 (Washington, D.C., World Bank, 1995).

26 Methods in current use fall into four broad categories, namely, cross-country regression analysis, partial equilibrium/cost-of-living analysis, general equilibrium simulation, and micro-macro synthesis. These four groups encompass both the "bottom-up" and the "top-down" approaches that are employed by poverty and trade specialists, respectively. The first approach is based on detailed survey information and emphasizes the heterogeneity of individual households and commodity market links between trade and poverty. The second methodology begins with microeconomic theory's "representative household" assumption and usually incorporates additional links between trade and poverty, such as factor earnings and terms-of-trade effects. One general conclusion of those working in this field is that any thorough analysis needs to incorporate both approaches. See Jeffrey J. Reimer, "Estimating poverty impacts of trade liberalization", Center for Global Trade Analysis and Department of Agricultural Economics, Purdue University, West Lafayette, Indiana, 2002.

27 L. Alan Winters, "Trade and poverty: is there a connection?", background paper (2000) for World Bank, *World Development Report 2000/2001: Attacking Poverty* (New York, Oxford University Press, 2001).

28 With 95 per cent confidence, a 1 per cent rate of growth of consumption per person can yield anywhere from a 0.5 to a 3.5 per cent decline in the share of population living on less than one dollar per day. See Martin Ravillion, "Have we already met the millennium development goal for poverty?", *Economic and Political Weekly*, 16 November 2002.

29 David Dollar and Aart Kraay, "Trade, growth and poverty", Development Research Group, World Bank, 2001. See also Dani Rodrik, "Comments on trade, growth and poverty" (2000) for a critique of this paper.

30 Paul A. Dorosh and David E. Sahn, "A general equilibrium analysis of the effect of macroeconomic adjustment on poverty in Africa", *Journal of Policy Modelling*, vol. 22, No. 6 (2000), pp. 753-776.

31 Gaurav Datt and Martin Ravallion, "Is India's economic growth leaving the poor behind?", *Journal of Economic Perspectives*, Vol. 16, No. 3 (2002), pp. 89-108.

32 L. Allan Winters, "Trade liberalisation and poverty: what are the links?", *The World Economy*, vol. 25, No. 9 (2002), pp. 1339-1367.

ADJUSTMENT

Trade liberalization may involve adjustment problems and costs. Examples include the loss of jobs that existed only by virtue of a subsidy or distortion, lower wages in contracting activities or higher prices for certain imports when their importation is no longer subsidized. For example, estimates of the effects of the Uruguay Round of multilateral trade negotiations found large potential gains in East Asian World Trade Organization members—such as Indonesia, Malaysia, the Republic of Korea and Thailand—as well as in the South Asia region. However, the Middle East and North Africa had relatively small gains, while a loss was projected for sub-Saharan Africa, reflecting the lack of liberalization in the area, and likely increases in prices for some foodstuffs, as well as higher prices of imported textile and apparel products.[33] Similarly, all the evidence shows that abolishing the Multifibre Arrangement would generate enormous benefits for importers, but that two groups of exporters would suffer, namely, those whose quotas are large relative to their comparative advantage and those that may have been induced by the Arrangement to enter the production of textiles and clothing without possessing a true comparative advantage in those goods.[34]

In each liberalizing country, there are always winners and losers if trade policy shifts to a significant extent, because of the need for the changes to work themselves through. Two problems can emerge during the adjustment process. The first occurs when adjustment is constrained and prolongs the dependence on products with poor export prospects for them.[35] Similarly, trade adjustment assistance—designed to overcome political opposition to trade liberalization—reduces policy makers' incentives to press for such liberalization and may thus slow down the pace of needed reform.[36] This problem arises when there is a lack of social safety nets to ease and mitigate the adjustment process. This is especially critical because those who are harmed the most in the short term typically lack political power.[37]

It has been suggested that international trade policies have a "gender-differentiated" impact: strong export performance in manufactures in developing countries is secured via reliance on female labour in such areas as textiles, apparel, electronics, leather products and food processing. By contrast, in most industrialized economies, increased trade with developing countries has led to a loss of employment in such industries as textiles, apparel and leather goods, in which women are heavily represented.[38]

Adjustment costs in a diversified economy are small relative to the benefits for several reasons. Adjustment costs related to unemployment are typically short-term and terminate when workers find new employment. The benefits of trade reform, meanwhile, grow with the economy. Second, in most industries, estimates indicate that the duration of unemployment of their workers is not long, especially, in cases where workers were not earning substantial wages in their original jobs. Third, in many industries, normal labour turnover exceeds the dislocation from trade liberalization, so that downsizing—where necessary—is accomplished without much forced unemployment. Moreover, in many instances in which a dynamic role is played by micro- and small-scale enterprises, which are quick to respond to new opportunities, a significant portion of the resource reallocation after trade liberalization has been observed to occur through inter-industry shifts, thereby minimizing the dislocation of labour.

33 G.W. Harrison, T.F. Rutherford and D.G. Tarr, "Quantifying the Uruguay Round", *Economic Journal*, vol. 107, No. 444 (1997), pp. 1405-1430.

34 Will Martin and L. Alan Winters, *The Uruguay Round: Widening and Deepening the World Trading System* (Washington, D.C., World Bank, 1995).

35 Mark S. Leclair, "Fighting the tide: alternative trade organizations in the era of global free trade", *World Development*, vol. 30, No. 6 (2002), pp. 949-958.

36 Christopher Magee, "Endogenous tariffs and trade adjustment assistance", *Journal of International Economics*, vol. 60 (2003), pp. 203-222.

37 Bernard Hoekman and others, "Trade policy reform and poverty alleviation", Development Research Group, International Trade Team, World Bank, Washington, D.C., 2002.

38 Nilüfer Cagatay, "Gender, poverty and trade", background paper (2001) for the UNDP Report on Trade and Sustainable Human Development, 2001, UNDP, New York.

Finally, developing countries typically have a comparative advantage in labour-intensive industries, hence trade liberalization, resulting in greater trade, tends to favour labour. This may partially explain why manufacturing employment has typically increased in developing countries after trade liberalization.[39]

Because the adjustment process may entail difficulties, which can be relatively more pronounced at lower income levels, many developing countries, including (but not only) the least developed countries, have been provided with longer transition periods in which to implement a variety of World Trade Organization liberalization agreements. These fall into such categories as safeguards, subsidies and countervailing measures, anti-dumping, sanitary and phytosanitary measures and trade related intellectual property rights (TRIPs). However, developing countries, especially those confronted by fiscal constraints, often have limited resources to direct towards the areas of public administration responsible for overseeing the implementation of these agreements, which can be both time-consuming and costly. A number of these transition periods expired before the developing countries in question could overcome their difficulties in establishing the institutions necessary for the implementation of the agreements.[40] Institutional weaknesses of this sort thus add greatly to the costs of adjustment, despite the fact that longer transition periods are set up precisely to reduce such adjustment costs. Therefore, special and differential treatment for developing countries should encompass more than just longer periods of implementation.

Finally, adjustment costs depend on individual circumstances and the external environment. The estimated adjustment costs in Mexico for the period 1987-1995 were found to be small—a result consistent with an earlier finding.[41] That adjustment costs vary between countries has been documented in analyses of developed economies, though few studies exist for developing countries.

THE CHANNELS FOR ASSURING THE WELFARE OF THE POOR

Prices and availability of goods and services

David Ricardo, in the early 1800s, demonstrated several important "gains from trade". Foremost among these was the ability of consumers to buy goods and services at prices lower than original home prices. However, a secondary advantage of a country's being open to trade is consumer access to goods and services that would otherwise not even be available for purchase and certainly not at prices that would prevail were these products to be produced domestically.

The removal of import tariffs, as well as any non-tariff barriers to trade, affects the prices and availability of goods and services. The prices of imports are thereby lowered. Additionally, the prices of substitutes for such imports are also kept down, effectively increasing the real incomes of the poor. Imported goods that might be of particular importance to the poor include basic foods, pharmaceuticals and other basic health products.[42] However, high import tariffs on agricultural products are a continuing reality in both developed and developing economies.[43] To counter the problem of high import tariffs on pharmaceuticals and other basic health products, at the African Summit on Roll Back Malaria held in Abuja in April 2000, Governments pledged to reduce or waive taxes and tariffs for the mosquito nets, insecticides and anti-malarial drugs necessary for malaria control.

39 Steven J. Matusz and David Tarr, "Adjusting to trade policy reform", Trade, Development Research Group, World Bank, Washington, D.C., 1999.

40 Constantine Michalopoulos, "Trade and development in the GATT and WTO: the role of special and differential treatment for developing countries", paper presented to the World Trade Organization Seminar on Special and Differential Treatment for Developing Countries, Geneva, March 2000.

41 Raymond Robertson and Donald Dutkowsky, "Labor adjustment costs in a destination country: the case of Mexico", *Journal of Development Economics*, vol. 67 (2002), pp. 29-54. See also Dani Rodrik, *Has Globalization Gone Too Far?* (Washington, D.C., Institute for International Economics, 1997).

42 For more on this point, see Geoffrey J. Bannister and Kamau Thugge, *International Trade and Poverty Alleviation*, IMF Working Paper WP/01/54 (Washington, D.C., 2001).

43 World Trade Organization, "Market access: post-Uruguay Round inventory and issues", *Special Studies*, No. 6 (Geneva, 2001), p. 48 and table III.3.

Another strategy that results in changed prices and availability of goods and services—and one that has burgeoned in recent years—consists in joining a regional trading arrangement. Such schemes are frequently trade-creating and can therefore be favourable from a welfare-enhancing perspective. In addition, there may be dynamic gains to be realized. For example, production will be possible on a larger scale and greater exposure to other markets may mean greater efficiency, which in turn, may lead to greater output at lower prices.

Joining a trading arrangement is a policy choice and, from that perspective, it is important to gauge whether it is the best choice that could be made. There are indications that the new wave of regionalism that had occurred during the 1990s—during which decade a number of preferential trading arrangements were either created (the Southern Common Market (MERCOSUR) and the North American Free Trade Agreement (NAFTA)) or revamped (the Association of the Southeast Asian Nations (ASEAN), the Central American Common Market (CACM) and the Andean Community (ANDEAN))—did little to boost intra-bloc trade significantly, above and beyond what historical trade trends would have predicted.[44] Moreover, evidence for a data set for about 40 developed and developing economies for the period 1950-1992 compares the growth performance of countries that liberalized broadly with those that joined a regional trading arrangement. Economies grew faster when they undertook broad-based liberalization than when they limited their liberalization efforts to participation in a regional trading arrangement.[45] Nevertheless, numerous countries have joined, or have expressed an interest in joining, a variety of regional trading arrangements. In Eastern Europe, a number of countries are waiting to join an enlarged European Union (EU).

Regional arrangements may have negative welfare implications for nearby countries that are excluded. For example, Argentina's beef and cattle exports to Peru fell when Peru established a pact whose members included Colombia, an exporter of the same products.[46] Another example was the reduction of prices on exports from Brazil—a non-member State of MERCOSUR—to member States of MERCOSUR, following the formation of this regional trading bloc. Because of high tariffs levied on exports from outside the trading bloc, Brazil's exporters had to reduce the prices of their products significantly, compared with prices of exports to countries outside the trading bloc, in order to maintain price competitiveness in markets of the member States.[47]

Sub-Saharan African countries have pursued regional integration schemes for over three decades in order to accelerate industrialization and growth. However, the problems associated with African regional trade arrangements as a means to this end are daunting, since Africa's exports are highly concentrated in a few products, so that the economies in question appear to have very little to trade with one another.[48]

Several Asian economies have used accession to a regional arrangement as part of their respective reform strategies in pursuit of the export and income growth necessary for poverty reduction. For Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam, forging regional linkages has been an important part of their export growth dynamic. Meeting the requirements of accession to the ASEAN Free Trade Area[49] has helped these countries to modernize their trade regulations and, at the same time, has required wide-ranging preferential trade liberalization.[50]

44 Isidro Soloaga and L. Alan Winters, *Regionalism in the Nineties: What Effect on Trade?*, World Bank Working Paper, No. 2156 (Washington, D.C., 1999).

45 Athanasios Vamvakidis, *Regional Trade Agreements Versus Broad Liberalization: Which Path Leads to Faster Growth? Time Series Evidence*, International Monetary Fund Working Paper, No. WP/98/40 (Washington, D.C., IMF, 1998).

46 The Andean Pact was created in 1969 between Bolivia, Chile, Colombia, Ecuador and Peru. Venezuela joined in 1973 and Chile withdrew in 1976. See Ana Gupta and Maurice Schiff, *Outsiders and Regional Trade Agreements among Small Countries*, World Bank Policy Research Working Paper, No. 1847 (Washington, D.C., World Bank, 1997).

47 Won Chang and L. Alan Winters, "Preferential trading arrangements and excluded countries: ex-post estimates of the effects on prices", *The World Economy*, vol. 24, No. 6 (2001), pp. 797-807.

48 Alexander Yeats, *What Can Be Expected From African Regional Trade Arrangements?: Some Empirical Evidence*, World Bank Policy Research Working Paper, No. 2004 (Washington, D.C., World Bank, 1998).

49 ASEAN members are Indonesia, Malaysia, the Philippines, Singapore, Thailand and Viet Nam.

50 *The Least Developed Countries Report, 2002…*, box 11; and Will Martin , *Trade Policy Reform in the East Asian Transition Economies,* World Bank Policy Research Working Paper, No. 2535 (Washington, D.C., World Bank, 2001).

There is a dilemma that arises, however, centering around the fact that costly trade diversion has been introduced alongside healthy trade creation.[51] Such a problem is particularly serious if the external trade barriers in the bloc are high. However, even in ASEAN—where external trade barriers are relatively low—welfare gains from trade creation have been substantially undermined for the new members of the group by their losses from trade diversion.[52]

While regional trade agreements (RTAs) have garnered a great deal of attention in recent years, there are other stratagems that affect liberalization and the level of trade and hence can affect growth and reduce poverty. One such stratagem entails the creation of an export processing zone (EPZ). Malaysia, the Republic of Korea and Thailand initiated their EPZs as part of a shift in policy from an inward to an outward orientation. China initiated its open-door policy and economic reforms by introducing special economic zones. In addition to fostering job creation, such zones have an indirect impact on poverty by promoting linkages with the domestic economy and encouraging technology transfers. The spillovers can affect the entire economy. The export-generating effect of the Malaysian EPZs has been significant, and foreign affiliates attracted to these EPZs stimulated local firms to begin to export by assisting them in producing, marketing and distributing manufactures internationally.[53] Zones in China, Indonesia, Malaysia, the Philippines, the Republic of Korea and Sri Lanka have been an important source of employment and have encouraged local entrepreneurship in some cases.[54]

Labour markets

Trade liberalization impinges on the labour market in a variety of ways. First and foremost, such reforms can lead to changes in the demand for labour, that is to say, to employment creation or contraction. Reforms may also have an effect on wages, including changing the relative wages of skilled versus unskilled labour. Trade liberalization can change conditions of work in the labour market. For example, when transnational corporations are allowed into a country, they may have more or less stringent health and safety standards than do local companies.

Trade liberalization is consistent with continued growth of employment. Following such liberalization in a sample of 19 countries, 12 of them developing, all but 1 experienced higher manufacturing employment during, as well as a year after, the liberalization. Moreover, the strongest liberalizers—Brazil and Chile—experienced the strongest employment gain.[55] Similar results have been observed in five African economies—Ghana, Malawi, Mali, Senegal and the United Republic of Tanzania,[56], as well as in Costa Rica, Peru and Uruguay. In Malawi, the welfare advantages were due to the increase in the number of traders and vendors throughout the country.[57]

Trade liberalization also exerts an influence on employment via wages. Under certain restrictive conditions, the opening of trade can be expected to increase the relative price of labour in the labour-abundant country as it decreases the relative price of labour in the capital-abundant country.[58] Empirical evidence from East Asia—especially from Hong Kong Special Administrative Region (SAR) of China, the Republic of Korea, Singapore and Taiwan Province of China—has lent credence to the view that greater openness

51 Trade creation results when domestic production is replaced by imports from a lower-cost and more efficient producer within the trading arrangement. Trade diversion results when higher-cost suppliers from within replace imports from lower-cost, more efficient producers outside a trading arrangement.

52 Emiko Fukase and Will Martin "Economic effects of joining ASEAN Free Trade Area (AFTA): the case of the Lao People's Democratic Republic", World Bank, Development Research Group (Washington, D.C., 1999); and Emiko Fukase and Will Martin, *Free Trade Membership as a Stepping Stone to Development: The Case of ASEAN* (Washington, D.C., World Bank, 2001).

53 Helena Johansson and Lars Nilsson, "Export processing zones as catalysts", *World Development*, vol. 25, No. 12 (1997), pp. 2115-2128. The 10 economies in the study were: the Dominican Republic, Egypt, Hong Kong SAR of China, Malaysia, Mauritius, the Philippines, the Republic of Korea, Singapore, Sri Lanka and Tunisia.

54 Kankesu Jayanthakumaran, "Benefit-cost appraisals of export processing zones: a survey of the literature", *Development Policy Review* (Overseas Development Institute, London), vol. 21, No. 1 (2003), pp. 51-65.

55 See Demetrios Papageorgiou, Armeane Choksi and Michael Michaely, *Liberalizing Foreign Trade in Developing Countries: The Lessons of Experience* (Washington, D.C., World Bank, 1990). The period examined was from the Second World War to 1984.

56 See Ronald Parker, Randall Riopelle, and Wiliam Steel, "Small enterprises adjusting to liberalization in five African countries", World Bank Discussion Paper, No. 271, Washington, D.C., 1995.

57 Sanjukta Mukherjee and Todd Benson, "The determinants of poverty in Malawi, 1998", *World Development*, vol. 31, No. 2 (2003), pp. 339-358.

58 The Stolper-Samuelson Theorem, so named after the two economists who proved it algebraically.

in countries with large reserves of unskilled labour has benefited this type of labour. However, in a number of Latin American economies—including Argentina, Chile, Colombia, Costa Rica, Mexico and Uruguay—increased openness has done little to elevate the wages of unskilled labour. Mexico actually experienced a substantial rise in the premium paid to skilled labour—and therefore an increase in overall wage inequality—following the trade reform of the mid-1980s. This reflected improved productivity in reformed industries and a shift towards the use of more skilled labour.[59] The consequence of trade liberalization of Mexico in the mid-1980s, prior to its joining the General Agreement on Tariffs and Trade (GATT), differed from the consequences of Mexico's entry into NAFTA in 1994. In the former episode, the wages of skilled Mexican workers had risen, while in the latter case, the wages of unskilled labour increased. This was because Mexico is a skill-abundant country vis-à-vis the rest of the world (comprising the relevant partner countries when Mexico joined GATT), but a labour-abundant country vis-à-vis its NAFTA partners.[60]

Brazil's trade liberalization between 1988 and 1994 contributed to the growing skill premium through technological change, instigated by increased foreign competition. Moreover, industry-specific returns to skill increased by a larger amount in industries that had undergone larger tariff reductions. Overall, however, the effects of trade liberalization on wage inequality were relatively modest.[61]

Wages in the Chilean cosmetics industry since it began to be liberalized in 1974 have also shown higher returns to skilled labour. One explanation hinges on the fact that the region as a whole had reduced trade barriers in the 1990s, leading to far greater competition and a surge in imports. Seeking to be more competitive, multinationals often closed local factories, forcing the dismissal of the mostly low-skill workforce, employed in simple, labour-intensive tasks. Many multinationals also outsourced non-core personnel, such as maintenance staff, who were then rehired through subcontractors at a lower salary. Meanwhile, the workers that had kept their jobs in multinational firms were employed in management, marketing and sales—all well-paid positions for educated workers. The net result was a large upward shift in the relative demand for skilled compared with unskilled workers in multinationals. Domestic firms, meanwhile, made every effort to keep costs down, resulting in employment gains for low-skill workers in these companies which were not, however, matched by wage gains, in large part because of union weakness.[62]

Increased openness also impacts on labour conditions. Among the outcomes ascribed to trade openness is the expansion of the categories of part-time, temporary and subcontracted labour, whose members do not receive the benefits enjoyed by those employed full-time and regularly. Also observed is an increase in the female labour force and an expansion of middle-salaried workers, especially in the service sectors. Several of these trends were observed in Brazil in the late 1990s. One startling statistic derived from data published in 2000 indicates that the economically active population in Brazil totalled 71 million workers, only one third of whom were found in the formal job market. The remaining two thirds worked in the informal sector, with few of the benefits that formal employment confers.[63] In Indonesia, wages are low by world standards and a sizeable portion of the workforce consists of young females,

59 Ana Revenga, *Employment and Wage Effects of Trade Liberalization: The Case of Mexican Manufacturing*, World Bank Policy Research Working Paper, No. 1524 (Washington, D.C., World Bank, 1995).

60 Raymond Robertson, "Relative prices and wage inequality: evidence from Mexico", Macalester College, Department of Economics, St. Paul, Minnesota.

61 Nina Pavcnik and others, *Trade Liberalization and Labor Market Adjustment in Brazil*, World Bank Working Paper, No. 2982 (Washington, D.C., World Bank, 2003).

62 Janine Berg, "Technology versus trade versus social institutions: rising wage inequality in the Chilean cosmetics industry", Center for Economic Policy Analysis, The New School (2002), New York.

63 Ricardo Antunes,"Global economic restructuring and the world of labor in Brazil: the challenges to trade unions and social movements", *Geoforum*, vol. 32 (2001), pp. 449-458.

who are frequently less activist than their male counterparts. However, while there may be a correlation between openness and sub-standard working conditions in Indonesia, this does not imply causality. In fact, working conditions in foreign-owned plants are frequently considerably better than in locally owned enterprises. Standard procedures in the former—for shift times, and medical leave, as well as health and safety precautions—often conform to global rather than local standards.[64]

While increased openness is conducive to increasing employment (both male and female), it is not clear how it benefits women differently from men. In some cases, for example, greater female secondary schooling has been found to have had a negative impact on levels of female employment. This may be because enterprises introduce technologies that require a small number of highly specialized employees and a large workforce with little training.[65]

Empirical estimates for the Philippines using data for the period from 1980 to 2000 indicate that, at both the aggregate and manufacturing sub-industry levels, increases in the propensity to export shift the demand for labour upward. In terms of the employment structure, the impact of openness on women workers, in particular, was not significant in the aggregate. However, at the manufacturing industry sub-level, the increase in the propensity to export has been a boom, especially for women workers. Finally, increases in export propensity increased the proportion of low-skilled production workers, at both the aggregate and manufacturing sub-industries levels.[66]

The effects of trade on women vary by socio-economic characteristics, sector and country. In Bangladesh, for instance, women's participation in market activities had traditionally been low and confined to a narrow range of casual jobs on the margins of the labour market.[67] With the establishment of a large number of garment factories in the 1980s (ready-made garments provide some 60 per cent of total foreign earnings), there were significant increases in female labour-force participation rates.

Investment and innovation: capital inflows and direct foreign investment

Increased openness might impact positively on growth through its effect on the rate of investment.[68] An increase in foreign investment impacts on growth and poverty reduction via improved efficiency and the adoption of new technologies. For example, in India, where liberalization began in July 1991, following a long-standing policy of fostering self-reliance, "liberalization has driven competition and competition has driven technical change".[69] Firms have therefore responded to post-1991 liberalization by improving their efficiency, by importing technology and by increasing in-house research and development. An analysis using data from Hong Kong SAR of China-based garment manufacturers, which had invested in mainland China in the 1990s, showed that such firms were endowed with valuable managerial technology and had acted as effective channels for the transfer of such technology to mainland China.[70]

After the Second World War, Mexico, like India, pursued an import substitution policy in order to reduce its dependence on both exports of raw material and imports of manufactured goods. The nascent manufacturing sector was protected from competition by heavy tariffs and quantitative restrictions on

64 Debora Spar, "Trade, investment and labor: the case of Indonesia", *The Columbia Journal of World Business* (Winter 1996)

65 Karin A. Siegmann, "Effects of foreign direct investment in manufacturing: gender-specific employment in Indonesia", Centre for Development Research (ZEF), University of Bonn, Germany, 2002.

66 Aniceto C. Orbeta, "Globalization and employment: the impact of trade on employment level and structure in the Philippines", Philippine Institute for Development Studies, Discussion Paper Series, No. 2002-04, Manila.

67 Marzia Fontana, " Modelling the effects of trade on women, at work and at home: a comparative perspective", International Food Policy Research Institute, Washington, D.C., 2002.

68 Romain Wacziarg, "Measuring the dynamic gains from trade", background paper for World Bank, *Global Economic Prospects and the Developing Countries, 1997* (Washington, D.C., 1997).

69 Naushad Forbes, "Technology and Indian industry: what is liberalization changing?", *Technovation*, vol. 19 (1999), pp. 403-412. See also: T.N. Srinivasan, "Economic liberalization and economic development: India", *Journal of Asian Economies*, vol. 7, No. 2 (1996), pp. 203-216.

70 Edmund R. Thompson, "Technology transfer to China by Hong Kong's cross-border garment firms", *The Developing Economies*, vol. 41, No. 1 (2003), pp. 88-111.

imports. Managers viewed this environment as "a means of avoiding technological change and pressures for greater competitiveness".[71] Much of this has changed since 1985, when reforms were initiated in anticipation of Mexico's 1986 admission to GATT. Most firms polled have reported significant revisions in their competitive strategies. Moreover, in addition to focusing on competitiveness, many firms saw the need to retool technologically—for example, by modernizing plant and equipment.[72] An examination of the development of technological capabilities by Vitro, a Mexican firm in the glass industry, confirms this finding. Under an import substitution regime, innovation efforts had been slow. As the Mexican market opened up, however, major innovative efforts were instigated. Not only were these efforts more specialized, but there was also an attempt to master production engineering faster and to adapt when this was required to increase Vitro's exports.[73]

Trade liberalization also has a role to play in increasing productivity. Studies on manufacturing productivity and costs in Japan found that the rapid increases in volume, due to freer trade, led to dramatic improvements in output per hour, especially in large plants, as well as reductions in average cost per unit.[74] Evidence from India, based on the sizeable 1991 trade liberalization, supports this link. Firm-level data from a variety of industries over the period 1986-1993 show large increases in the growth rate of productivity in three of the four industries investigated: electronics, non-electrical machinery and electrical machinery (transport equipment was the fourth). One explanation for these increases invokes a traditional efficiency argument.[75] Additional substantiation comes from an investigation of 30 Indian industries over the period 1973-1988 which found that trade liberalization had raised total factor productivity growth.[76]

The potential for greater openness to increase investment flows to a country is of particular importance because of the likelihood that foreign investment will bring with it new technologies and greater innovation. The causality runs both ways. Increased investment can bring in new technology, enhance productivity and increase innovation, as in the case of the Mexican firm Vitro. At the same time, these domestic developments can induce greater foreign investment. Hence, the process becomes a "virtuous circle", spurring poverty reduction via growth. However, for investment to be encouraged, the trade liberalization and reforms being undertaken have to be credible. Investor confidence in the viability of liberalization and reform is thus decisive for the success of these measures.[77]

Government revenue

Although trade liberalization generates greater efficiency and potentially higher levels of output and welfare, some real trade-offs, involving, for example, the impact on government revenues, have to be considered.[78] For countries with fiscal imbalances, any loss of revenue is an important consideration, especially since this may translate into reduced spending on the poor.

Frequently, a first step in trade liberalization is to replace quantitative restrictions with tariffs. The process then continues with the gradual reduction of tariffs. However, such tariff reductions can lower government revenue. The impact can be considerable. In 1997, trade taxes accounted for 24 per cent of central government revenue in developing countries overall and for 33 per cent

71 Len J. Trevino, "Strategic responses of Mexican managers to economic reform", *Business Horizons*, May-June 1998.

72 Ibid.

73 Cristina Casanueva, "The acquisition of firm technological capabilities in Mexico's open economy: the case of Vitro", *Technological Forecasting and Social Change*, vol. 66 (2001), pp. 75-85.

74 Donald J. Daly, "Canadian research on the production effects of free trade: a summary and implications for Mexico", *North American Journal of Economics and Finance*, vol. 9 (1998), pp. 147-167.

75 Pravin Krishna and Devashish Mitra, "Trade liberalization, market discipline and productivity growth: new evidence from India", *Journal of Development Economics*, vol. 56 (1998), pp. 447-462. The contention of X-efficiency is that firms seek to produce the maximum output technically possible from any given inputs.

76 Satish Chand and Kunal Sen, "Trade liberalization and productivity growth: evidence from Indian manufacturing", *Review of Development Economics*, vol. 6, No. 1 (2002), pp. 120-132.

77 Halvor Mehlum, "Zimbabwe: investments, credibility, and the dynamics following trade liberalization", *Economic Modelling*, vol. 19 (2002), pp. 565-584.

78 Andrea Cattaneo and others, "Costa Rica trade liberalization, fiscal imbalances and macroeconomic policy: a computable general equilibrium model", *North American Journal of Economics and Finance*, vol. 10 (1999), pp. 39-67.

in Africa.[79] The problem can be great in those economies for which tariff revenue makes the largest contribution to government revenue: in 1997, tariff revenues amounted to over 12 per cent of GDP in the Gambia and over 26 per cent of GDP in Lesotho. The specific impact of a tariff reduction varies by country, depending on a country's initial conditions and its reform strategy. An examination of the relationship between trade liberalization and the budget position in Kenya concluded that liberalization may be strongly budget-enhancing because of increased trade flows.[80] An analysis of the case of China suggests the use of various tax instruments to compensate budget losses arising from trade liberalization.[81]

If import values are unchanged, the short-term effect of tariff reductions is to lower government revenue. However, increased demand for now-cheaper products could compensate for this loss—eventually even outweighing it, depending on the elasticity of demand for the goods in question. In the case of differentiated tariffs, by reducing higher tariffs and increasing lower ones to create a more uniform average rate, Governments may increase revenues (depending upon which goods are affected). In addition, such a uniform tariff rate alleviates administrative difficulties and discourages tariff evasion, thus allowing for increased—rather than decreased—revenue, since the lower the tariff rate, the smaller the motivation to seek exemptions. Mexico's 1985 liberalization plan serves as one example. Tariffs gradually replaced quantity restrictions. Tariff rates were, in turn, reduced and their range and coverage were made more uniform, with positive results in terms of the productivity of the export sector. Moreover, total revenues from import duties remained approximately constant in real terms, while overall budgetary revenues rose.[82]

Reducing tariffs has important implications for the fiscal position of many countries, especially smaller economies, which are traditionally more dependent on this type of revenue. For this reason, a reduction in tariffs should be a part of the package through which the overall tax structure is changed.[83] Since domestic taxes and the expanded tax base provided by economic growth eventually compensate for the role of tariff revenues in GDP, strengthening domestic taxes is very important, especially during the initial stages of liberalization. In this regard, taxes on international trade should play a minimal role since using trade taxes/subsidies to raise government revenue is not a first-best policy from a welfare perspective.[84] From a welfare standpoint, trade tariffs and/or subsidies should be levied only to affect trade-related variables. To raise government revenue, personal and corporate and excise taxes are the more appropriate tools. However, personal and corporate income taxes need to be simplified, modernized and reformed. Finally, a simplified and streamlined tax process is often a necessity.[85]

Several case studies highlight specific examples of the impact of tariff reduction on government revenue. In Malawi, the initial focus on reducing quantitative restrictions and tariff dispersion, together with the favourable impact of foreign exchange market liberalization and enhanced tax administration, resulted in both strengthened revenue mobilization and a more liberal trade regime. Following reform in the Philippines, imports increased significantly as a percentage of GDP. The increase in imports, coupled with a reform strategy, resulted in an increase in trade taxes as a percentage of GDP and of total tax revenue, even as the tax rate declined. Argentina and Morocco, like the Philippines and

79 *World Public Sector Report: Globalization and the State 2001* (United Nations publication, Sales No. E.01.II.H.2). See also Liam Ebrill, Janet Stotsky and Reint Gropp, *Revenue Implications of Trade Liberalization*, IMF Occasional Paper, No. 180 (Washington, D.C., IMF, 1999).

80 David Bevan, *Fiscal Implications of Trade Liberalization*, IMF Working Paper No. 95/50 (Washington, D.C., IMF, 1995).

81 Zhi Wang and Fan Zhai, "Tariff reductions, tax replacement, and implications for income distribution in China", *Journal of Comparative Economics*, vol. 26, issue 2 (1998), pp. 358-387.

82 Andrew Feldenstein, *Tax Policy and Trade Liberalization: An Application*, IMF Working Paper, No. 92/108 (Washington, D.C., IMF, 1992).

83 See Hubert Escaith and Keiji Inoue, "Small economies' tariff and subsidy policies in the face of trade liberalization in the Americas", *Integration & Trade* (Inter-American Development Bank, Buenos Aires), vol. 5. No. 14 (2001).

84 See Jagdish Bhagwati and T.N. Srinivasan, *Lectures in International Trade* (Cambridge, Massachusetts, The MIT Press, 1983).

85 See, for example, Ebrill, Stotsky and Gropp, op. cit.; and George T. Abed, *Trade Liberalization and Tax Reform in the Southern Mediterranean Region*, IMF Working Paper, No. 98/49 (Washington, D.C., IMF, 1998).

Malawi, consolidated tariffs and reduced the range that they covered.[86] In Argentina, following post-1991 reforms, overall revenue rose. Morocco, commencing with its initial reforms in the 1980s, coupled an overhaul of the domestic tax system with trade liberalization. It had reduced its maximum tariff rate from 400 to 35 per cent between 1982 and 1993 and the number of tariff bands was reduced from 47 to 6 in 1996. The combination of tax charges and tariff reductions resulted in relatively stable government revenues.[87] Numerous examples suggest that it is possible to undertake domestic fiscal reform so as, over time, to offset any revenue losses from reductions in trade taxes.

The distribution of income

There is a debate on whether trade liberalization is associated with a narrowing or widening of the intra-country distribution of income. Evidence garnered from over 40 developed and developing economies between 1978 and 1994 suggests that reduced protection worsened the distribution of income in the developing countries examined, but did not contribute significantly to increased income inequality in the developed economies.[88] On the other hand, observations covering 137 countries over the past four decades led to the conclusion that several determinants of growth, including openness to international trade, had had little systematic effect on the share of income accruing to the bottom quintile.

A focus on individual countries indicates that China, for example, dramatically increased its openness over the 1980s and 1990s. Income inequality rose as well. According to one estimate, China's Gini coefficient rose from 28.8 in 1981 to 38.8 in 1995.[89] However, disaggregating the data further shows that regions that had experienced an increase in openness between 1988 and 1993 also experienced a faster decrease in inequality. Embracing trade openness created opportunities for rural areas not only to grow, but to grow faster, than their urban neighbours. However, evidence for the Republic of Korea, using annual data for the period 1975-1995, showed that changes in the openness ratio had not been significant in influencing the distribution of income.[90] Meanwhile, there is evidence, using the 1996 Mexican National Household Income and Expenditure Survey, that, in Mexico, the impact of tariff reform on welfare was positive in general for all income deciles, with poor individuals having benefited relatively more than rich ones.[91]

Cross-country evidence suggests that, on balance, trade liberalization benefits the poor via its beneficial impact on economic growth, particularly when accompanied by other policies that are generally considered to foster growth;[92] but trade openness may not have systematic effects on the poor beyond its effect on overall growth and thus on overall poverty reduction. Micro-evidence from a large number of individual liberalization episodes shows that there is no clear-cut relationship between trade liberalization and income distribution. Even if trade liberalization results in aggregate welfare gains over all households, it is possible that the poorest households might not benefit as much in relative terms. Such a scenario has been of concern in Turkey as it deepens its relationship with EU.[93]

The policy implication—and the explanation for the diverse findings—lie in the distinction between "necessary" and "sufficient" conditions. Thus, trade

86 This is referred to as reduced "dispersion" and is typically consistent with a reduction in average effective protection.

87 Ebrill, Stotshy and Gropp, op. cit.

88 Andras Savvides, "Trade policy and income inequality: new evidence", *Economics Letters*, vol. 61 (1998), pp. 365-372.

89 Shang-Jin Wei, "Is Globalization good for the poor in China?", *Finance and Development*, vol. 39, No. 3 (September 2002).

90 Jai S. Mah, "A note on globalization and income distribution: the case of Korea, 1975-1995", *Journal of Asian Economics*, vol. 14 (2003), pp. 157-164.

91 Elena Ianchovichina, Alessandro Nicita and Isidro Soloaga, "Trade reform and poverty: the case of Mexico", *World Economy*, vol. 25, No. 8 (2002), pp. 945-972.

92 Andrew MaKay, L. Alan Winters and Abbi Mamo Kedir, "A review of empirical evidence on trade, trade policy and poverty", report to the Department for International Development (DFID), prepared as a background document for the Second Development White Paper, London, 2000.

93 Glenn W. Harrison, Thomas F. Rutherford and David G. Tarr, "Trade liberalization, poverty and efficient equity", *Journal of Development Economics*, vol. 71 (2003), pp. 97-128.

liberalization can be expected to help the poor overall. However, trade liberalization, while necessary, may not by itself be sufficient to achieve this end.[94] The outcome may differ depending on the route that is taken. For example, prior to 1990, the distributional impacts of the liberalization measures undertaken by Chile had been relatively unfavourable for the poor. However, post-1990, Chile managed to combine high growth with decreasing inequality.[95] Similarly, it has been suggested that trade liberalization enhanced both economic efficiency and income equality in China: the extent of the efficiency gains appear to have depended on which instrument the Government chose to balance its budget. Imposing a progressive household income tax reduced the Gini coefficient while retaining most of the efficiency gains.[96]

Concomitant policies are then critical to whether liberalization will actually result in poverty reduction. It is especially the case that these policies need to be appropriate and balanced. In particular, the success of trade liberalization and its impact on the poor depend critically on the extent to which product and labour-market reforms are synchronized.

The focus on domestic reforms and policies in areas other than trade raises another issue. Increasingly, the two goals of promoting development and maximizing trade are viewed as identical by policy makers. However, an alternative account of economic development questions the centrality of trade and trade policy and emphasizes instead the critical role of domestic institutional innovations. This train of thought argues that imported blueprints rarely spark economic growth and that opening up the economy is hardly ever critical at the outset. Rather, policy reforms must be "targeted to domestic investors and tailored to domestic institutional realities".[97] However, liberalization and institutional reform do not constitute the terms of an either-or proposition. Both are necessary for a successful development strategy.

94 Ramkishen S. Rajan and Graham Bird, "Trade liberalization and poverty: where do we stand?", University of Adelaide, Australia, 2002.

95 Lance Taylor, "External liberalization, economic performance, and distribution in Latin America and elsewhere", United Nations University, World Institute for Development Economics Research, Helsinki, 2000.

96 Zhi Wang and Fan Zhai, "Tariff reduction, tax replacement, and implications for income distribution in China", *Journal of Comparative Economics*, vol. 26 (1998), issue 2, pp. 358-387.

97 Dani Rodrik, "The global governance of trade: as if development really mattered", background paper for the Project on Trade and Sustainable Human Development, UNDP, New York, 2001.

THE ROLE OF THE INTERNATIONAL COMMUNITY

Thus far, the discussion has reviewed the various internal mechanisms whereby trade expansion and trade liberalization can have an impact on poverty in a developing country. However, intrinsic to this process is the ability of the economy in question to integrate with the global economy. This, in turn, raises the question of the role of developed countries—to which 55 per cent of developing economies' exports were directed in 2001—in facilitating such integration.

Trade policy of developed countries is key, since shutting out the exports of developing countries condemns the poor to remaining poor. It has been estimated that developed countries' trade barriers cost developing countries more than 100 billion dollars per year, roughly twice what is provided in aid. Among the most protected sectors in industrialized countries are agriculture, textiles and apparel—exactly those where developing economies are most competitive and where they could create the most jobs, including jobs for low-skilled and poor people, were such protection absent. Producers in industrialized countries often benefit from a combination of government subsidies and import tariffs and quotas.

The issue of the need for specific market access advantages for developing countries was first raised at the Second Session of the United Nations Conference on Trade and Development (UNCTAD) in 1968. Special treatment specifically geared to the least developed countries has been provided by developed countries through the Generalized System of Preferences (GSP) schemes, and by developing countries through the Global System of Trade Preferences among Developing Countries (GSTP).[98] While these schemes are designed to assist developing countries in promoting faster export growth, the fact that preferences are granted does not guarantee that they will be effectively utilized.

Nevertheless, various attempts to ascertain levels of market access have been made, most recently in mid-2003. A Commitment to Development Index (CDI) has been compiled whose trade component measures developed countries' barriers to developing country exports, as well as the income that poor countries forgo owing to internal production subsidies in richer economies. Protection against developing countries is lowest in Australia, New Zealand and the United States, intermediate in EU and highest in Japan and Norway.[99]

A number of developing countries have successfully seized the export opportunities presented to them as a consequence of trade preferences from developed countries. Two prominent measures in this regard are the United States African Growth and Opportunity Act (AGOA) and the EU's Everything But Arms Initiative. The former had been signed into law in May 2000 and as of January 2003, 38 sub-Saharan African countries were eligible for tariff preferences.[100] The Everything But Arms Initiative was approved in February 2001 and will eventually eliminate quotas and duties on all products, except arms, from the world's poorest countries. In September 2000, the Canadian Government enlarged the product coverage of its GSP scheme to allow 570 products originating in the least developed countries to enter its market duty-free. Some countries are already benefiting from these measures. For example, Ghana, whose main trading partner is EU, has been developing a furniture-manufacturing export sector (see box VI.1). Lesotho benefits from at least two agreements—the Southern African Development Community Protocol and AGOA (see box VI. 2). These agreements have enabled Lesotho to expand clothing and textile exports to its two main export markets, South Africa and the United States.

A wider window of opportunity currently exists to assist all developing economies in the trade arena in the wake of the Fourth Ministerial Conference of the World Trade Organization which took place in Doha in November 2001. The outcome of the Conference was a Ministerial Declaration (see document A/C.2/56/7, annex) and ministerial decisions which set out the elements of a work programme with important development components, referred to as the Doha Development Agenda—The low-income countries, in particular, have much to gain from these negotiations, especially in the areas of agriculture and textiles. One of the more important deadlines in the Doha trade round slipped by, however, on 31 March 2003 when the 145 members of the World Trade Organization were unable to agree on a framework for cuts to farm subsidies and import duties on agricultural goods.[101] It has been estimated that abolishing Organisation for Economic Cooperation and Development (OECD) agricultural subsidies would provide developing countries with three times their current official development assistance (ODA) receipts. The elimination of all tariff and non-tariff barriers could result in static gains for developing countries of about $182 billion in the area of services, $162 billion in manufactures and $32 billion in agriculture.[102]

98 *The Least Developed Countries Report, 2002 ...*, pp. 223-228.

99 For most countries, the results are driven by estimates of agricultural protection, which is so high that it dominates the results despite the fact that the share of agriculture in total developed country imports is modest. See William R. Cline, "An index of industrial country trade policy toward developing countries", Working Paper, No. 14 (Washington, D.C., Center for Global Development, 2002).

100 Paul Brenton, "Integrating the least developed countries into the world trading system: the current impact of EU preferences under everything but arms", World Bank, International Trade Department, Washington, D.C., 2003; and www.whitehouse.gov/news/releases/2003. See also, *World Economic and Social Survey, 2001* (United Nations publication, Sales No. E.01.II.C.1), chap. V.

101 See IMF, "Developments in the Doha round and selected activities of interest to the Fund", 8 April 2003 (available at http://www.imf.org/external/np/pdr/doha/2003/040803.htm).

102 Economic Commission for Africa, *Economic Report on Africa, 2003: Accelerating the Pace of Development* (United Nations publication, Sales No. E.03.II.K.1).

Box VI.1

BEYOND AGRICULTURE: FURNITURE MANUFACTURING IN GHANA

For much of the world's population, the growing integration of the global economy has provided an opportunity for substantial income growth. Manufactured exports are seen as a key factor in a small number of African economic "lions" that have pursued sound macroeconomic policies—Ethiopia, Ghana, Mozambique, Uganda and the United Republic of Tanzania—enabling them to achieve higher and sustainable levels of economic growth.[a]

Like many African countries, Ghana is still predominantly an agrarian economy heavily dependent upon primary production, especially if subsistence agriculture is taken into account. Trade is relatively concentrated, both in commodities and in markets. Primary production (especially agriculture), and services each account for over 40 per cent of gross domestic product (GDP), while manufacturing represents about 10 per cent. Government policy has been aimed at diversifying the economy's export base away from the traditional commodities of cocoa, logs, gold and electricity.[b] To this end, the focus has shifted from the production of mainly agricultural products to manufactured products with a higher value added.

Ghana's main trading partner is the European Union (EU), accounting for almost half of total exports—partly owing to trade preferences—and imports. Within EU, Italy, the United Kingdom of Great Britain and Northern Ireland and France are the main European sources of imports.[c]

Firms in the wood and furniture sector have a higher export intensity than those in other sectors.[d] The high probability of exporting in the wood sector was due to comparative advantage. Ghana has a relative abundance of natural resources, including wood, and labour. Ghana's furniture exports increased almost 250 per cent over the last decade.[e] This was despite the global furniture industry's being characterized by increased competition, with unit prices converging across countries and falling overall.[f]

Some of the characteristics to which this export success can be attributed are: size of firms, their age and their technical efficiency. For example, there is a strong positive relationship between size and export success, as firms face large fixed costs in entering the export market.[g] Such costs include establishing an overseas supply network, market research in foreign markets, and specific product design for overseas markets.

Larger firms tend to be older and are more likely to invest and export. However, in the case of Ghana, firm age has been found to have a significant—but negative—impact on the probability of exporting. This may be attributed to the fact that recently established firms are more outward-oriented than are older firms. Alternatively, it may be because the newer firms have more advanced capital equipment and are thus better able to produce goods for export. This suggests that these factors may overshadow the benefits of "learning-through-exporting", if there are any.

The lesson to be learned from Ghana's furniture industry is that both macroeconomic policy and firm-level efficiency are key ingredients in enabling firms to enter the export market. Policies that improve the performance of firms can greatly enhance the growth prospects of developing economies, including those facing problems in respect of taking the first step into the export market in labour-intensive sectors, such as furniture manufacturing[h].

a N. Rankin, M. Söderbom and F. Teal, "The Ghanaian Manufacturing Enterprise Survey 2000", Centre for the Study of African Economies (CSAE), University of Oxford, Oxford, November 2002, p. 31.

b World Trade Organization secretariat, "Trade Policy: Ghana", Trade Policy Review Body (WT/TPR/S/81), p. 1.

c Ibid., p. 8

d N. Rankin, M. Söderbom and F. Teal, loc. cit., p. vi.

e United Nations Statistical aggregated country data, 1991-2001.

f R. Kaplinsky, M. Morris and J. Readman, "The globalization of product markets and immiserizing growth: lessons from the South African furniture industry", *World Development*, vol. 30, 7: 1159–1177, p. 1173.

g M. Söderbom and F. Teal, "Can African manufacturing firms become successful exporters?", Centre for the Study of African Economies (CSAE) in cooperation with United Nations Industrial Development Organization, CSAE-Unido Working Paper No. 4, Vienna and Oxford, United Kingdom, 2001.

h N. Rankin, M. Söderbom and F. Teal, loc. cit., p. 9.

Box VI.2

BEYOND AGRICULTURE: CLOTHING AND TEXTILE MANUFACTURING IN LESOTHO

Landlocked and completely surrounded by South Africa, Lesotho's main economic activity has been subsistence farming. However, the manufacturing industry in Lesotho constituted 44 per cent of gross domestic product (GDP) in 2000, compared with just over 25 per cent in 1985 and 33 per cent in 1990. It now employs a quarter of the workforce. Future development of the manufacturing sector is therefore seen as vital for improving the living standards of the population of 2.2 million. Clothing and textile companies have led the way in growth terms. In 1999, the sector employed about 18,000 people and contributed 30 per cent of total value added in manufacturing. Companies export to the United States of America, the European Union (EU) and South Africa.[a] With the nationwide unemployment rate estimated at 45 per cent, job creation is central to government policy, which places the future expansion of the clothing and textile sector—with its high labour-intensiveness—in sharp focus.

The growth of Lesotho's textile sector can be attributed mainly to external factors: Lesotho is too small to sustain a manufacturing sector on its own. Gaining a foothold in the overseas market is therefore all-important for boosting the economy. Although trade linkages exist among the members of the States of the Southern African Development Community (SADC), most are more integrated with EU and the United States than they are within SADC, though Lesotho is an exception in this respect owing to its strong reliance on South Africa.

The textiles and clothing industry is mainly influenced, or regulated, by a plethora of different bilateral and multilateral trade arrangements that have been largely geared towards greater market access and an expansion of market boundaries. The sector mainly benefits from two agreements—the Southern African Development Community Trade Protocol and the African Growth and Opportunity Act (AGOA) of the United States. It further continues to benefit from preferential access to markets in EU under the Lomé Convention, though quotas limit access to this market.

Promotion of a SADC free trade area will yield benefits to all participants, but the small size of SADC relative to the global economy and trade imbalances among its members are likely to limit the medium-term scope for trade expansion.[b] However, AGOA offers sub-Saharan African countries duty-free and quota-free status into the United States for those products meeting the eligibility requirements. Since April 2001, Lesotho has been eligible for duty-free access to United States markets for textiles and apparel under AGOA.

For the firms in this sector, the benefits have been significant and have provided a huge boost. Lesotho has established a growing presence in the United States clothing and textile market. About one third of Lesotho's exports are sold there, and 90 per cent of those sales are of jeans and T-shirts. Since April 2001, apparel and textile exports to the United States from Lesotho have risen by nearly 40 per cent.[c] The jump in Lesotho's exports of apparel to the United States from \$140.3 million in 2000 to \$215.3 million in 2001, has led to the soaring of investment to \$122 million. For example, the Taiwan Province of China textile firm Nien Hsign is building a clothing factory outside Maseru, scheduled for completion in 2004. Some 20,000 extra jobs in the textile industry have been created as a result of AGOA—jobs that pay 5 to 10 times the average wage.[d]

Although the clothing and textile industry in Southern Africa is large, directly employing up to 260,000 workers and contributing 6 per cent towards the region's

a South African Ministry of Finance, "Lesotho", 1999, p. 3.

b Samson Muradzikwa, "Textiles and clothing in SADC: key issues and policy perspectives", Policy Brief, No. 01/P20, Development Policy Research Unit (DPRU), University of Cape Town, Cape Town, 2001, p.10.

c http://www.finance.gov.za/documents/fiscu/summits/1999/lesotho.pdf.

d Samson Muradzikwa, "The Southern African regional clothing and textile industry: case studies of Malawi, Mauritius and Zimbabwe", Working Paper, No. 01/58, Development Policy Research Unit (DPRU), University of Cape Town, Cape Town, 2001, p.9.

Box VI.2 (continued)

national output, in a global context the industry is still very small; and even though the benefits of bilateral trade agreements like AGOA have started to materialize, African clothing manufacturers exported only 3 per cent of the apparel they had been entitled to ship into the United States tariff-free—suggesting that there is still a huge potential for SADC producers to seize the opportunities presented by this market. At present, the United States imports 85 per cent of its clothing. Of the total clothing imports amounting to $60 billion, approximately $600 million are from Africa.[e]

The presence of spinners and weavers, garment manufacturers, and cross-border formal and informal trade means that this sector has both vertical and horizontal growth possibilities. By creating an attractive investment climate, Lesotho continues to encourage foreign investors with the financial, managerial and technical skills to expand the country's industry.

There are, however, concerns related to the success of the sector. Weak tax administration continues to give scope to smuggling and undervaluation of imports, thereby causing market instability within Lesotho. Customs authorities and border/port controls need to be strengthened so as to combat smuggling, especially of illegal second-hand clothing.[f] Although legal and illegal imports of second-hand clothing imports provide cheap clothing for scores of relatively poor people in Southern Africa, these imports have devastating effects on clothing and textile producers in the region.[g] Finally, there is growing unease regarding the chemical effluent from textiles production, which is fed virtually untreated into the Caledon River, an important source of drinking water, downstream, for both Lesotho and South Africa[h].

e *Business Day*, 16 February 2001.

f Muradzikwa, "The Southern African regional clothing and textile industry" …, p. 23.

g Muradzikwa, "Textiles and Clothing in SADC" ..., p. 13. Used clothing accounted for 51 per cent of total United States exports of textiles and apparel to sub-Saharan Africa (United States, Department of Trade, "US trade and investment with sub-Saharan Africa", 2002, p. xv.

h *EU Courier*, Country report 194 (2002), p. 91.

In Doha, ministers had also agreed to negotiate on improved market access for non-agricultural goods. The aim was to reduce or eliminate tariff peaks and tariff escalation (said to exist when tariff rates rise as the level of the processing of a product increases) as well as to abolish non-tariff measures. These measures would be particularly important to poor African countries because the region as a whole is highly dependent on external trade. Tariff escalation makes it difficult for African countries to diversify their economies towards high-value-added processed goods. Tariff peaks are often concentrated in products of export interest to developing countries. In respect of the two sectors of particular importance to these exporters, textiles and agriculture, tariff barriers in textiles remain high, while high tariffs for agricultural commodities and the continued subsidization of agriculture repel agricultural exports.

For many developing countries, a successful outcome to the Doha round will necessitate obtaining significant concessions on special and differential treatment (SDT). While there are a wide assortment of SDT and implementation proposals, most seek either to exempt eligible countries from World Trade Organization disciplines (or soften them) or to deal with capacity shortfalls in meeting such regulations. One key concern is the criteria for eligibility—at present, developing-country status in the World Trade Organization is conferred through self-declaration. The group of least developed countries, however, is an exception, their identification being carried out by the United Nations.

Since almost 40 per cent of developing-country exports in 2001 were directed to other developing countries, a discussion of the role of the international community in assisting developing countries on the trade front no longer can—nor should—focus exclusively on the developed economies. The average unweighted tariff rates in developing economies in Africa, East Asia, Latin America, the Middle East and North Africa, and South Asia were 17.8, 10.4, 11.1, 19.3 and 30.7 per cent, respectively, in 1996-1999 (in contrast with a rate of 6.1 per cent in the developed countries). While these tariff rates came down in the 1990s, non-tariff barriers persist. For example, not only have developing countries become frequent users of anti-dumping measures, a predominant non-tariff barrier to trade, but on a per-dollar-of-import basis, they are the most intensive users.[103]

103 J. Michael Finger, Francis Ng and Sonam Wangchuk, *Antidumping as safeguard policy*, World Bank Policy Research Working Paper, No. 2730 (Washington, D.C., World Bank, 2001).

CONCLUSIONS

While increased openness is conducive to economic growth, and growth, in turn, is conducive to poverty reduction, openness and liberalization are not a panacea for poverty reduction. The prime explanation for this lies in the fact that the impact of trade on an economy is generally rather small, particularly in the short run. Trade policy is but one element in the relationship between growth and poverty reduction.

The effects of liberalization can manifest themselves in the short, medium and long run. In the short-to-medium term, adjustment costs are of major concern to policy makers. Stabilization schemes and other safety nets capable of being quickly implemented—such as temporary income support, and relocation assistance—are called for. All reforms—and there is no reason that trade liberalization should be an exception—create winners and losers. Indeed, this notion is built into conventional trade theory, the argument being that the "gains from trade" will be so great that the winners will be able to compensate the losers so that the welfare of both groups will rise. Reality is, unfortunately, not so neat, and appropriate policy responses are therefore required to mitigate hardships and facilitate adjustment. Potential safety net measures include targeted subsidies, cash transfers (such as fee waivers for basic services or child allowances), retraining for workers laid off from non-competitive firms, and public works employment.

In the longer run, however, due to their dynamics, trade liberalization and increased trade contribute to growth, which is necessary for poverty reduction. One lesson, therefore, is that the appropriate reaction to any of the short- and medium-run problems engendered by trade liberalization is to devise suitable policy responses, such as the introduction of retraining programmes for displaced workers, rather than to abort the trade reform process. Identification of hardships arising from generally desirable policy reforms should spur the search for complementary policies to minimize adverse consequences, such as providing training and disseminating best business practices so that new market opportunities can be exploited, and gradually phasing in trade reforms in sectors that are likely to have a particularly large impact on the poor. Rejecting all reforms that could adversely affect any poor person would be a recipe for long-run stagnation, which would ultimately increase—rather than reduce—poverty. Such a policy is not only undesirable but unnecessary, since it is possible to design approaches to trade liberalization that preclude losses by the poorest households. One such method is selective, rather than across-the-board, tariff reform; but while tariff exemptions can redress the adverse distributional impacts of tariff reform, they incur the danger of inducing rent-seeking practices.

Finally, the results of trade policies tend to be country-specific because effects are contingent on individual conditions. This makes it extremely difficult to gauge and predict the outcome of trade liberalization on poverty by applying the results derived from a given country at a given time to other countries and periods. Nevertheless, there are two compelling arguments for trade liberalization and the importance of trade to economic growth and, via growth, to poverty reduction. The first is that trade liberalization is generally not undertaken in isolation; rather, it is part of a "package" of complementary reforms—all of which may be necessary for, and conducive to, growth. The second argument attesting to the importance of trade reform is based on the fact that there are virtually no "counter-examples"—that is to say, cases of *closed* economies that have thrived in the long term. Countries that have performed well as regards economic growth over the past 20 years or so have made opening up part of the reform process. Given today's ever more globalized world economy, it is difficult to imagine that any country hoping to prosper and reduce poverty in the future could do otherwise.

VII MARKET-BASED APPROACHES TO RURAL DEVELOPMENT IN SUB-SAHARAN AFRICA

Policies to improve the economic efficiency of agriculture can play a critical role in the implementation of rural development strategies, including efforts to combat rural poverty. The present chapter focuses on selected market-based policies, namely food marketing reform and land redistribution, intended to increase agricultural efficiency and identifies the indirect impacts of such policies on the achievement of more equitable patterns of rural development, particularly in sub-Saharan Africa, a region in which the total number of people living in extreme poverty is expected to rise between 1990 and 2015. Although market-based policies are not usually adopted primarily to reduce rural poverty, they can have overall positive impacts on poverty alleviation.

Better access to staple food markets is especially important for the rural poor, who often generate the bulk of their income from producing staple foods. Particular attention should thus be paid to the role of food marketing in rural economic growth. Until the mid-1980s, the marketing of major food crops in many African countries was carried out by ad hoc State agencies, notably marketing boards. State intervention in food marketing, however, created economic inefficiencies and unsustainable fiscal costs, besides proving generally ineffective in ensuring sustained rural economic growth. This led to greater emphasis on market-based approaches aimed at improving the efficiency and cost-effectiveness of agricultural marketing. The case studies of marketing reform presented in this chapter suggest that providing the enabling environment for improved marketing efficiency—through a better transport network, food storage capacity and credit provision for poor farmers—can be a more effective form of government involvement in food marketing than direct intervention through marketing boards.

The chapter also argues that market-based land redistribution policies can promote greater economic efficiency and more equitable rural growth. When small-scale farmers have secure access to arable land—in the form of land titles or long-term rental—they are likely to increase investment in their land, produce more food and raise their incomes. Expanded land-use or ownership rights also increase their chances of securing cheaper and more extensive credit by using land as collateral. At the same time, success with redistributive land reform depends, to a large extent, on the implementation of complementary measures to foster rural development.

Market-based schemes can be considered one of the most innovative approaches to land reform that have emerged over the last decade, and provide a useful alternative to more conventional, State-controlled land

redistribution programmes. The chapter concludes, however, that when countries opt for market-based approaches to land redistribution, the State still has an important role to play, without necessarily deciding which land parcels change hands.

RURAL DEVELOPMENT AND POVERTY REDUCTION IN SUB-SAHARAN AFRICA

The need for greater emphasis on rural poverty reduction

Approximately 75 per cent of the world's extreme poor live and work in rural areas and two thirds of them depend for their livelihoods mainly on farming or farm labour.[1] Although rural poverty rates fell sharply in many developing countries during the 1970s and 1980s, the decline has slowed down around the world since then. It is estimated that 60 per cent of the world's poor will still live in rural areas by 2020, even though the world urban population is likely to have overtaken the rural share.[2] Substantial progress on rural poverty reduction in developing countries will thus be crucial for the attainment of the Millennium Development Goal for poverty.

Rural poverty is a multidimensional phenomenon that is reflected by low income, inequality in access to resources, low education standards, poor nutrition, inadequate health services and vulnerability to shocks, among other factors. Sustainable development strategies to combat rural poverty must reflect its multidimensional nature and thus be targeted at different economic, social and environmental objectives. This implies that social policies to improve poor people's access to health, nutrition, education and training should become an integral part of rural development strategies, even though a discussion of these issues lies beyond the scope of this chapter.[3] The chapter examines selected market-based policies to improve the economic efficiency of agriculture—and looks at their indirect impact on the promotion of more equitable patterns of rural development—as opposed to broad socio-economic policies to combat rural (and urban) poverty.

The relationship between rural and urban poverty is a critical underlying factor in the analysis of poverty issues, given that persistently high levels of rural poverty in developing countries have stimulated migration of the rural poor to urban areas. A significant share of urban poverty can be seen as a result of the personal poverty alleviation strategies of poor rural people who have few options other than migrating to urban areas.[4] In many developing countries, economic policies primarily based on urban development seem unlikely to alleviate poverty as effectively as policies that also incorporate rural development strategies. Furthermore, government policies that penalize the agricultural sector and neglect the social and physical infrastructure in rural areas have been major contributors to both rural and, through migration, urban poverty.[5] Examples of policies that negatively affect the rural poor include urban bias in the public provision of social services and infrastructure; and bias in favour of large landowners and agribusinesses with respect to land ownership rights, publicly provided extension services and subsidized access to credit and irrigation water. Unequal land distribution is one of the greatest obstacles to rural poverty reduction in developing countries.

1 International Fund for Agricultural Development (IFAD), *Rural Poverty Report 2001: The Challenge of Ending Rural Poverty* (New York, Oxford University Press, 2001). The United Nations Millennium Declaration (See General Assembly resolution 55/2 of 8 September 2000) defines people in extreme poverty as those whose income is less than one dollar a day.

2 M. Ravallion, "On the urbanization of poverty", *Journal of Development Economics*, vol. 68 (2002), pp. 435-442.

3 See, for example, *Report of the World Summit for Social Development, Copenhagen, 6-12 March 1995* (United Nations publication, Sales No. E.96.IV.8); and *Report on the World Social Situation, 2001* (United Nations publication, Sales No. E.01.IV.5).

4 M.H. Khan, *Rural Poverty in Developing Countries: Issues and Policies*, IMF Working Paper, No. WP/00/78 (Washington, D.C., International Monetary Fund, April 2000).

5 See R. Sobhan, "Eradicating rural poverty: moving from a micro to a macro agenda", mimeo, Centre for Policy Dialogue, Dhaka, June 2001.

It can be argued that the success of efforts to combat rural poverty depends on at least two economic factors: granting the rural poor legally secure entitlement to assets—notably land—and improving their access to agricultural markets.[6] Inadequate access to arable land is probably the most important cause of rural poverty, and redistributive land reform is increasingly seen as crucial in many developing countries. There is an urgent need, therefore, to focus attention on the implementation of land redistribution policies as a means to promote more equitable rural growth patterns. Similarly, better access to staple food markets is especially important because staples farming often accounts for a large proportion of the income of the rural poor. Particular attention should thus also be paid to the role of food marketing reform in rural economic growth, even if this type of policy reform is not designed to reduce poverty directly.

6 In addition to social factors based on improved access to human assets, such as health, nutrition, education and skills. See *Rural Poverty Report, 2001* ... .

Focusing on sub-Saharan Africa

The latest poverty projections suggest that the Millennium Development Goal of halving extreme poverty between 1990 and 2015 (see document A/56/326, annex, goal 1, target 1) is likely to be achieved on a global level, although there will be considerable regional disparities. While the largest share of the world's extremely poor people live in South Asia (41.7 per cent in 1999), the highest proportion of poor people within a region is found in sub-Saharan Africa, where over 315 million people (approximately 40 per cent of the population) lived on less than one dollar a day in 1999. Moreover, sub-Saharan Africa is the only developing-country region in which the total number of people living in extreme poverty is expected to *rise* considerably between 1990 and 2015.[7] With more than 400 million people projected to be in extreme poverty in Africa in 2015, this region will have a total number of extremely poor people equal to that of all other developing-country regions put together (see figure VII.1).

7 See World Bank, *Global Economic Prospects and the Developing Countries, 2003* (Washington, D.C., World Bank, 2002), p. 30.

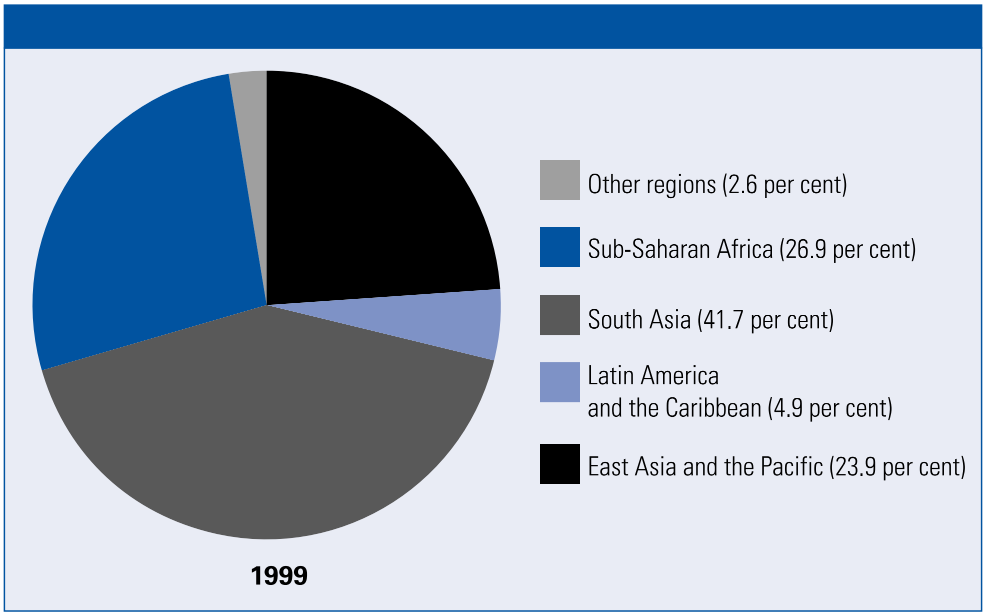
Non-income poverty indicators have also deteriorated in sub-Saharan Africa. For example, while East Asia has made significant progress in reducing the proportion of people who suffer from hunger, the estimated number of undernourished Africans rose by 27 million during the 1990s.[8] Similarly, sub-Saharan Africa has the highest share of its population below the minimum level of dietary energy consumption; the lowest net enrolment ratio in primary education; the highest under-five mortality rate; the highest prevalence and death rates associated with human immunodeficiency virus/acquired immunodeficiency syndrome (HIV/AIDS), malaria and other diseases; and the highest proportion of its population without access to safe drinking water.

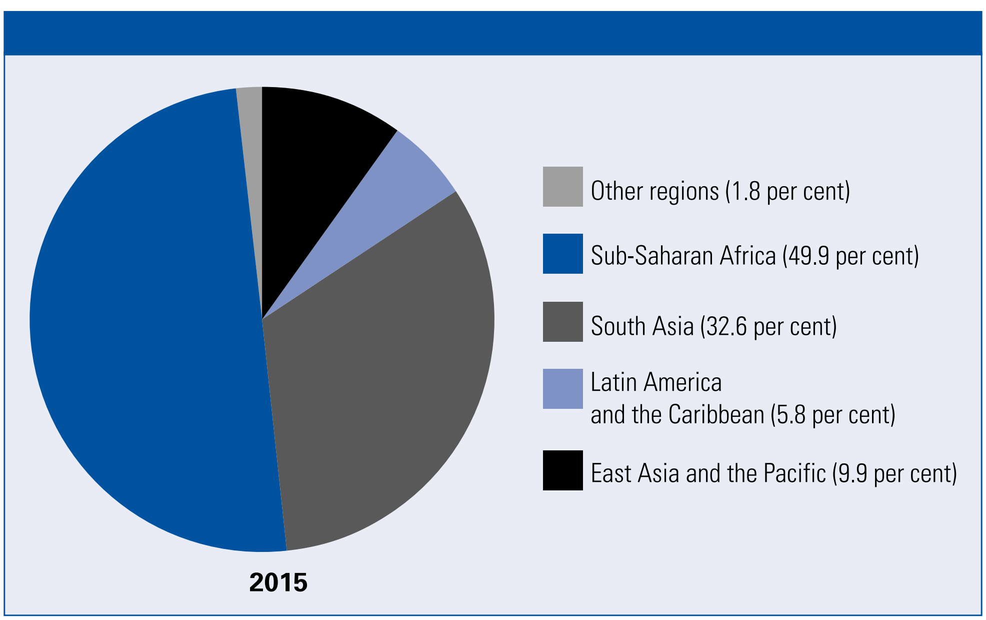
8 Report of the Secretary-General entitled "Implementation of the United Nations Millennium Declaration" (document A/57/270 and Corr.1).

This significant deterioration of poverty indicators calls for systematic action to deal with the dire situation in sub-Saharan Africa. The international community and sub-Saharan African Governments must pull together to promote sustained economic growth and combat poverty. In other words, just as there is an urgent need to give greater emphasis to rural poverty reduction around the world, international efforts to achieve the Millennium Development Goal for poverty reduction should also give greater priority to sub-Saharan Africa.

A greater international focus on rural poverty alleviation would strengthen poverty reduction efforts in sub-Saharan Africa, where the vast majority of the

Figure VII.1.
SHARE OF DEVELOPING-COUNTRY REGIONS IN WORLD EXTREME POVERTY,[a] 1999 AND 2015





Source: UN/DESA, based on *Global Economic Prospects and the Developing Countries, 2003* (Washington, D.C., World Bank, 2002), p. 30.

a Regions are defined by the World Bank. The country data necessary to compute these aggregates according to the country grouping used elsewhere in the *Survey* are not available.

poor live and work in rural areas. In Eastern and Southern Africa, at least four fifths of the extreme poor live in rural areas and 85 per cent of the poor depend on agriculture for their livelihood.[9] In the United Republic of Tanzania, for example, income from agriculture—including crops, livestock and wage labour—is the main income source for 96 per cent of the households in the bottom income quintile.[10] Even in Central and Western Africa—where urban poverty has been rising rapidly—the incidence of poverty is still much higher in rural (as opposed to urban) areas in most countries.[11] In Ghana, for instance, 83 per cent of the poor lived in rural areas in 1998-1999 and most of them were food crop farmers.[12] The most recent projections indicate that in only two African countries—Ghana and Madagascar—are rural poverty rates likely to decline at a pace adequate to achieve the Millennium Development Goal for poverty.[13]

Sustained growth of the farm sector could offer an opportunity for many Africans to escape from poverty. One of the most important means for reducing rural poverty in Africa would be to raise the incomes of poor farmers by increasing their agricultural productivity and output. For example, the significant reduction of rural poverty in the developing countries between 1970 and 1990 was closely associated with increased agricultural productivity, arising primarily from the expansion of irrigated croplands and the introduction of other forms of enhanced agricultural technology during the so-called green revolution, between the mid-1960s and the mid-1980s.

At the regional level, however, the implementation and success of both these policies were highly unbalanced. For example, East Asia's and South Asia's considerable agricultural growth and poverty reduction during that period are partly explained by their expansion of irrigation agriculture. Conversely, the persistence of rural poverty and agricultural stagnation in most of sub-Saharan Africa has been partly caused by its meagre 5 per cent of irrigated cropland area.[14] Similarly, although the green revolution did reach sub-Saharan Africa, the region failed to benefit from it as much as Asia, which experienced a significant agricultural "technology shift" that increased the productivity of staple foods, notably rice, wheat and maize.[15] Higher crop yields arising from technological progress achieved during the green revolution contributed to the rapid decline of rural poverty in many Asian developing countries.

For the rural economy to be Africa's growth engine, appropriate economic policies to promote agricultural growth are thus crucial. Over the past two decades, many sub-Saharan African Governments have introduced significant macro- and microeconomic policy changes that have had a direct impact on agricultural productivity and rural development. While agricultural policy reform throughout the continent has been closely associated with aid conditionality in general, and structural adjustment programmes in particular, there are also key endogenous dimensions of economic policy change. The heavy fiscal burden of State intervention and the need to improve efficiency were particularly instrumental in encouraging African Governments to introduce different approaches to agricultural development in their countries.

Among the economic policies that can promote agricultural development in Africa are agricultural market reform; policies to provide better access to physical assets (mainly land) and financial assets, and to improve extension services, transport and irrigation infrastructure; pricing, tax and exchange-rate policies

9 IFAD, *Assessment of Rural Poverty: Eastern and Southern Africa* (Rome, IFAD, 2002).

10 Ibid.

11 IFAD, *Assessment of Rural Poverty: Western and Central Africa* (Rome, IFAD, December 2001), p. 24. One country (Cameroon) currently has a higher poverty incidence rate in urban than in rural areas.

12 C.K. Dordunoo and G.Y. Dogbey, "Globalization and economic reforms in Ghana", in *Globalization and the Developing Countries: Emerging Strategies for Rural Development and Poverty Alleviation,* D. Bigman, ed. (Wallingford, United Kingdom, Centre for Agriculture and Biosciences International/International Service for National Agricultural Research (CABI/ISNAR) 2002), chap. 4.

13 D.E. Sahn and D. C. Stifel, "Progress toward the Millennium Development Goals in Africa", *World Development*, vol. 31, No. 1 (2003), pp. 23-52.

14 *Rural Poverty Report, 2001*... .

15 See *World Economic and Social Survey, 2002* (United Nations publication, Sales No. E.02.II.C.1), chap. V.

that do not penalize agriculture; agricultural trade liberalization; and the expansion and dissemination of agricultural technology research. This chapter argues that innovative market-based approaches aimed at increasing agricultural efficiency in Africa have emerged under the first two of these sets of policies, namely, marketing reform and a market-based approach to land reform.

FOOD MARKETING REFORM IN SUB-SAHARAN AFRICA

The role of food markets in rural poverty alleviation

Agriculture is vital to most of Africa's rural population as their major source of both food and income. Furthermore, while the urban poor derive their main source of income from the urban informal sector, smallholder agriculture is by far the main source of income of the rural poor in sub-Saharan Africa.[16] Farming of basic food crops (staples), in particular, account for a considerable share of the income of Africa's rural poor, although an increasing proportion of them also generate income from other sources, notably cash crops, livestock and some non-farm activity. In addition, the rural poor usually obtain 70 to 80 per cent of their calorie intake from staple foods.[17]

Domestic production of basic food crops also has considerable impacts on domestic inflation in poor African countries in view of their significant effect on (national) retail price index baskets of goods and the well-being of the poor. In sum, properly functioning food markets are crucial for poverty alleviation in Africa, for three major reasons: food purchases tend to dominate the expenditure of the poor; the sale of staples is one of the major sources of income of the rural poor; and poorly organized food markets and food distribution systems often result in heavy socio-economic costs, including famine, in both rural and urban areas.

There is plenty of evidence to show that food marketing uncertainty in sub-Saharan Africa contributes to stagnation in agricultural output and productivity.[18] Grain markets in the region are prone to instability owing to a series of unique physical and economic characteristics that set them apart from other agricultural markets. First, staple grains are subject to large differences between import and export prices because their value tends to be low relative to transportation costs, notably in areas with poor transport infrastructure. Second, since grains can be stored at relatively low cost, price expectations have considerable influence on current price movements in grain markets. Third, low short-run price elasticity of aggregate demand and supply of grains means that even moderate changes in output are likely to lead to large price fluctuations.

In addition, international grain markets tend to be dominated by the activities of a relatively small number of countries whose surplus disposal policies are a further source of price instability.[19] International price fluctuations for some staple food commodities, such as rice, for example, tend to be much greater than domestic fluctuations. Greater alignment between domestic and international grain prices arising from agricultural trade liberalization can thus increase domestic price volatility. Nonetheless, as chapter VI illustrates, there have been several "success stories" that can be at least partly associated with agricultural trade liberalization in Africa.[20] The present section, however, will

16 The term "smallholder" is often used to refer to poor small farmers without formal land titles, sometimes tilling poor-quality soils—inter alia, on plots owned by large landlords—and who depend directly on this activity for their subsistence. This broad definition thus includes tenants and sharecroppers but not landless farm labourers, many of whom subsist on very low wages and the pay derived from insecure jobs, and are thus also part of the rural poor. See, for example, E. R. Wolf, *Peasant Wars of the Twentieth Century* (New York, Harper and Row, 1969).

17 *Rural Poverty Report, 2001*... .

18 J. Coulter and G. Onumah, "The role of warehouse receipt systems in enhanced commodity marketing and rural livelihoods in Africa", *Food Policy*, vol. 27 (2002), pp. 319-337.

19 There has been, however, a long-term downward trend in international grain prices in general, sometimes interrupted by sharp price rises, as in 1995. See also S. Jones, *Liberalized Food Marketing in Developing Countries: Key Policy Problems* (Oxford, United Kingdom, Oxford Policy Management (OPM), May 1998), p. 2.

20 For a criticism of the assumed connection between agricultural trade liberalization and poverty reduction, see the Special Contribution by J. Stiglitz in United Nations Development Programme, *Human Development Report, 2003* (New York, Oxford University Press, 2003), p. 80.

focus on food production for domestic markets, in view of its close links to rural poverty through smallholder production and the dominant share of food staples in the consumption of the rural poor.

Although State intervention in food markets is generally aimed at stabilizing domestic prices, it is often justified on three main grounds: (a) to avoid interruption of food supply and to ensure food access for the poor; (b) to protect consumers (both urban and rural) from sharp price rises; and (c) to protect producers from sharp price falls associated with imbalances in demand and supply. State intervention has thus often involved granting price-reducing subsidies to consumers and price-raising subsidies to producers. However, restraining retail food prices has not always been compatible with guaranteeing minimum producer prices, especially in poor countries with limited budgets. Despite the fiscal costs arising from State intervention in food markets, marketing and storage of major food crops in most African (and many other developing) countries tended to be in the hands of State agencies until the 1980s. Furthermore, State institutions in many countries also controlled both international purchases and domestic distribution of critical inputs, such as fertilizers and pesticides.

This intervention in food production and marketing was often carried out through State marketing boards that had a statutory monopoly over key domestic marketing functions, as well as (external) agricultural trade. Marketing boards in Africa have usually been associated with export cash crops—such as cocoa, coffee, cotton, groundnuts and tea—and with their price stabilization functions. However, at least one of these (cash crop) marketing boards—as well as several ad hoc food marketing boards—also intervened in the purchasing, processing and distribution of staple food crops, such as maize, millet, rice, sorghum and yam. Regardless of their intervention in food staple or cash crop markets, most marketing boards in sub-Saharan Africa either have failed to achieve their price stabilization objectives—mainly because of financial or managerial constraints—or have achieved them only temporarily, at the cost of fiscal destabilization.[21] As a result of these domestic constraints, the 1980s and 1990s witnessed a redefinition of the State's role in food marketing and a marked trend towards food (and agricultural) marketing reform throughout Africa. There were therefore critical endogenous reasons for this reform, notably the unsustainable fiscal cost of pricing intervention by State agencies.

At the same time, policy reform has been closely associated with the implementation of the structural adjustment programmes promoted by the Bretton Woods institutions and bilateral aid programmes from the early 1980s onward. For example, a World Bank report published in 1981 advocated a series of actions for African economies caught in a downward spiral, including a recommendation that African Governments reduce control over food markets and increase the role of market forces.[22] Aid conditionality thus also contributed to shaping policies on food (and agricultural) marketing reform in Africa over the past two decades.[23] The main features of this reform have been (a) the partial or complete withdrawal of State agencies from staple food marketing; (b) the reduction or removal of consumer and producer pricing subsidies, including input subsidies; (c) a gradual movement away from State-controlled prices towards market-determined pricing; and (d) relaxation of regulatory controls over private marketing activities.

21 See S. Jones and S. Wickrema, "Price stabilization policies in the context of market liberalization", *OPM Policy Briefing Note 2* (Oxford, United Kingdom, OPM, n.d.).

22 World Bank, *Accelerated Development in Sub-Saharan Africa: An Agenda for Action* (Washington, D.C., World Bank, 1981). This document is widely referred to as "The Berg report" after its senior author, E. Berg.

23 Many African countries have also liberalized markets of non-staple commodities, such as cotton and coffee, but their analysis lies outside the scope of this chapter. See, for example, T. Akiyama and others, "Commodity market reform in Africa: some recent experience", *Economic Systems* (forthcoming, 2003); and A. W. Shepherd and S. Farolfi, "Export crop liberalization in Africa: a review", *FAO Agricultural Services Bulletin 135* (Rome, FAO, 1999).

Food marketing reform in selected African countries

The implementation of food marketing reform in sub-Saharan Africa has varied considerably across countries and the achievement of reform objectives has often been closely associated with the degree of political commitment. Reform measures have focused mainly on reducing State involvement in marketing and price-fixing, or on increasing the efficiency of the remaining marketing boards. By the end of the 1990s, these boards were either "generally losing out in competition with the private sector" throughout sub-Saharan Africa or had "been converted into non-trading industry boards for the purpose of promotion and regulation".[24]

Some countries, such as Ghana and Mali, had already had significant private sector involvement in food marketing (often in contravention of marketing boards' monopoly status) before reforms were introduced. In many Western African countries, State marketing boards nominally had statutory monopsonies and monopolies over food marketing but rarely handled more than a fifth of total marketed staples output. Well-established private grain trading networks operated extensive parallel markets, both within countries and across borders. In these cases, reform eventually focused on providing the enabling environment for the expansion of private trading, inter alia, by improving physical infrastructure, extension services and access to credit.

Countries that had more effective State intervention in food marketing before reform, notably in Eastern and Southern Africa, embarked on market liberalization as a result of fiscal constraints and aid conditionality, but several of them did so without full political commitment to reform. Frequent policy reversals in some of these countries have undermined the attainment of major reform objectives and also have created a good deal of uncertainty for the emerging private sector. For example, a comprehensive review of marketing reform in Kenya, Malawi and the United Republic of Tanzania found out that private agricultural traders repeatedly complained about the unpredictability of Government policies.[25] However, South Africa—and, to a lesser extent, the United Republic of Tanzania—have succeeded in making a transition from a State-controlled food marketing system to an increasingly market-based one. In addition, as will be shown below, the transition in South Africa has led to greater reliance on existing private commodity markets to correct price fluctuations arising from the withdrawal of marketing boards from price stabilization.

The following seven case studies illustrate the varied extent of marketing reform in sub-Saharan Africa, and their different degrees of success in improving food marketing efficiency and reducing the real prices of staple foods, as well as the indirect impacts of the reforms on household food security and poverty alleviation.

Ghana

Even prior to reform, small private traders were already responsible for the bulk of food marketing in Ghana, including staple foods such as maize. Partly in response to the food shortages associated with the drought of 1982-1983, the Government sought to expand the role of the Ghana Food Distribution Corporation (GFDC) in maize marketing activities, notably through pricing stabilization;[26] but the inability of GFDC to maintain this pricing policy—

24 Food and Agriculture Organization of the United Nations, "A guide to maize marketing for extension officers", *Marketing Extension Guide 2* (Rome, FAO, 1999).

25 P. Seppälä, ed., *Liberalized and Neglected? Food Marketing Policies in Eastern Africa*, World Development Studies, No. 12 (Helsinki, United Nations University (UNU) World Institute for Development Economics Research (WIDER), March 1998).

26 See M. Kherallah and others, *Agricultural Market Reforms in Sub-Saharan Africa: A Synthesis of Research Findings* (Washington, D.C., International Food Policy Research Institute (IFPRI), August 2000), chap. 4.

mainly because of its deteriorating finances—contributed to a rapid reversal of State intervention and greater marketing liberalization.

The Economic Recovery Programme (ERP), initiated in 1983 with the support of the Bretton Woods institutions, introduced several market-based macro- and microeconomic reforms. These included the elimination of guaranteed minimum maize prices and the creation of an enabling environment for the expansion of private sector grain trading, including small-scale traders. In the early 1990s, the Government introduced a medium-term agricultural development programme (MTP), covering the period 1991-2000, whose aim was "to establish and support market-led growth in agriculture".[27] MTP reforms included the Government's withdrawal from price fixing and price support operations in the agricultural sector—with the notable exception of cocoa—and a significant reduction in Government subsidies for State agencies, such as GFDC.

Marketing reform has changed the Government's role from that of intervening in food pricing and marketing to one of implementing measures in support of private sector expansion, such as the provision of better storage services to both maize farmers and traders and the construction of rural feeder roads and other infrastructure essential for agricultural and marketing expansion. Improvements in local storage capacity and transport systems have helped to reduce both long-term food prices and their variability.[28] GFDC is now focused on the provision of marketing support services—notably grain drying, cleaning and storage—to private sector clients. Support for small-scale marketing has also had positive gender effects, given that women traders are particularly active in small-scale food marketing in Ghana.[29]

Marketing reform, however, has had mixed results for agricultural development. For example, real grain prices have fallen since 1984 and agricultural output per capita also declined between the mid-1980s and mid-1990s.[30] In addition, the expansion of small-scale agricultural marketing activities has often been hampered by the inability of commercial financial institutions to serve rural areas and the rural poor adequately. In order to deal with this problem, the Government, in cooperation with bilateral donors and multilateral agencies, is currently implementing a programme aimed at strengthening microfinance institutions and improving rural access to financial services, particularly for the poorest segments of the rural population.[31]

Political resistance to further restructuring of GFDC has limited the potential benefits of food marketing reform in the country. Particular problems have arisen from the Government's unwillingness to deal with overstaffing in GFDC and the latter's resistance to making its warehouses fully available to the private sector.[32] It has been recommended that "serious consideration should be given to … selling off or leasing (GFDC) stores and grain handling equipment to the private sector".[33] However, the privatization of grain storage facilities may raise problems of monopoly power in cases where other storage opportunities are limited. As a result, efforts to increase the efficiency of food distribution should address such problems by leasing storage facilities to the private sector and by obliging private operators to facilitate competition by making grain storage services available to third parties on commercial and non-discriminatory terms.[34]

27 See Dordunoo and Dogbey, loc. cit.

28 O. Badiane and G. E. Shively, "Spatial integration, transport costs and the response of local prices to policy changes in Ghana", *Journal of Development Economics*, vol. 56 (1998), pp. 411-431.

29 F. Lyon, "Trust, networks and norms: the creation of social capital in agricultural economies in Ghana", *World Development*, vol. 28, No. 4 (2000), pp. 663-681.

30 T.S. Jayne and others, *Trends in real food prices in six Sub-Saharan African countries*, MSU International Development Working Paper, No. 55 (East Lansing, Michigan, Michigan State University, n.d.).

31 See *Assessment of Rural Poverty: Western and Central Africa…*, p. 61.

32 See J. Coulter and A. W. Shepherd, "Inventory credit: An approach to developing agricultural markets", *FAO Agricultural Services Bulletin 120* (Rome, FAO, 1995), case study 4.

33 Ibid., sect. 7.

34 See, for example, S. Jones and S. Wickrema, "Defining the role of the State in staple food markets", OPM *Policy Briefing Note 3* (Oxford, United Kingdom, OPM, n.d.).

Kenya

Kenya has had a slow and uneven process of marketing reform, for several economic, social and political reasons. Until the 1980s, State intervention in food marketing was exercised through a monopoly, granted to the National Cereals and Produce Board (NCPB), over grain movements between different districts of the country, sales to large grain mills and international agricultural trade. The Government also set a fixed national price for producers. Despite the monopoly status of NCPB, private sector trading (both legal and illegal) accounted for a significant share of marketed maize output. Because of this private involvement in food marketing, as well as restrictions on internal grain movements, NCPB was unable to eliminate disparities between official and parallel market prices, and there were large price differentials among different areas of the country.

In 1980, the country's first structural adjustment programme included limited reform of producer prices, but pressure to reform NCPB met with stiff political resistance. Increased producer prices and a threefold increase in NCPB personnel associated with the establishment of local buying centres in the mid-1980s made that marketing board a considerable fiscal burden to the country. By 1987, NCPB accumulated debt was equivalent to 5 per cent of Kenya's gross domestic product (GDP).[35] Radical reform of NCPB was repeatedly emphasized in structural adjustment and bilateral aid programmes throughout the 1980s and early 1990s, but never fully implemented owing to a lack of political commitment.

Grain marketing reform has, however, made significant progress in other areas. The partial implementation between 1986 and 1991 of a Cereal Sector Reform Programme (CSRP)—with the financial support of the European Union (EU)—allowed grain millers to purchase an increasing proportion of their supplies from the private sector. By 1992, about 50 per cent of (national) millers' requirements were purchased from non-NCPB sources. In addition, small-scale (hammer) mills gained a significant market share from large-scale (subsidized) millers. By the mid-1990s, urban hammer meal consumption had increased to as much as 40 per cent of total maize meal consumption. Given that a large proportion of low-income families own or work in those small urban mills, this is likely to have had a positive impact on poverty alleviation.

Another important outcome of reform has been the partial lifting of controls on grain movements within the country. As a result, consumer prices have fallen in most parts of Kenya as trade flows between surplus and deficit areas rose, and increased private sector efficiency has been encouraged by a "spatial configuration of agricultural production more in line with regional comparative advantage".[36] In addition, the parallel liberalization of the country's fertilizer market has produced broad efficiency gains in the farming sector. There is also evidence that the liberalized maize milling has improved the sector's competitiveness—notably through the expansion of small-scale hammer mills—and contributed to lower maize flour (real) prices.[37]

Nonetheless, in key reform areas, such as NCPB restructuring, price liberalization and allowing licensed buying agents to operate legally in the food market, Kenya's marketing reform programme has suffered from erratic implementation. Opposition to reform by past Kenyan Governments meant that private marketing was liberalized only during the 1990s and only after concerted donor

35 S. Jones and S. Wickrema, "The use of conditionality in reform: food markets in Africa", *OPM Policy Briefing Note 1* (Oxford, United Kingdom, OPM, n.d.).

36 S. Were Omamo and L. O. Mose, "Fertilizer trade under market liberalization: preliminary evidence from Kenya", *Food Policy*, vol. 26 (2001), pp. 1-10. See also J. K. Nyoro and others, "Evolution of Kenya's marketing system in the post-liberalization era", paper presented at the Workshop on Agricultural Transformation in Africa, Nairobi, 27-30 June 1999.

37 Seppälä, op. cit.

pressure. Lack of political commitment, and major weaknesses in the formulation and implementation of the reform programme, have been the two main reasons for the relatively slow pace of reform so far. Although real grain prices gradually fell during the 1990s, further success in marketing reform will require policies to intensify marketing liberalization, including the creation of favourable economic conditions for private sector expansion in food marketing.

Malawi

Malawi's agricultural sector includes a smallholder subsector—which accounts for 70 per cent of agricultural output, including the bulk of food staples—and the private commercial subsector, which mainly produces cash crops.[38] In 1971, the Government set up the State-owned Agricultural Development and Marketing Corporation (ADMARC) to intervene in the purchasing and marketing of agricultural produce. ADMARC had monopsonist powers only in the purchase of non-food crops, such as cotton and tobacco. However, it became increasingly involved in the purchasing and marketing of food products that were supposed to be freely traded, which led to some crowding-out of private traders.[39]

The marketing activities of ADMARC aimed at providing a reliable market for smallholder output; setting uniform national prices that cross-subsidized less competitive farmers living in areas lacking adequate transport networks; and providing subsidized agricultural inputs. It also provided large subsidies for the consumption of maize and rice.[40] The activities of ADMARC during its first decade played an important role in sustaining the smallholder sector and contributing to household food security. However, from the early 1980s onward, ADMARC had increasing difficulty in sustaining its pricing policy, with increasing losses in its food marketing activities, owing to several micro- and macroeconomic problems, including exogenous shocks. These problems included the escalating fiscal cost of producer and consumer subsidies; the inflated number of ADMARC employees and their decreasing productivity; Malawi's falling or negative economic growth rates and deteriorating terms of trade; increasing transport costs arising from the civil war in Mozambique; and falling world prices for tobacco, whose export tax revenues were used to subsidize the marketing board's maize support operations.

As a result of these economic difficulties, as well as aid conditionality, Malawi launched a series of structural adjustment programmes during the 1980s and 1990s, which led to the gradual liberalization of grain pricing and marketing. In fiscal year 1981/82, the producer price of maize was increased by two thirds and the ADMARC statutory monopsony in smallholder agriculture purchases was officially eliminated in 1987, although the State marketing board still remained active in food markets. Despite the considerable pressure exerted by international financial institutions to promote extensive price and marketing liberalization, Malawi has been one of the African countries that most resisted the dismantling of a State marketing agency.

Although price and marketing liberalization led to a considerable increase in maize production, it did not guarantee household food security. While smallholders who are net food sellers have gained from liberalization, small farmers who are net food buyers or who live in remote areas appear to have become worse off.[41] Small-scale traders as a whole—a significant proportion of whom

38 See W. Chilowa, "The impact of agricultural liberalization on food security in Malawi", *Food Policy*, vol. 23, No. 6 (1998), pp. 553-569.

39 The increasing involvement of ADMARC in food marketing was facilitated by its establishment of 1,400 marketing points by the early 1980s. See T. S. Jayne and S. Jones, "Food marketing and pricing policy in Eastern and Southern Africa: a survey", *World Development*, vol. 25, No. 9 (1997), pp. 1505-1527.

40 Chilowa, loc. cit., p. 557.

41 Chilowa, loc. cit.

have relatively low incomes—have benefited from marketing reform, even though they have also faced serious constraints that have hindered their ability to improve marketing efficiency. These constraints include poor and costly transport infrastructure, inadequate storage facilities and lack of credit, training and extension services, including insufficient technical advice. Greater Government (and donor) efforts are thus needed in order to accelerate food marketing reform and ensure that the benefits of improved private marketing efficiency are passed on to consumers, especially the poor.

Mali

The establishment of Mali's agricultural marketing board—*L'Office malien des produits agricoles* (OMPA)—dates back to the mid-1960s. Before marketing reforms, it had a statutory monopoly over grain trade and the authority to set uniform prices for both producers and consumers throughout the country. Food pricing policy was primarily aimed at providing "cheap food to the army, State employees, and the urban population".[42] During the 1960s and 1970s, OMPA was also the main State agency responsible for the distribution of food aid.

Partly as a result of its ineffective monopoly status, questionable food pricing policy and inefficient marketing operations, private traders developed an extensive parallel grain market. By the early 1980s, the OMPA "monopoly" accounted for as little as 15 per cent of total marketed production, although its operational deficit had increased significantly, mainly as a result of its food import operations and (consumer) price subsidies. The increasing fiscal drain of OMPA on the Malian Government's financial resources drove the Government to adopt marketing reforms—with the support of donors—in 1981.[43] Reform has taken place over the past two decades through the gradual implementation of different phases of the Cereal Market Restructuring Programme (*Programme de restructuration du marché céréalier*), known by its French acronym, PRMC.

Phase I of PRMC (1981-1986) aimed at increasing the role of the private sector in official grain trading and reducing subsidies to both producers and consumers. During this phase, physical grain losses were sharply reduced and the operational deficit of OMPA was cut by two thirds. However, the marketing board was unable to maintain the official price at the end of this phase, eventually leading to its withdrawal from price stabilization in order to comply with the fiscal terms of an International Monetary Fund (IMF) structural adjustment programme. The major objectives of OMPA for phase II (1988-1990) included managing a national food security buffer stock and food aid distribution. In addition, donor aid support was channelled into a credit programme for private grain traders. Phase III (1991-1994) focused on extending credit to farmers associations (administered by a State-owned development bank) and promoting the expansion of private sector storage, including the privatization of State-owned storage facilities.

PRMC succeeded in removing OMPA from price stabilization activities and reducing its role in (non-aid) food distribution, together with ensuring greater competition and private sector involvement in food marketing. The increasing fiscal costs of the State marketing system were reversed and average grain output over the period 1985-1991 was 40 per cent larger than the averages for the

42 Jones and Wickrema, "The use of conditionality in reform"… .

43 See, in particular, N.N. Dembele and J.M. Staatz, "The impact of market reform on agricultural transformation in Mali", paper presented at the Workshop on Agricultural Transformation, Egerton University, Nairobi, 27-30 June 1999.

periods 1975-1979 and 1980-1984.[44] There is also evidence that marketing reform contributed to an increase in competition, lower grain distribution costs and improved physical access to grains by consumers.[45] In addition, reduced marketing costs and improved market integration associated with the reform have benefited both urban and rural consumers by improving food access for the poor and by ensuring lower grain prices.

Nonetheless, the continuing responsibility of OMPA for food aid distribution and the national food security stock has continued to be a fiscal burden and has contributed to a distorting of prices. For example, the national food security stock has suffered from "political pressure to provide price support (subsidies) to some producers and to favour certain suppliers in the awards of contracts".[46] In addition, there are still substantial problems in ensuring reliable access to cereals by low-income consumers owing to structural problems that marketing reform alone is unlikely to resolve, including, in particular, poor transport infrastructure in many parts of the country.[47] While some progress has been achieved to date, the future success of the marketing reforms is likely to be compromised unless those problems are dealt with by the Government, with the cooperation of its international partners.

South Africa

South Africa's food marketing system has undergone a decisive transition from being State-controlled to being predominantly market-based, notably in maize marketing. For over five decades up to the mid-1990s, the South African Maize Board (SAMB) operated a price stabilization scheme that provided significant subsidies to maize farmers.[48] The Government began to curtail the activities of this maize marketing board in 1995, although it continued to collect a stabilization levy and to support maize exports. In 1996, new legislation still allowed certain types of market intervention, including the collection of stabilization levies and export controls, although there are important checks and balances. In particular, the Minister of Agriculture must be satisfied that any proposed intervention advances the improvement of market access and the optimization of export earnings, without being significantly detrimental to specific socio-economic objectives, including household food security.

Statutory intervention in the South African maize market ceased in 1997, when SAMB was closed down. Controls over who buys or sells maize, or on the prices at which maize is traded, were abolished, together with all restrictions on maize exports. In addition, the South African Futures Exchange (SAFEX) has been trading future maize contracts on a regular basis for several years. One of the reasons for the growth of SAFEX is that maize market liberalization created a great deal of spot market price volatility and this caused "farmers, traders, and millers to use forward contracts and futures contracts to manage their price risk".[49] However, small-scale, black farmers still contribute a very small part of the marketed grain production of South Africa which, in this respect, is unlike most other countries in Southern Africa.

The effectiveness of SAFEX as a food commodity market was first tested during the 1997 El Niño/Southern Oscillation (ENSO) event.[50] The expected drought in the region caused a sharp rise in futures prices of white maize as millers tried to secure supplies for the following season. The price of yellow maize (not used for human consumption)—which had always been pegged to

44 Jones and Wickrema, "The use of conditionality in reform"… .

45 Coulter and Shepherd, loc. cit., case study 3.

46 Jones and Wickrema, "The use of conditionality in reform"… .

47 See Dembele and Staatz, loc. cit.

48 See, in particular, B. Bayley, *A Revolution in the Market: The Deregulation of South African Agriculture* (Oxford, United Kingdom, OPM, January 2000).

49 S. Jones, op. cit., p. 33.

50 See Jones and Wickrema, "Price stabilization policies in the context of market liberalization"… .

white maize prices under the State marketing regime—increased very little by comparison. This led to a considerable shift to white maize planting by many farmers. As fears of drought receded, futures contract prices fell, showing that markets are often better prepared than State-controlled systems to respond to shocks. The range of risk-hedging opportunities allowed by SAFEX futures contracts thus provides a solution to increased price instability arising from food market liberalization. Other countries in the region—including those with a significant proportion of smallholders—are also considering the use of similar futures markets.

United Republic of Tanzania

Despite initial resistance to marketing reform, the United Republic of Tanzania eventually liberalized maize trading decisively, particularly during the 1990s. Marketing reform in the country can be traced to the "collapse after 1981 of the official marketing system as a result of the unsustainable pricing policies implemented by the National Milling Corporation (NMC)".[51] Even prior to liberalization, parallel markets were handling a significant share of grain trading owing to the inability of NMC to enforce its statutory monopoly status. Illegal trade among different regions was also encouraged owing to differences among local prices arising from Government restrictions on interregional trade.

Although the Tanzanian Government had tried to suppress illegal private trading until 1983, restriction of private marketing was afterwards gradually reduced, as it had become clear that the inefficient and costly State marketing system could neither compete with the (legal or illegal) private sector nor maintain official prices. Marketing liberalization thus merely legalized rapidly expanding parallel grain markets. In 1984, liberalization policies were launched and, as part of structural adjustment programmes, the Government eliminated subsidies for maize. Between 1987 and 1990, restrictions on interregional trade were also removed. Private trading was fully liberalized in 1990, and NMC activities were basically limited to milling maize.

The private marketing system has expanded throughout the country but, partly because of a lack of investment in both greater storage capacity and better transport infrastructure, price fluctuations are still large. The private marketing system has faced other obstacles to its further expansion, notably the lack of credit for purchases and investment. Most of the operators are small traders with a limited amount of capital. The lack of both capital and transport facilities means that many small farmers also have difficulties selling their crops at reasonable prices. Nonetheless, it can be argued that the liberalization of the maize market "has been one of the success stories of agricultural liberalization in Tanzania".[52] Furthermore, while the withdrawal of subsidies has sometimes caused urban riots in other African countries, the availability of maize generally kept pace with demand during and after marketing reform.[53]

Zambia

The main priority of State intervention in food marketing in Zambia has been to benefit urban consumers. The Government established the National Agricultural Marketing Board (Namboard) shortly after independence in the mid-1960s. Namboard monopolized maize marketing and fixed producer and consumer prices until the late 1970s.

51 Jones and Wickrema, "The use of conditionality in reform"... .

52 B. Cooksey, "Marketing reform? the rise and fall of agricultural liberalization in Tanzania", *Development Policy Review*, vol. 21, No. 1 (2003), pp. 67-91.

53 Ibid.

Marketing reform was initiated in 1981, when the Government partially transferred maize marketing to cooperatives and allowed maize meal and fertilizer prices to rise in order to comply with an IMF structural adjustment programme. The Government attempted to reduce maize subsidies in the mid-1980s but the design and implementation of the subsidy reduction programme were badly mishandled and resulted in a reduced supply of maize meal products and sharp consumer price increases.[54] Serious food riots at the end of 1986 prompted the Government to increase subsidies and nationalize large-scale private maize mills. Further attempts to reduce subsidies were made through the introduction of food coupons in the late 1980s but another policy U-turn eliminated the food coupon system in the early 1990s. In addition, Namboard was abolished, the national milling industry was privatized and many production and consumption subsidies were eliminated at around the same time.

Although the State's involvement in marketing was significantly reduced during the first half of the 1990s—following the abolition of Namboard—the State-owned Food Reserve Agency, established in 1995, has continued to use public funds to sell maize to industrial millers below market prices. While this agency's grain sales have been relatively small—given the lack of funding to support its expanded operation—they have contributed to the disruption of private marketing and trading in some local markets. At the same time, the expansion of smallholder production and private marketing has been hindered by poor road infrastructure, and lack of credit and adequate provision of inputs and extension services. This has been particularly detrimental to the rural poor, as it has contributed to a rise in grain (consumer) prices in rural areas. Furthermore, the party winning the 2001 election had run on the premise of reintroducing a food marketing board to provide subsidized maize prices to farmers and consumers and the legislation for the new Crop Marketing Authority was set for parliamentary consideration in 2002.[55]

The rural poor in Zambia will be able to derive significant benefits from liberalized maize marketing only if such policy reversals are avoided, the Government's pro-urban bias is reduced and further reform measures are implemented decisively, including policies to increase agricultural output and productivity, and the provision of the necessary infrastructure and extension services for efficient marketing, as well as adequate technical and financial support by donors. However, the implementation of these policies is likely to fail unless there is full political commitment to reform.

An assessment of food marketing reform in Africa

An examination of reform experiences in selected African countries shows that food marketing liberalization has produced several positive (as well as negative) socio-economic results. One general point is that in most, if not all cases, there was private sector food marketing, whether legal or not. This itself suggests that food marketing boards were not performing their statutory functions effectively.

The withdrawal of marketing boards from food pricing and trading activities has generally contributed to increasing the efficiency and thus reducing the cost of grain distribution. It has also reduced the fiscal burden of State-controlled food marketing systems, which is a particularly important issue in poor countries

54 S. Jones, op. cit., p. 8.

55 T.S. Jayne and others, "False promise or false premise? the experience of food and input market reform in Eastern and Southern Africa", *World Development,* vol. 30, No. 11 (2002), pp. 1967-1985.

with scarce financial resources. Greater spatial market integration arising from the removal of State restrictions on private grain trading between contiguous regions (both subnationally and internationally) has also contributed to lower prices and an increase in the range of food products available. Both rural and (especially) urban consumers in many African countries now have a greater availability of food products as a result of the increased entry of private traders into the food and agricultural marketing sector. While consumer vulnerability to price fluctuations arising from marketing liberalization has sometimes increased in the short run, this negative impact has often been eventually mitigated by greater private investments in grain processing and distribution, as well as inter-regional or cross-border trade, which contributed to the expansion of consumer choice and the ability to stabilize expenditures on maize meal.[56]

Consumers in many countries have generally benefited from efficiency gains of private marketing through lower prices, notably by small-scale hammer mills.[57] A survey of grain and grain meal prices in six African countries that have liberalized food marketing (to different degrees) shows that real prices declined in five of them during the 1980s and 1990s: Mali, since 1982; Ghana, since 1984; Zambia, since 1987; Kenya, since 1988; and Ethiopia, since 1990.[58] There were, however, different reasons for the decline in real consumer food prices in these countries, including increased competition and lower costs in food marketing and processing in Kenya, Mali and Zambia; and better transmission of falling real world prices into the domestic economies by removal of trade barriers in Ghana and Mali. Nonetheless, in all five countries, increased efficiency arising from greater private sector involvement in grain distribution contributed to lower real prices.

At the same time, food market liberalization has given rise to some critical problems that require corrective policy action. First of all, withdrawal of the State marketing boards from food marketing has sometimes made net purchasers of food more vulnerable to short-run price fluctuations, given that State intervention had some success in ensuring price stabilization, even if the benefits of such policies had often been limited by fiscal constraints on marketing boards' ability to defend official prices. Since price fluctuations sometimes have a negative impact on rural (and urban) poverty, corrective measures are required to maintain household food security, including the distribution of (means-tested) food coupons.

Second, some small farmers have been negatively affected by the withdrawal of guaranteed official purchasing at fixed prices, particularly when marketing boards are abolished before an adequate private food marketing system is in place. In addition, the abolition or streamlining of State marketing boards has sometimes disrupted the provision of essential support services to smallholders. The above-mentioned case studies underline that the adequate provision of both credit[59] and extension services is vital for agricultural development in Africa. Similarly, improving infrastructure—notably roads and storage facilities—is critical for raising the efficiency of food marketing activities (carried out by either the public or private sectors). There is particular evidence that lack of rural feeder roads is a major cause of high transportation costs and poor market integration in most African countries.[60]

Third, it is also argued that the removal of fertilizer subsidies arising from food marketing reform has reduced their use by smallholders. This, in turn, has

56 See T.S. Jayne and others, *Successes and Challenges of Food Market Reform: Experiences from Kenya, Mozambique, Zambia and Zimbabwe* (East Lansing, Michigan, Michigan State University, 1999). Those negative short-term impacts, however, suggests a need for targeted action, such as the provision of food stamps for the poor.

57 Ibid.

58 T.S. Jayne and others, *Trends in real food prices*… .

59 It is worth noting, however, that credit provision by marketing boards (and agricultural banks) in the past was not only officially subsidized but sometimes constituted unofficial subsidies through the failure of farmers, many of them politically well connected, to repay loans.

60 See S. Jones (op. cit., pp. 21-22), who also proposes a "road funds" tax earmarked to finance road improvements and maintenance in poor countries.

often had negative effects on agricultural output and productivity, and thus on rural income and poverty. However, evidence from both Kenya and the United Republic of Tanzania indicates that subsidized fertilizer supply benefited primarily commercial farms, as opposed to smallholders.[61] As often happens with general price subsidies granted by public water agencies for both irrigation and household consumption, larger farmers (and higher-income urban-dwellers) tend to benefit disproportionately from such subsidies.[62] Nonetheless, since marketing boards often played a significant role in the supply of (subsidized) inputs to farmers as a whole, their reduced role has sometimes created obstacles for the expansion of agricultural output.

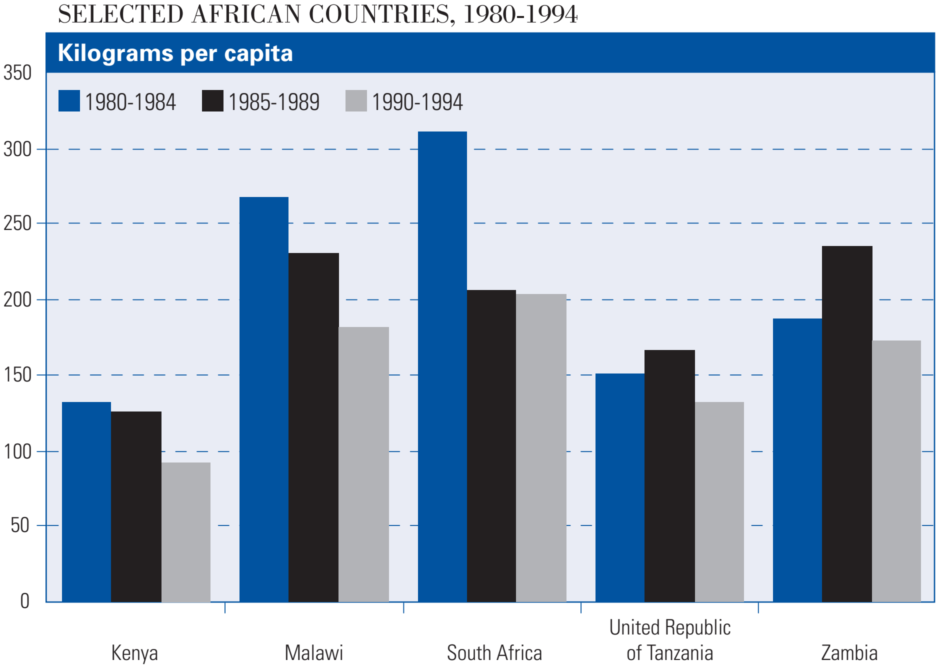
Last, but by no means least, a drop in per capita food production in many African countries in the post-reform period could imply that marketing reform has been generally detrimental to agriculture. As figure VII.2 shows, grain production per capita fell in all five Eastern and Southern African countries covered in this section, although the drop in the first half of the 1990s is partly attributed to the drought that hit Southern Africa in 1991-1992. In addition, this drop in per capita food production is partially associated with some diversification beyond food crops into cash crops, which is generally considered a risk-minimization strategy. In any case, a drop in per capita output does not necessarily entail a welfare loss, given that in most of these countries output levels before market liberalization had been propped up by State subsidies. The operation of marketing boards basically shifts the costs of maintaining economically inefficient State-controlled food systems from one social group to others and, in many cases, large-scale (and wealthier) farmers have benefited disproportionately from such subsidies, including input subsidies.[63]

61 Cooksey, loc. cit., p. 71. See also Omamo and Mose, loc. cit.

62 See *World Economic and Social Survey, 1996* (United Nations publication, Sales No. E.96.II.C.1 and Corr.1), chap. XI.

63 See, in particular, T.S. Jayne and others, *Trends in Real Food Prices*... .

Figure VII.2.
COARSE GRAIN OUTPUT PER CAPITA IN SELECTED AFRICAN COUNTRIES, 1980-1994



Source: UN/DESA, based on T.S. Jayne and S. Jones, "Food marketing and pricing policy in Eastern and Southern Africa: a survey", *World Development,* vol. 25, No. 9 (1997), p. 1518.

Similarly, negative impacts of reforms on smallholders in isolated areas raise the question whether cross-subsidies are preferable to providing an enabling environment for increasing their economic efficiency vis-à-vis more competitive farmers, inter alia, through the State provision of better transport and grain storage infrastructure. Following marketing reform and the withdrawal or reduction of producer subsidies, the production of staple crops in excess of subsistence requirements is not economically viable to many smallholders in remote areas, given that transport costs may exceed the value of the crops themselves. While improved road networks can help to reduce costs, marketing liberalization also has encouraged remote farmers "to change their cropping patterns and identify new crops which have higher value-for-weight ratios and can thus absorb higher transport costs".[64] Marketing boards' withdrawal from—or reduced involvement in—food pricing, purchasing, transport and distribution has thus encouraged food production to be more responsive to demand and consumer preferences.

While food marketing liberalization may have adverse impacts on less efficient farmers, the reversion to State marketing systems with their associated operational inefficiencies, pricing distortions and heavy fiscal cost would be a worse alternative. The move towards greater liberalization in Africa was a result of not only aid conditionality, but also the unsustainable fiscal burden and inefficient operation of State marketing boards. There is, however, concern that, since many sub-Saharan African countries had little experience with market-oriented food systems before the 1980s or 1990s, pricing and marketing liberalization should be implemented gradually.

The case studies show that corrective Government policies to reduce market instability and increase efficiency in both food production and marketing include: (a) improving the transport infrastructure and food storage capacity in rural areas; (b) adequate provision of extension services and credit to both small farmers and private traders; (c) dissemination of reliable market information to smallholders;[65] (d) market-based measures to reduce the effects of price fluctuations, as reflected, for example, in South Africa's innovative experience with future commodity exchanges; and (e) regional trade integration measures, such as those supported by the New Partnership for Africa's Development (NEPAD) (see document A/57/304, annex).[66] Some of these functions were, in theory, supposed to be carried out by marketing boards but, in practice, they were poorly provided by such boards, partly because of their central focus on (and problems with) pricing intervention and direct food marketing. It is now also recognized that food security objectives can be achieved more effectively (and more economically) through targeted socio-economic policies rather than through State marketing boards that have other primary objectives and are often inefficiently operated.

Finally, the development of a competitive (and more efficient) private food marketing calls for effective regulation to deal with potential market failures, detrimental activities by powerful traders and food quality control. Since these functions—notably quality control for food and non-food export crops—were partly carried out by marketing boards, it is critical that other Government agencies enforce food quality regulation after the abolition or streamlining of marketing boards. Effective regulation is important not only to secure export markets but also to ensure adequate standards of human health for domestic

64 Food and Agriculture Organization of the United Nations, "Understanding and using marketing information", *Marketing Extension Guide 2* (Rome, FAO, 2000), p. 3.

65 FAO has produced several useful guides to assist extension workers in sub-Saharan Africa in advising small farmers and traders how best to use market information for marketing maize and other food crops. See, for example, "Understanding and using marketing"...; and "A guide to maize marketing"... .

66 See Declaration on Democracy, Political, Economic and Corporate Governance of 18 June 2002 (NEPAD, n.p.), paras. 3 and 24. See also *World Economic and Social Survey, 2002*, pp. 111-112.

food consumers. The development of a legal framework should also include the clear definition of property rights and a legitimate authority to enforce these rights.[67] In this context, as will be argued in the next section, there is a particularly strong case to be made for strengthening the land-use and ownership rights of small farmers as a means of increasing agricultural productivity and promoting more equitable rural growth patterns.

A MARKET-BASED APPROACH TO LAND REFORM

The central role of land reform in rural poverty alleviation

In most developing countries, agriculture makes a significant contribution to employment, income and economic growth. Policies to promote more efficient and equitable agricultural growth should thus play a central role in rural poverty reduction strategies. Increasing agricultural productivity and output is particularly critical for improving living standards and reducing rural poverty in sub-Saharan Africa, where most of the poor depend on farming for their livelihood.

While much economic research on agricultural productivity focuses on increased mechanization, revolutionary technology shifts and increased soil fertility, higher yields can also be derived from redistributive land reform. Small farms in developing countries tend to be more productive than larger farms per unit of land, notably because hired labour on large farms is usually less productive than family labour, unless there is effective supervision or appropriate incentives—both of which can be very costly.[68] In north-east Brazil, for example, farm yields rose by between 10 and 40 per cent on non-irrigated land and between 30 and 70 per cent on irrigated land that was redistributed to small farmers.[69]

In the 1960s, some economists argued that redistributing land to small farmers would lead to lower crop yields, but subsequent empirical research showed that land redistribution to the poor increased agricultural output per hectare in many developing countries, at least in the medium to long run, for three main reasons.[70] First, small farms often use more labour per hectare—extra labour that might not have otherwise been used—and thus tend to be more productive. Second, as noted above, the costs of supervising farm labour increase with the size of the farm. Third, when small farmers have secure land titles, they are more likely to obtain cheaper and more extensive credit—by using land as collateral—and undertake farm improvements and increase output. More equal patterns of land ownership thus often contribute to faster, as well as more equitable, aggregate economic growth.[71]

Redistributive land reform has traditionally been carried out by (a) distributing unused State lands to the rural poor; (b) expropriating large private landholdings—with or without compensation—for division and distribution to landless peasants and small farmers without land titles; and (c) strengthening the land rights of smallholders. Strengthening the land-use or property rights of small farmers, in particular, has made a significant contribution to the production of greater food output per hectare and thus to poverty alleviation in several Asian developing countries, including the world's two most populous ones.

In India, greater increases in food output and faster poverty reduction were achieved in States that had implemented redistributive land reform.[72] While

67 Jones and Wickrema, "Defining the role of the State"... .

68 See R. A. Berry and W. R. Cline, *Agrarian Structure and Productivity in Developing Countries* (Baltimore, Maryland, Johns Hopkins University Press, 1979); and A. V. Banerjee, "Land reforms: prospects and strategies", mimeo (Cambridge, Massachusetts, Massachusetts Institute of Technology, n.d.).

69 UNDP, *Human Development Report, 2003...*, p. 89.

70 For a detailed discussion of these factors, see *World Economic and Social Survey, 2000* (United Nations publication, Sales No. E.00.II.C.1), chap. V; and E. Wayne Nafziger, *The Economics of Developing Countries* (Upper Saddle River, New Jersey, Prentice Hall, 1997), chap. 7.

71 A recent analysis of incentives conducive to economic growth across countries stresses that more unequal land distribution patterns are often associated with lower growth. See W. Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* (Cambridge, Massachusetts, MIT Press, 2001), chap. 13.

72 *Rural Poverty Report, 2001...* .

increased agricultural productivity in the country is often associated with the green revolution in the late 1960s and 1970s, empirical research covering the period between 1955 and 1988 also shows a clear link between poverty reduction and land reform, notably tenancy reform.[73] The Indian experience indicates, in particular, that a more adequate legal title to ownership or tenancy of land provides an incentive for small farmers to invest in the land and enables them to use land as collateral in accessing the credit market.

China provides one of the most remarkable examples of the positive impacts of land reform on agricultural growth and rural poverty reduction. The household responsibility system (HRS), introduced during the 1978-1984 land reform, was based upon the distribution of collectively owned land to households, mainly according to family size.[74] While collective land ownership was officially maintained, the granting of land-use rights to peasant households linked their remuneration to output. This contributed to reducing costs and boosting agricultural production and rural incomes. Between 1978 and 1984, output of the three main types of crops—grain, cotton and oil-bearing seeds—increased at annual rates of 4.8 per cent, 7.7 per cent and 13.8 per cent, respectively, compared with the average annual growth rates of 2.4 per cent, 1.0 per cent and 0.8 per cent between 1952 and 1978.[75] Similarly, while the per capita income of farmers had risen at an average annual rate of 3.9 per cent between 1949 and 1978, the rate increased to 13.1 per cent between 1978 and 1986.[76] Although there were other reasons for this significant rise of productivity and incomes during the 1980s, such as the expansion of irrigated croplands, land reform played a crucial role in agricultural expansion and socio-economic development. The resulting fall in rural poverty is ultimately attributed to the "combined impact of egalitarian distribution of communal lands, better seeds, more irrigation and less repression of farm prices".[77]

In Viet Nam, rapid growth of agricultural output, achieved through land redistribution and market liberalization, is considered the main reason for the country's success in reducing poverty during the 1990s.[78] The liberalization of the agricultural sector began in the late 1980s with the granting of long-term land leases, the lifting of price controls and the gradual removal of restrictions on agricultural trade. A 1993 law allowed landholders to sell, lease and inherit land, and use it as collateral. Private ownership of agricultural machinery and farm animals, as well as the right to buy and sell them, was also permitted. These reforms allowed the development of a private land market and the eventual privatization of agriculture. Greater security of tenure, particularly from the distribution of collective farmlands to small-scale farmers, has been responsible for increased productivity and agricultural diversification, notably into cash crops with large export potential, such as rice and coffee. Recent research also indicates that land reform led to a considerable increase in the total area devoted to (more productive) multi-year crops between 1993 and 1998.[79]

The strengthening of land property rights achieved under Viet Nam's decollectivization programme can be considered a type of *market-oriented* land reform in that it has led to the development of private land markets. Tenure reform is based on the recognition that rural economic development requires a secure system of property rights for small farmers that encourages investment and facilitates access to credit. In cases where land markets do not function satisfactorily, and where it is impossible to enforce land repossession, formal land

73 See *Human Development in South Asia 2002: Agriculture and Rural Development* (Karachi, Oxford University Press, 2003).

74 See *World Economic and Social Survey, 2000…*, p. 144.

75 Fu Chen, L. Wang and J. Davis, "Land reform in rural China since the mid-1980s", *Land Reform*, No. 2 (1998), pp. 122-137. While HRS has succeeded in raising agricultural productivity and output, the authors identify several institutional weaknesses and propose measures to strengthen land use or property rights. See also J. M. Zhou, "Principal forms of land consolidation and expansion in China", *Land Reform*, No. 1 (2000), pp. 89-107.

76 See United Nations University (UNU), *The Impact of Economic Development on Rural Women in China* (United Nations publication, Sales No. E.92.III.A.2).

77 *Rural Poverty Report, 2001…*, chap. II, p. 28, see also chap. III. According to this report, the rural Poverty Head Count Index in China fell from 33.0 in 1978 to 11.5 in 1990 and to 4.6 in 1998 (see table 2.1).

78 See, for example, *World Economic and Social Survey, 2000…* , box VIII.3; and World Bank, "Viet Nam: Delivering on Its Promise", Development Report 2003, No. 25050-VN (Washington, D.C., World Bank, November 2002), pp. 45-50.

79 See Q.T. Do and L. Iyer, "Land rights and economic development: evidence from Viet Nam, mimeo (Cambridge, Massachusetts, MIT, July 2002).

titles tend to be useless as collateral.[80] Secure access to land—in the form of ownership or long-term rental—also tends to reduce landless peasants' dependence on poorly paid and volatile rural labour markets.

Land tenure reform is particularly suitable to countries with large numbers of labourers working on State farms or small farmers working on State-owned lands. Market-oriented land reform can also be used to settle landless peasants and smallholders without land titles in countries with large tracts of unused State land that are suitable for agriculture. By contrast, countries with large numbers of landless peasants—or small farmers without land titles—and whose most arable land is formally owned by private landlords, have often redistributed such land through coercive measures. While coercive land reform is normally associated with expropriation without compensation, land redistribution can also be based on compulsory purchase below market prices.

Japan, for example, was one of the first countries to successfully implement this type of land redistribution in the modern world, during the late 1940s and early 1950s. The State played a central role in that programme by redistributing land owned by large landholders in equal lots to landless peasants and smallholders for individual ownership. The Government also implemented a range of complementary policies, including the adequate provision of credit and extension services for small farmers. More controversial measures—such as Government subsidies, tax preferences and import barriers—also contributed to the success of land reform in the country. Since many of the new (small-scale) landowners had been tenants working the land prior to reform, the implementation of the programme was further facilitated by the fact that the beneficiaries had a proved capacity to work (and even manage) the farms they received.

Japan's pioneering programme was different from other coercive types of land reform—notably those associated with widespread political upheaval[81]—in that former landowners were at least partially compensated for the expropriated land by the Government, "which reconveyed the fields at nominal prices to the small sharecroppers already working on them".[82] Japan's land redistribution programme contributed to increasing productivity and raising the small farmer's income substantially.[83] Successful land reform programmes—sometimes even State-controlled programmes, as in Japan—can thus lead to both greater aggregate economic growth and a more equitable income distribution among farmers as well as between farmers and non-farmers.[84]

Although land reform programmes similar to the one implemented by Japan were subsequently introduced successfully in the Republic of Korea and Taiwan Province of China, other forms of land reform have been used more extensively in developing countries, ranging from more radical coercive approaches to market-based land reform. The rest of this section focuses on the latter approach.

The case for market-based land reform

Interest in market-based land reform has increased because of the problems with coercive forms of land reform—notably land expropriation without compensation—in many developing countries. First of all, because land expropriation is fundamentally inconsistent with the protection of private property rights, it tends to undermine private investment and even "international confi-

80 See H. de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York, Basic Books, 2000), who argues that the formal recognition of property rights would enable property currently held informally to be used as collateral and thus unlock the "hidden" capital assets of the poor.

81 In the past, most (coercive) large-scale land redistribution was associated with socio-political revolts or the demise of colonial rule. See H. Binswanger, K. Deininger and G. Feder, "Power, distortions, revolt and reform in agricultural land relations", in *Handbook of Development Economics*, vol. III, J. Behrman and T. Srinivasan, eds. (New York, Elsevier, 1995), pp. 2659-2772.

82 M.G. McDonald, "Agricultural landholding in Japan: fifty years after land reform", *Geoforum*, vol. 28, No. 1 (1997), p. 58.

83 *World Economic and Social Survey, 2000…*, p. 139.

84 Recent research, however, point to long-term problems with Japan's pioneering land reform programme, including lower efficiency arising from land fragmentation and political obstacles to the expansion of the non-farm economy. See, for example, M. G. McDonald, loc. cit. and J. M. Zhou, loc. cit.

dence in the economy".[85] In addition, landowners and other local elites often use political power to weaken the implementation of coercive land redistribution programmes. Reaction to the confiscatory nature of these programmes has led powerful landowners to slow down their implementation through various legal or other means, including subdividing their land to evade expropriation or submitting the plots unsuitable for agriculture for compulsory purchase.[86] Resistance to expropriation, in turn, has often led to political instability and more radical, undemocratic responses by Governments.

Second, Governments sometimes attempt to introduce coercive land reform as a response to immediate socio-political pressure rather than as part of a long-term rural development strategy. For example, Government efforts to redistribute land are often made in regions where well-organized and politically active land reform movements exist.[87] As a result, such efforts tend to ignore the needs of the poorest peasants, who are often disorganized. In addition, efforts to placate the most vigorous peasant organizations may open the way for political manipulation, the inappropriate selection of both the beneficiaries and the tracts of land expropriated, and even the exacerbation of social conflict.[88]

A third problem is that many land reform programmes became inefficient because they were often accompanied by a considerable expansion of agrarian reform bureaucracies at the central Government level. Political interference can also contribute to the undermining of land redistribution and lower land-use efficiency when land is allocated for speculative rather than productive purposes. It is argued, for example, that this was a major problem in Kenya's attempt to replace the colonial land tenure system with a new system in which Africans purchased land from Europeans between 1954 and 1974. Although huge tracts of land were transferred to Africans in the central and western highlands, "the political leadership redistributed most of the land to itself, allies, and clients, many of whom had no experience in farming".[89]

Similarly, it can be argued that coercive land reform tends to be supply-driven and thus to lead to greater economic inefficiency.[90] This aspect is significant because coercive forms of land reform usually begin by identifying farmland for expropriation and then looking for potential landless beneficiaries to receive and settle on this land. Lower land-use efficiency results when productive farms (as opposed to underutilized land) are expropriated and given to settlers who lack the knowledge and means to become efficient producers or when environmentally fragile land is distributed by the State. Even in countries with a long history of smallholder agriculture, State institutions have been ineffective at targeting underutilized land and in achieving the intended gains in economic efficiency.[91]

The final—and arguably most significant—problem is that coercive forms of land reform often distort the operation of land markets. Two of the most useful functions of (arable) land markets are to allow more efficient producers to purchase or increase their landholdings and, conversely, to allow inefficient farmers to exit from agriculture. While there are structural obstacles that hinder the rural poor from obtaining land through the market, evidence also shows that State institutions in many developing countries use regulatory tools to restrict (rather than facilitate) land use, sales and rental, as part of coercive land reform programmes.[92] In the absence of these restrictions, "land rental markets tend to be friendlier to the rural poor … in allowing them access to

85 K. Deininger and J. May, "Is there scope for growth with equity: the case of land reform in South Africa", mimeo (Washington, D.C., World Bank, 2000).

86 See, for example, A. de Janvry and E. Sadoulet, "A study in resistance to institutional change: the lost game of Latin American land reform", *World Development*, vol. 17, No. 9 (1989), pp. 1397-1407.

87 K. Deininger, "Making negotiated land reform work: initiatives from Colombia, Brazil and South Africa", *World Development*, vol. 27, No. 4 (1999), pp. 651-672.

88 See United Kingdom Department for International Development (DFID), "Better livelihoods for poor people: the role of land policy", consultation document (London, DFID, November 2002).

89 E. Wayne Nafziger, op. cit., p. 194.

90 See S. M. Borras, "Towards a better understanding of market-led agrarian reform in theory and practice: focusing on the Brazilian case", *Land Reform*, vol. 33, No. 1 (2002), pp. 32-50.

91 Deininger and May, loc. cit., p. 20.

92 See A. de Janvry and others, "Access to land and land policy reforms", in *Access to Land, Rural Poverty and Public Action*, A. de Janvry and others, eds. (Oxford, United Kingdom, Oxford University Press, 2001), pp. 1-26; and K. Deininger and H. P. Binswanger, "The evolution of the World Bank's land policy: principles, experiences and future challenges", *World Bank Research Observer*, vol. 14, No. 2 (1999), pp. 247-276.

land", owing to lower transaction costs and greater opportunities for mitigating the market failures to which the rural poor are exposed.[93]

When coercive land reform programmes create or exacerbate socio-economic tensions among central or local Governments, large landowners and smallholders or landless peasants, they tend to escalate social conflict and undermine agricultural development, as was the case in parts of Brazil, the Philippines and Zimbabwe. There are, however, several non-coercive alternatives for improving land distribution—without resorting to expropriation of private landholdings—that may also increase agricultural productivity and reduce rural poverty. These include (a) the distribution of unused State lands that are neither environmentally fragile nor unsuitable for agriculture, (b) the introduction of progressive land taxes to discourage ownership of large tracts of land for non-productive purposes over the long run and (c) market-based land reform.

Market-based land reform could be particularly suitable for countries with little unused State lands and with large numbers of landless peasants and small farmers without satisfactory claims to (arable) land rights. Its main innovation is to enable beneficiary farmers to receive grants from State institutions in order to purchase land from voluntary sellers at market prices. This "willing seller-willing buyer" approach differs markedly from land expropriation, as it can encourage landowners to sell idle land, and provide an alternative to illegal occupation by landless peasants.

A market-based approach to land redistribution is thus, to a large extent, *demand-driven* in that it involves voluntary exchanges between willing buyers—initially assisted by a Government grant—and land sellers in the market. Rather than depend on Governments' deciding who will benefit from expropriated land—sometimes on political grounds—the potential beneficiaries themselves "compete" for available land in the market. The potential beneficiaries who want land the most, and who are best prepared to farm it, are likely to navigate the screening process for obtaining the Government grants better than other segments of the peasantry. This would lead not only to more effective targeting but also to higher productivity, given that the most skilled potential farmers are likely to be more successful in obtaining land than those with little interest in or knowledge of farming.

This approach is intended to stimulate the operation of rural land markets from both the supply and the demand sides. On the supply side, it encourages landowners to undertake the reduction of their holdings of (underutilized) farmland, which could be reinforced by the introduction of progressive land taxes and other fiscal mechanisms. On the demand side, it provides Government grants to poor small farmers or rural labourers with farming experience to purchase land through the market. In order to strengthen the bargaining position of potential beneficiaries and to reduce transaction costs, beneficiaries are encouraged to join community organizations designed for those purposes. These organizations, sometimes in cooperation with local Governments or rural financial institutions willing to provide loans to beneficiaries, can help to screen applicants, negotiate purchases on their behalf and provide follow-up technical assistance.

Several developing countries, such as Brazil, Colombia, Ecuador and South Africa, have experimented with market-based land reform. Since implementation is most advanced in South Africa, the following section will examine its

93 A. de Janvry and others, op. cit., p. 15.

experience with this innovative approach to land reform and assess its effectiveness as an alternative to coercive forms of land reform.

Market-based land reform in South Africa

As in most sub-Saharan African countries, there is a much higher incidence of poverty in rural (as opposed to urban) areas in South Africa. As shown in table VII.1 in 1995, 71 per cent of all rural-dwellers were classified as poor, compared with 29 per cent of urban-dwellers. Furthermore, rural households headed by women are likely to suffer from poverty more than male-headed households: estimates show that female-headed households accounted for 77 per cent of all poor households living in rural areas in 2000.[94] This is partly explained by the existence of a relatively developed non-agricultural sector—notably mines and manufacturing—which has encouraged migration of rural adult males to urban and mining areas, leaving many women, children and elderly persons in rural areas.[95]

Poverty in South Africa is not only associated with gender but also very much race-related: over 60 per cent of black South Africans were poor in the mid-1990s, compared with only 1 per cent of whites (see also table VII.1). Many of the reasons for this race-related, as well as rural, characteristic of poverty in South Africa can be traced to past apartheid policies. One of the most important causes was the exclusion of black South Africans from owning or renting land outside so-called homelands covering less than 15 per cent of the country's area. In 1997, there were at least 900,000 black households living in former homelands without access to arable land and it is estimated that more than 80 per cent of arable land was still owned by white farmers in the late 1990s.[96]

In order to deal with this highly unequal pattern of land ownership, the South African Government began to implement an extensive programme of land reform in the mid-1990s. This programme consisted of three main components: (a) the restitution of or compensation for land lost by black citizens due to colonial or apartheid policies; (b) the redistribution of white-owned farmland to black farmers; and (c) land tenure reform to provide more secure access to land in the former homelands.[97] Given the large number of black households that wanted to gain access to land, but lacked the required documentation or were otherwise ineligible to participate in either the restitution or the tenure compo-

94 M. Aliber, "Chronic poverty in South Africa: incidence, causes and policies", *World Development*, vol. 31, No. 3 (2003) pp. 473-490.

95 In many African countries, there are also institutional obstacles to women's access to land ownership titles. See, for example, African Development Bank, "Achieving the Millennium Development Goals in Africa: Progress, Prospects and Policy Implications" (n.p., June 2002).

96 See M. Aliber, loc. cit., p. 480; and J. Kirsten, S. Perret and J. van Zyl, "Land reform and the new water management context in South Africa: principles, progress and issues", paper prepared for a seminar of the Natural Resources Management and Land Policy Thematic Group (Washington, D.C., World Bank, September 2000).

97 For details of this comprehensive land reform programme, see L. Cliffe, "Land reform in South Africa", *Review of African Political Economy*, No. 84 (2000), pp. 273-286; and M. Aliber, loc. cit.

Table VII.1.
POVERTY IN SOUTH AFRICA, 1995

Indicator	Number of people (thousands)	Proportion of population (percentage)
National poverty	19 700	49.9
Poverty in rural areas	13 700	70.9
Poverty in urban areas	6 000	28.5
Poverty among black population	18 300	60.7
Poverty among white population	44	1.0

Source: K. Deininger and J. May, "Is there scope for growth with equity: the case of land reform in South Africa", mimeo (Washington, D.C., World Bank, 2000). table 1a.

nents, redistribution became the major pillar of land reform in the country. The Government set ambitious targets for land redistribution: the (voluntary) transfer of almost 30 million hectares of farmland—that is to say, 30 per cent of the country's total arable land area—between 1995 and 1999.

Particular efforts were made to formulate a land redistribution programme that avoided the above-mentioned problems connected with coercive forms of land reform—notably expropriation, compulsory acquisition below market prices and the expansion of agrarian reform bureaucracies. Greater emphasis was thus placed on assisting potential beneficiaries, including landless peasants who had been dispossessed during apartheid, to purchase land through the development of land markets. This innovative approach to land redistribution was based upon the provision of a Government grant—known as the Settlement and Land Acquisition Grant (SLAG)—to enable rural households to purchase arable land in the market. The SLAG was originally equal to the maximum subsidy under the national housing programme, that is to say, 16,000 rand (R) (equivalent to approximately US$ 2,000 at present). The grant was available only to potential beneficiaries with a monthly income below R 1,500.

Potential beneficiaries could use the grant to purchase land on offer from private owners so long as the purchased land was intended for an agricultural use, such as cultivation of cash crops, grazing or even subsistence farming intended to improve household food consumption. Large landowners could initiate transactions, for example, by dividing a portion of a commercial farm into small parcels for sale under the programme. In addition, property developers could purchase arable land (with private funds, rather than Government grants), build basic infrastructure, divide it into parcels and then sell it to beneficiaries under the programme. Potential beneficiaries were otherwise responsible for designing their own projects, although they could use grant money to hire consultants for that purpose.

In practice, beneficiaries have often grouped together in order to obtain the grant, design projects and acquire land collectively. This type of collective action was particularly encouraged after the Government enacted the Communal Property Associations Act in 1996. This Act established mechanisms to finance and facilitate community initiatives to purchase land on behalf of groups of landless citizens. However, an unexpected degree of State interference in providing assistance to these community initiatives had an adverse impact on the implementation of the market-based land redistribution programme. The Department of Land Affairs (DLA), established by the Government to implement the land reform programme, played a central role in mobilizing community associations, on behalf of potential beneficiaries, to access different types of grants available for land purchases. The paternalistic way in which proposed projects were dealt with by DLA slowed down the programme's implementation: it is estimated that it took an average of two years to approve a project.[98]

As a result, the land redistribution programme failed to avoid one of the major problems faced by coercive programmes as "it has become an over-centralized and bureaucratic process where the public sector tries to do everything".[99] Bureaucratic delay in the implementation of the programme was partly responsible for its failure to meet the land redistribution targets. Between 1995 and 2000, less than 1 per cent of the country's commercial farmland was

98 Deininger and May, loc. cit., p. 24.

99 See Kirsten, Perret and van Zyl, loc. cit.

willingly sold by private landowners under the programme: 0.6 per cent to less than 60,000 beneficiaries and another 0.3 per cent in the form of municipal commonages.[100] This disappointing rate of land transfer was also associated with other obstacles to participation by the poor in market-based land reform. These obstacles included (a) upfront costs not covered by the Government grant, (b) human capital constraints associated with modern farming, (c) low geographical mobility of certain groups of landless peasants and small farmers without land titles and (d) inadequate provision of rural and extension services required for the success of small-scale farming.[101]

The poor rate of delivery during the second half of the 1990s was mitigated, however, by the fact that most of the transferred land was used for cultivation and other agricultural purposes,[102] with less than 5 per cent being left idle in 1999 (see figure VII.3). This supports the argument that market-based land reform reduces the incentive for maintaining farmland for speculative purposes, and successfully targets smallholders and landless peasants who are better prepared to use redistributed land productively. In addition, a considerable proportion of successful beneficiary farmers were also able to (collectively) obtain complementary private loans. This is significant for two reasons: (a) it proves that beneficiaries with land titles can gain access to sources of credit other than the Government grant and (b) it encourages private lenders to help to strengthen the screening process so as to ensure that the most suitable applicants purchase redistributed land. There is also evidence that the programme succeeded in reaching the rural poor: a survey conducted in 1999 shows that three quarters of land reform beneficiaries were below the national poverty line.[103]

In addition, significant progress has been made in improving access to irrigation water for small farmers, a particularly important prerequisite for the

100 See M. Aliber, loc. cit. Since under municipal commonage schemes, landownership is vested in the municipality and is made available to low-income households, mainly for the grazing of their livestock, it is particularly difficult to quantify the exact number of beneficiaries.

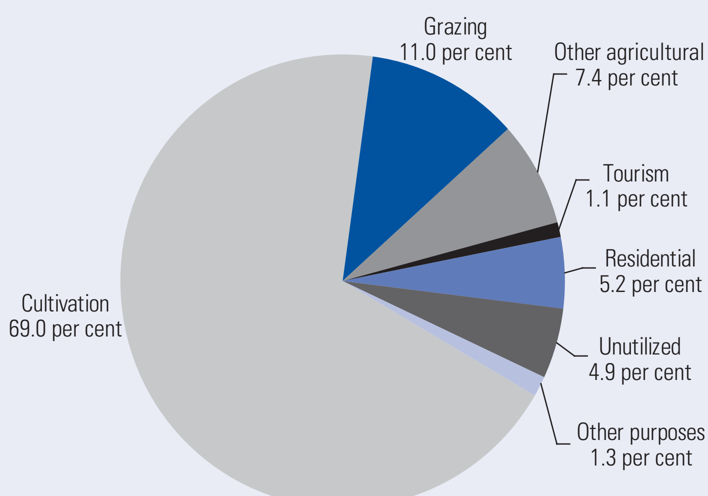
101 See F. J. Zimmerman, "Barriers to participation by the poor in South Africa's land redistribution", *World Development*, vol. 28, No. 8 (2000), pp. 1439-1460.

102 Although this is usually a requirement of land redistribution programmes—both market-based and State-controlled ones—in practice, large plots of redistributed land often end up in the hands of speculators without farming experience.

103 Deininger and May, loc. cit., p. 14.

Figure VII.3.
DISTRIBUTION OF LAND TRANSFERRED UNDER THE SOUTH AFRICAN REDISTRIBUTION PROGRAMME, BY TYPE OF USE

In projects approved by 1999



Source: UN/DESA, based on data supplied by the South African Department of Land Affairs (as mentioned in Cliffe, "Land reform in South Africa", *Review of African Political Economy*, No. 84 (2000), p. 281).

success of land reform. The South African National Water Act of 1998 recognized that water must be used to promote socio-economic development and introduced a series of innovative measures to tackle the highly unequal patterns of access to water resources in the country, including the strengthening of water user associations and smallholding irrigation schemes.[104] Although there are difficult transition issues arising from past apartheid water resource policies, the new water policy formulated in the Act can be "a powerful tool to achieve equity, poverty alleviation and development in rural areas".[105]

Furthermore, market-based land reform took place in the context of broader economic liberalization in the country. Relevant liberalization policies included the withdrawal of State agencies from agricultural marketing activities and a movement from State-controlled prices towards market-determined pricing, as the experience of the above-mentioned SAFEX market illustrates. It also included the reduction or removal of input subsidies to commercial (white-owned) farms that created distortions in the agricultural sector. These subsidies contributed to South Africa's focus on the production of low-value crops (such as wheat), rather than "specialization in labour-intensive production of high value crops and agro-exportables that one would expect given the country's natural endowment".[106] In addition, there was a major restructuring of financial institutions, including rural financial agencies, and greater public investment in physical and social infrastructure, notably rural roads, schools and hospitals. These complementary economic policies to promote macroeconomic and sectoral liberalization were essential for the introduction of market-based land reform in the country. This broad process of economic liberalization was closely associated with an increase in the number of land transactions: while an annual average of 4.5 per cent of arable land had changed hands during apartheid, this figure increased to more than 6 per cent in both 1997 and 1998.[107]

Nonetheless, by the late 1990s, it became clear that the major challenges were how to accelerate the redistribution of land and to provide more effective extension services to farmers already resettled under the programme. It became increasingly recognized that the long-term economic viability of the land reform programme required new measures to create greater opportunities in small-scale commercial agriculture and to streamline programme implementation. The revised market-based programme, entitled "Land Reform for Agricultural Development", was launched in 2001 with a number of key adjustments, summarized below.[108]

In order to increase the pace of land redistribution and reduce bureaucratic delay, implementation has been decentralized. While district-level officials now provide assistance to applicants in the preparation of project proposals, a committee at the provincial (as opposed to national) level has become responsible for approval of those project proposals. As a result, beneficiaries can now join the programme, purchase land from willing sellers and obtain land titles more swiftly than in the original programme. By speeding up the effective transfer of underutilized land to small farmers, the revised programme is expected to accelerate the growth of agricultural output and income, and thus contribute to alleviating rural poverty.

The most significant adjustment is that all beneficiaries must now make a contribution—in cash, labour and/or kind—in order to obtain the grant. The minimum grant amount requires a minimum personal contribution of R 5,000

104 See S. R. Perret, "Water policies and smallholding irrigation schemes in South Africa: a history and new institutional challenges", *Water Policy*, No. 4 (2002), pp. 283-300; and Kirsten, Perret and van Zyl, loc. cit.

105 See, in particular, Perret, loc. cit., p. 298.

106 Deininger and May, loc. cit., p. 6.

107 Ibid., p. 7.

108 See Kirsten, Perret and van Zyl (loc. cit.) for details of the revised programme.

(approximately US$ 650 at 2003 exchange rates). Greater grant amounts are available to beneficiaries on a sliding scale, according to the size of their contribution (see table VII.2). As the amount of the grant and the amount of the contribution increase, there is a decline in the size of the grant as a proportion of total project cost. Both the grant and the contribution are calculated on a household basis. If beneficiaries decide to apply collectively, the personal contribution and the total grant are both scaled by the number of households represented in the group.

While the programme continues to focus on achieving a more equal distribution of land ownership (between black and white landholders), the introduction of personal contributions is intended not only to strengthen the commitment of beneficiaries in their projects, but also to increase the average grant amount (and thus the personal contribution) per beneficiary. This may make it harder for some potential (very poor) applicants to access the Government grant. The personal contribution mechanism thus implies that the revised programme is aimed more towards farmers intending to undertake the establishment or expansion of small and medium-sized commercial farms than towards poor landless peasants without any assets. As a result, there has been some concern that the poorest segments of the peasantry will be priced out of the revised land redistribution programme. One preliminary analysis of the revised programme, for example, concludes that a "clear danger under the demand-led rationing scheme is that the wealthier segments of the rural population will prove more apt to participate, and will therefore be the major beneficiaries, while the poorer segments will be left largely without programme benefits".[109]

[109] F.J. Zimmerman, loc. cit., p. 1441.

To assess whether the revised programme will have a significant positive impact on rural poverty alleviation in South Africa would be premature. It is evident, however, that by increasing access options to (different amounts of) grants, the revised programme should facilitate structural change in the long run with the establishment of greater numbers of competitive small and medium-sized farms producing food and cash crops. It is also expected that the best-prepared beneficiary farmers will use the distributed land more productively.

That a cash contribution is provided by beneficiaries means that the new landowners now have a greater incentive to use the land for the most productive uses so as to maximize returns on personal investment. The minimum contribution to the total costs of projects will also help to screen out applicants who are

Table VII.2.
LAND REDISTRIBUTION IN SOUTH AFRICA: SLIDING SCALE OF GRANTS AND PERSONAL CONTRIBUTIONS

Government grant (rand)	Own contribution (rand)	Total project cost per household (rand)	Share of grant (percentage)	Share of own contribution (percentage)
20 000	5 000	25 000	80	20
40 871	35 000	75 871	54	46
68 888	145 000	213 888	32	68
100 000	400 000	500 000	20	80

Source: J. Kirsten, S. Perret and J. van Zyl, "Land reform and the new water management context in South Africa: principles, progress and issues", paper prepared for a seminar of the Natural Resources Management and Land Policy Thematic Group (Washington, D.C., World Bank, September 2000), p. 10.

interested in an easy transfer of wealth but do not have the intention of farming the redistributed land. As a result, the share of unutilized land in approved projects is likely to drop even below the 5 per cent figure recorded in the original land redistribution programme. In addition, by promoting the growth of small and medium-sized commercial farms, the programme is also expected to encourage increased involvement of private financial institutions in project implementation through the provision of complementary (private) loans. This will not only reinforce beneficiaries' commitment to the success of their farms, but also encourage private lenders to strengthen the screening process and to provide independent monitoring of projects after they come on-stream.

The revised programme is intended to increase agricultural output, stimulate rural income growth—notably the income of beneficiaries—and improve land-use efficiency, given that small-scale beneficiaries often convert underutilized farmland to productive purposes. By ensuring greater agricultural output and productivity by small farmers, market-based land reform can indirectly contribute to growth in rural areas and more equitable rural development patterns (notably with respect to white and black farmers). It cannot, however, eradicate rural poverty on its own. In order to maximize its effectiveness, the revised programme, like all forms of land reform, also needs to be complemented by better infrastructure, such as rural roads, the provision of agricultural support services and adequate financial resources for its implementation.

While it has sometimes been argued that the implementation of market-based land reform would be hindered by its cost, the annual capital expenditure on the original South African land redistribution programme at the peak fiscal year (1998/99) was equivalent to only 0.2 per cent of the total annual government budget.[110] Although this relatively insignificant share of Government expenditure can also be associated with the poor rate of delivery of the original land redistribution programme, the annual expenditure on the provision of the physical and social infrastructure required to support, for example, 40,000 small-scale beneficiaries under the revised programme would be less than 1 per cent of general Government expenditure in 2001.[111] The provision of infrastructure and agricultural support services—in addition to the provision of Government grants—is thus within the budget of many developing countries. What is required is the political will to give greater priority to redistributive land reform within broader rural development strategies and to invest in the infrastructure and services required to support the activities of land redistribution beneficiaries, with the aim of turning many rural people into landowners.

An assessment of market-based land reform

It is increasingly recognized that market-based land redistribution programmes can be a useful alternative to coercive forms of land reform in many developing countries. While the implementation of market-based land programmes can be slowed down by teething problems, the South African experience shows that this type of land reform can be adjusted to respond to such problems without compromising the shift towards greater economic efficiency in the operation of land and agricultural markets. Market-based schemes also tend to be far less politicized than coercive approaches.[112]

110 See A.V. Banerjee, loc. cit., p. 31; and M. Aliber, loc. cit., p. 486.

111 See Kirsten, Perret and van Zyl, loc. cit. This estimate includes water supply and sanitation, electricity, and rural roads, as well as health and education. At this rate, it would take 11 years to successfully settle as many as half of the 900,000 landless households living in the former homelands in 1997. The term "general government expenditure" is used as defined in *World Development Report, 2003* (Washington, D.C., World Bank, Oxford University Press, 2003).

112 It is worth noting, however, that similar initiatives have been fiercely opposed by landless or revolutionary movements in other developing countries, such as Brazil, Colombia and the Philippines.

At the same time, market-based approaches to land redistribution are likely to be implemented more effectively when targeted towards beneficiaries with agricultural skills and at least a little financial capital reserve. By encouraging the most dynamic segments of the peasantry to obtain arable land, market-based programmes can thus increase agricultural efficiency (a particularly important objective in countries with relative scarcity of arable land), output and rural incomes. In addition, market-based schemes often contribute to the development of land markets and make them more accessible to peasants with lower incomes, even when the poorest landless peasants experience difficulty in participating in those schemes.

As a result of this focus on increased productivity, the poorest (and least competitive) segments of the peasantry may have difficulty participating in schemes such as the South African one. Market-based programmes, on their own, are thus unlikely to transfer enough land to meet the needs of all poor rural people with the desire and the ability to farm it. When countries opt for market-based approaches to land redistribution, the State still has an important role to play, without necessarily deciding which land parcels change hands. In this regard, Governments need: (a) to draw up the criteria for selecting beneficiaries; (b) to reserve areas that are environmentally inappropriate for farming; (c) to provide grants and loans for land purchases; (d) to provide extension services and better transport infrastructure; and (e) to consider complementary policies to reach landless peasants unable to benefit from existing programmes. Market-based land reform can be a more effective policy tool when it becomes an integral part of a larger rural development and poverty alleviation strategy.

Market-based reform could be particularly useful in countries such as South Africa with little unused arable land and many landless peasants and smallholders without clear-cut claims to land rights. South Africa's experience with land reform could thus be relevant to other developing countries—not only in sub-Saharan Africa, but also in Latin America and parts of Asia—with highly unequal patterns of land distribution. In Southern Africa, for example, market-based land schemes could be implemented, at least to a limited extent, in countries such as Malawi and Namibia—where land reform is urgently needed—and could have offered a less conflictual option for land reform in Zimbabwe.[113] In other countries—such as Angola, Mozambique and the United Republic of Tanzania—where there are large tracts of unused State-owned land suitable for agriculture—smallholder expansion does not require land reform measures, as much as credit, extension services and improved rural infrastructure.

113 There are, in fact, proposals for a market-based scheme intended to benefit 15,000-20,000 rural households in Malawi.

CONCLUDING REMARKS

Over the past two decades, the Governments of many poor countries have realized that certain types of State intervention in the agricultural sector have created economic inefficiencies and unsustainable fiscal cost, besides proving generally ineffective in ensuring sustained rural economic growth. In addition, bilateral and international donor or lender institutions have become increasingly unwilling or unable to fund the rising cost of direct State intervention in agricultural production and marketing, as well as the maintenance of inefficient land-use policies. This has led to greater emphasis on market-based approaches aimed at improving both the efficiency and the cost recovery of agricultural production and marketing. These approaches, however, have produced mixed results in respect of rural poverty alleviation. The major challenge for the future is therefore to implement corrective measures to deal with reform problems while maintaining the efficiency improvements, marketing cost reductions and fiscal savings that have resulted from market-based approaches to reform.

Future efforts to consolidate or intensify food marketing reform in African (and other developing) countries must thus be better integrated into broader rural development strategies focusing on household food security and poverty alleviation. It is crucial, however, to design and use alternative instruments to achieve the food security objectives that many developing countries have long pursued through food marketing boards. Reform should have increasing the efficiency of food marketing systems as its primary objective, as opposed to questionable objectives, such as propping up inefficient farmers, which have contributed to the disappointing performance (and eventual demise) of food marketing boards over the long run.

At the same time, the case studies show that poor transport infrastructure and high transport costs of marketing agricultural produce pose serious obstacles to the successful implementation of both marketing and land reform. It can be concluded, therefore, that Government intervention in food marketing should move away from monopsonistic approaches and price-fixing, towards efforts to provide the enabling environment conducive to improved marketing efficiency, which would include better transport infrastructure, improved food storage capacity and the development of rural markets. Improved access to rural markets can make a significant contribution to raising the incomes of the rural poor and thus combating rural poverty.

The rural poor will be able to increase their income significantly only if their access to available productive resources—the most important of which, in poor countries, remains land—is substantially expanded. Although land redistribution is only one of several options for raising agricultural productivity, it is increasingly seen as crucial in many developing countries with highly unequal patterns of land ownership, particularly in Southern Africa, Latin America and parts of Asia. While it is now broadly recognized that land redistribution can play a critical role in efforts to reduce poverty in rural areas and to promote more equitable growth patterns, there has been an increasing interest in market-based approaches to land reform, as a result of the problems associated with coercive forms of land reform in many developing countries. The path-breaking South African experience with market-based land reform shows that this approach is flexible enough to respond to country-specific problems without compromising efforts towards the development of land markets, greater economic efficiency in agriculture, improved rural incomes and rural poverty alleviation.

Inasmuch as land redistribution can make a significant contribution to poverty alleviation, market-based land reform cannot be considered the single solution to rural poverty, in isolation from other policies designed to increase agricultural productivity, and to promote integrated rural development. Success with market-based land reform depends, in particular, on the implementation of complementary measures to foster rural development and smallholder agriculture. Such measures must address the availability of credit, the provision of extension services, the dissemination of appropriate agricultural technology, the access to irrigation water and better transport infrastructure, among other factors. Governments therefore still have an important role to play in promoting more equitable patterns of rural development, not only in terms of ensuring effective regulation but also with respect to the creation of a favourable environment for increased private investment, in the context of a broader economic liberalization strategy.

As in other sectors, the move towards greater overall economic efficiency may produce adverse socio-economic impacts and may even mean the contraction of some economic sectors. The fundamental goal, however, must be to raise employment and production in the economy as a whole and thereby raise overall living standards and reduce poverty. How to reduce rural poverty is a complex issue, which requires a comprehensive set of economic (and social) policies; the promotion of market-based approaches to food marketing and land redistribution are two such policies that could be potentially helpful.

VIII TRANSITION ECONOMIES AND POVERTY

After more than a decade of reforms, most of the former centrally planned countries of Eastern Europe and the former Soviet Union have largely completed their transition from central planning to a market economy.[1] However, only a few of these countries were able to restore and surpass the pre-reform level of output and employment. The transition was achieved at a very high human cost, leading to unprecedented increases in poverty and inequality. In the course of the 1990s, the region of the transition economies was the only region in the world that experienced an overall decline in living standards. The present chapter focuses on some of the key policy-related problems of poverty in the transition economies. The main questions the chapter tries to answer are: What caused the dramatic increase in poverty in the transition economies? What is the nature of poverty in the transition economies? What explains the major differences in poverty levels in different transition economies? How do Governments and individuals in transition economies cope with poverty? In what ways can these coping strategies be made more successful?

The transition to a market economy that started in the Eastern European countries in 1989 and in countries of the former Soviet Union in 1992 led to a dramatic increase in poverty. Prior to the start of reforms, in 1989, the number of the poor in the region, as measured by those living on less than $4 a day at international prices, had been 13.6 million, about 4 per cent of the population, with 6.5 million in the Central Asian republics of the then Soviet Union, 3.6 million in Belarus, the Russian Federation and Ukraine, 3.6 million in the Balkans, and 0.1 million each in the Central European centrally planned economies and the Baltic States. By 1993-1994, the total number of poor in the region was 119.2 million, of whom 83.2 million were in Belarus, the Russian Federation and Ukraine, 19.9 million in the Central Asian Republics, 12.9 million in the Balkan countries, 3.0 million in the Baltic States and 0.4 million in Central Europe.[2]

These figures show that the countries and areas that were under central planning the longest, namely, the Russian Federation and the other parts of tsarist Russia, had a much higher rate of poverty both before and after the transition than the countries of Central Europe, namely, the Czech Republic, Hungary, Poland and Slovakia. The Central European countries had been forced to adopt

1 In the present chapter, the region of the transition economies is understood to comprise 30 countries, including 15 Eastern European countries (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, the former Yugoslav Republic of Macedonia and the Federal Republic of Yugoslavia), the three Baltic States (Estonia, Latvia and Lithuania) and 12 countries members of the Commonwealth of Independent States (CIS) (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, the Republic of Moldova, the Russian Federation, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan). As of 4 February 2003, the official name of "Federal Republic of Yugoslavia" was changed to "Serbia and Montenegro". It will be noted that "Eastern Europe" refers to all the transition economies except the CIS member States and thus includes the Baltic States.

2 United Nations Development Programme, Regional Bureau for Europe and CIS, *Poverty in Transition* (United Nations publication, Sales No. E.98.III.B.27), p. 15, figure 1.8. These figures were based upon a $4 purchasing power parity (PPP) per day poverty line.

the centrally planned system only after the Second World War. They were wealthier than the republics of the Soviet Union and still retained some of the institutions that were to make it easier to operate a market economy. If it had not been for the imposition of central planning, they would have been developed economies like their neighbours to the West and would almost certainly have become members of the European Union (EU) many years earlier. The Balkan countries were less advanced economically than the Central European countries and the Baltic States were among the wealthiest republics of the former Soviet Union. Thus, the relative states of impoverishment of the different transition economies could not be considered altogether surprising. However, what was unexpected to some observers—and to many of the inhabitants of the region—was that the transition, instead of lasting for a few years and resulting in faster growth and rising living standards once the inefficiencies of central planning had been removed and a futile and costly arms race with the developed countries abandoned, had actually led to mass pauperization in many countries. This was especially the case in those parts of the Soviet Union that, unlike the Baltic States, had no experience of independence in the modern era and had not been prepared for the shock that would be caused by attaining independence and being set free to operate in a world economy that was increasingly subject to market forces.

Table VIII.1 shows how, in the late 1990s, absolute poverty, defined as those living on less than $1 a day at international prices, was still less than 2 per cent in the countries of Eastern Europe, with the exception of Romania, which, apart from Albania, had the lowest gross domestic product (GDP) per capita in the region in 2001. Measured at $2 per day, the poverty rates in Bulgaria and Romania stand out as much higher than those of the other Eastern European countries. Not only were these countries poorer, in terms of average income per capita, than those set to enter EU in 2004, but they had still not recovered fully from the transition recession. Thus, while Poland's GDP per capita in 2002 was nearly 30 per cent above its level of 1989, Bulgaria's and Romania's was over 10 per cent lower.

None of the members of the Commonwealth of Independent States (CIS), with the exception of Uzbekistan, had surpassed its 1989 level of GDP per capita by 2002. Poverty rates, when measured by the percentage of the population living on less than $2 per day, were considerably higher in CIS countries than in Eastern Europe. The problems confronting the CIS countries in tackling poverty are of a different order of magnitude from those confronting the Eastern European countries: they must recover their output levels of before the transition and ensure that the fruits of economic growth are enjoyed by the poorer members of society. Much of the analysis in this chapter, then, will be concerned with the CIS countries rather than with the Eastern European countries.

The shock that was followed by a rise in poverty in the transition economies was primarily a result of political factors—the breakdown of Soviet control first over the nominally independent countries of Central and Southern Europe and then, later, over the individual republics within the Soviet Union. These political factors had economic roots—the poor performance of the centrally planned system as compared with the market economy system in terms of delivering the goods and services that the citizens of these countries actually

Table VIII.1.
ABSOLUTE POVERTY RATES IN TRANSITION ECONOMIES, 1992-1999

Country	Survey year	Population below $1 a day (percentage)	Population below $2 a day (percentage)	Real GDP, 2002 (1989=100)
Eastern Europe				103.4
Albania		..	..	113.9
Bulgaria	1997	<2	21.9	82.9
Croatia	1998	<2	<2	86.4
Czech Republic	1996	<2	<2	105.8
Estonia	1998	<2	5.2	93.6
Hungary	1998	<2	7.3	111.7
Latvia	1998	<2	8.3	80.6
Lithuania	1996	<2	7.8	74.1
Poland	1998	<2	<2	129.6
Romania	1994	2.8	27.5	87.4
Slovakia	1992	<2	<2	108.7
Slovenia	1998	<2	<2	117.3
The former Yugoslav Republic of Macedonia		...	...	78.5
Commonwealth of Independent States				68.0
Armenia	1996	7.8	34.0	79.3
Azerbaijan	1995	<2	9.6	63.1
Belarus	1998	<2	<2	95.2
Georgia	1996	<2	<2	35.1
Kazakhstan	1996	<2	15.3	85.4
Kyrgyzstan		..	..	73.2
Republic of Moldova	1997	11.3	38.4	38.6
Russian Federation	1994	7.1	25.1	70.2
Tajikistan		..	..	43.1
Turkmenistan	1998	12.1	44.0	98.4
Ukraine	1999	2.9	31.0	47.3
Uzbekistan	1993	3.3	26.5	106.3

Sources: Economic Commission for Europe, *Economic Survey of Europe, 2003, No 1.* (United Nations publication, Sales No. E.03.11.E.26); and World Bank, *World Development Indicators* (Washington, D.C., World Bank, various issues).

wanted. Dismantling the centrally planned system and erecting a market system was bound to result in shocks, and historians will continue to discuss whether the steps that individual countries took minimized the disruption and maximized the possibilities for future growth. While there were great differences in the path to the market that the various countries followed, in the early days of transition this path had several common elements, which are analysed below. Those elements were: (a) a transformational recession, which could have been foreseen as overmanned and inefficient State enterprises reduced employment and which led to a sharp reduction of GDP; (b) hyperinflation which destroyed the savings of the population and helped to depress real wages in many transition economies; (c) an increase in income inequality across social groups, regions and sectors of the economy; and (d) the disintegration of the Soviet-era social protection system. In addition, in almost half of the countries in the region, people suffered severe losses of income from civil and ethnic conflicts. Given that, before the transition, incomes of a large part of the population in transition economies had been relatively low, any one of the above factors could have pushed them under the poverty line. This was even more likely when these factors worked in concert.

The negative factors were particularly evident in the poorest countries of CIS, which suffered greatly from the loss of federal subsidies that had been terminated with the dissolution of the Soviet Union.[3] In addition, during the 1990s, five of these countries were affected by wars and civil conflicts and had to accommodate sometimes hundreds of thousands of refugees and internally displaced persons (IDPs). Moreover, some countries suffered from extensive natural disasters and from recurring political crises (see box VIII.1, for the example of Armenia).

3 For example, for Kyrgyzstan in the last years of the Soviet Union, these subsidies were equivalent to 30 per cent of the government budget and 10-12 per cent of the GDP, while in Uzbekistan subsidies constituted 18.5 per cent of GDP. See *World Economic and Social Survey, 2001*.(United Nations publication, Sales No. E.01.11.C.1), chap. VI, subsect. entitled "Increased vulnerability: poverty and deteriorating social conditions"; and Martin C. Spechler, "Hunting for the Central Asian tiger", *Comparative Economic Studies*, vol. 42, issue 3 (fall 2002), p. 17.

Box VIII.1

POVERTY IN ARMENIA

The Republic of Armenia, with a population of 3.8 million, was one of the 15 constituent republics of the former Soviet Union and is a current member of the Commonwealth of Independent States (CIS). Relatively poor in natural resources and landlocked, it nevertheless was one of the more prosperous republics in the Soviet Union, where Armenians enjoyed the reputation of being a well educated, industrious and entrepreneurial people.

The break-up of the Soviet Union at the end of 1991 dealt a severe blow to the well-being of Armenia. The transfers from the federal Government, mostly in the form of low-priced energy, which in 1989-1991 had constituted 31 per cent of fiscal revenues and 12 per cent of the gross domestic product (GDP) of Armenia, were abruptly ended. The timing was most unfortunate, as at the time Armenia still had to deal with the consequences of the devastating earthquake of 1989. The simultaneous collapse of inter-republic trade virtually cut off Armenian exports to the rest of the Soviet Union. To aggravate the situation, hostilities with Azerbaijan over the disputed enclave of Nagorny Karabakh escalated into a full-scale war, further draining the budgetary resources, and causing refugees to flow in both directions. Close to 300,000 refugees entered Armenia.

In the first four years of transition, Armenia's GDP dropped by 63 per cent. During the worst years of the crisis, in the mid-1990s, with almost no electricity or heating, many Armenian cities looked like ghost towns. In the capital city of Yerevan, with a population of over 1 million, people cut down trees in city parks for use as fuel.

The shrinking economy and the war meant that government spending on social protection had to be drastically reduced. At the end of the 1990s, pension spending was just 3.1 per cent of GDP, with the average pension dropping to less than one fifth of the average per capita income. Public spending on education fell to 2 per cent of GDP, and that on health care to 3.5 per cent of GDP. Faced with the economic crisis and inability

THE MACROECONOMIC BACKGROUND

The transformational recession

During the 1990s, the main cause of mass poverty in transition economies was the deep recession that had followed the collapse of the centrally planned economies. The length of the transformational recession across the 27 countries of the region ranged between three years (Poland) and nine years (Ukraine). The fall in GDP ranged from 15 to 70 per cent, although the fall cannot be attributed entirely to the transformation. In the CIS countries, the recession led to a fall in incomes surpassing that of the Great Depression and comparable only with the situation during periods following the Russian (Bolshevik) Revolution of 1917 and the Second World War.

In view of the widespread suffering of the poor in the transition economies, in particular the successor States of the former Soviet Union, the following question is often asked: Was it possible to escape the massive increase in poverty in the course of market reforms?

Box VIII.1 (continued)

of the State to protect them from poverty, hundreds of thousands Armenians left the republic for the Russian Federation and countries further away. Many of those who stayed turned to the informal economy.

The recovery started in Armenia earlier than in most other members of CIS and in the last seven years GDP has been growing at 6 per cent annually, helped by foreign assistance and remittances from Armenians abroad which constitute an estimated one eighth of GDP. Still, the per capita GDP of Armenia is just over $2,000 at purchasing power parity (PPP) valuation. In 1999, the poverty headcount, measured at the international poverty line of $4.30, was 86.2 per cent of the population, while acute poverty, measured at half that line, was 43.5 per cent of the population. This high incidence of poverty was also to a large degree the result of an extremely sharp disparity of incomes. Between 1987-1990 and 1996-1998, the Gini coefficient of inequality in Armenia had gone up from 0.27 to 0.61, with 50.6 per cent of incomes going to the richest, and only 5.5 per cent to the poorest quintile of the population.

In the last several years, thanks to economic recovery, large remittances from migrants and substantial international assistance, massive transitory poverty in Armenia has diminished. Government efforts to rebuild the social protection system are also bringing results. Armenia has become one of the leaders in CIS in the volume and efficiency of the distribution of targeted subsidies to the poorest families. Targeted means-tested subsidies constitute 2 per cent of GDP, a figure much higher than that in other CIS countries, where such subsidies constitute between 0.1 and 1.5 per cent of GDP. The poor in Armenia should also benefit from the new international "CIS-7" Initiative, launched in 2002 by the World Bank, the International Monetary Fund (IMF), the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank and the Governments of the Netherlands and Switzerland to provide assistance to the seven poorest countries of CIS (Armenia, Azerbaijan, Georgia, Kyrgyzstan, the Republic of Moldova, Tajikistan and Uzbekistan).

Sources: *World Economic and Social Survey, 2001* (United Nations publication, Sales No. E.01.II.C.1), chap. VI entitled "The challenge to small, landlocked transition economies"; *Transition: The First Ten Years. Analysis and Lessons for Eastern Europe and the Former Soviet Union* (Washington, D.C., World Bank, 2002); *Making Transition Work for Everyone: Poverty and Inequality in Europe and Central Asia* (Washington, D.C., World Bank, 2000); and Sam Vaknin, United Press International, 23 January 2003.

Most specialists agree that the initial sharp drop in output in the transition economies was caused by the combination of the demand shock brought about by the change in relative prices, the reduction of Government orders and the disruption of foreign trade, and the supply shock resulting from the inability of producers to quickly reallocate resources to the new uses. The poor quality of market institutions and a high degree of corruption in many transition economies contributed to the depth of the recession.[4]

There is still disagreement about the speed and sequencing of reforms. Some argue that the more rapid reforms would have been more beneficial to growth, while others think that the more rapid reforms, while more painful in the short run, were more conducive to higher longer-term growth.[5] With the benefit of hindsight, it would appear that the course that the reforms took in a particular country was largely predetermined by the distribution of political power.[6] Thus, in the republics of the former Soviet Union, practically all power on the eve of reforms was concentrated in the hands of the former Communist Party bureaucracy and managers of large State-owned enterprises. The majority of the population had little role in determining the reform agenda. In many Eastern European countries, in contrast, civil society was quite vocal and grass-roots organizations, such as the "Solidarity" trade union in Poland, were important players in their own right. As a result, in Eastern Europe the working population could count on poverty alleviation measures, being incorporated in the reform programme from the very start.

Inflation

Political differences were significant in the case of inflation. The poor suffer from inflation more than the well-to-do, as they usually lack the information and skills to protect their incomes and assets from rapidly rising prices. As a result, hyperinflation generally leads to an increase in poverty and income inequality.[7] However, in the transition economies, the success of stabilization policies generally depended on political factors. Governments of the leading Eastern European countries, operating under national consensus, were able to contain inflation relatively quickly. In the CIS countries, the struggle with inflation was frequently complicated by the presence of powerful political interests. In the Russian Federation, in the first years of reform, the lobbying by enterprise directors secured a massive flow of Government credits to their firms which helped fuel the hyperinflation. By some estimates, in 1992-1993, these credits had resulted in a net transfer of wealth to enterprises of about 15 per cent of GDP.[8] The net losers from hyperinflation were private savers, mostly pensioners. Overall, the destruction of private savings in the Russian Federation eliminated up to one fourth of household wealth.[9]

Inflation damaged or destroyed private savings in many other transition economies, in most of which deposits were not indexed or otherwise compensated for inflation. However, in Eastern European countries such as in Hungary and the Czech Republic, where levels of inflation were lower, and in countries such as Poland where most savings were kept in foreign currencies, losses of depositors were relatively small.[10]

4 Janos Kornai, *Highways and Byways: Studies on Reform and Postcommunist Transition* (Cambridge, Massachusetts, and London, England, The MIT Press, 1995); World Bank, *Making Transition Work for Everyone: Poverty and Inequality in Europe and Central Asia* (Washington, D.C., World Bank, 2000); Vladimir Popov, "Shock therapy versus gradualism: the end of the debate", *Comparative Economic Studies*, vol. XLII, No. 1 (spring 2000), pp. 1-58; and Jan Svejnar, "Transition economies: performance and challenges", *Journal of Economic Perspectives*, vol. 16, No. 1 (winter 2002), pp. 3-28.

5 Joseph Stiglitz, *Globalization and Its Discontents* (New York, W.W. Norton, 2002); World Bank, *From Plan to Market* (Washington, D.C., World Bank, 1996); Marek Dabrowski, Stanislaw Gomulka and Jacek Rostowski, *Whence Reform? A Critique of the Stiglitz Perspective* (London, Centre for Economic Performance, London School of Economics and Political Science, 2000); and Stanley Fischer and Ratna Sahay, "Taking stock", *Finance and Development*, vol. 37, No. 3 (September 2000), pp. 2-6.

6 "Much of the reform policy has been driven by the weakness of the Government and by the desire to preserve freedom through preventing a return of the communists", admits one of the leading Western consultants on the market transition. See Richard Layard, "Why so much pain?", in *Emerging From Communism: Lessons from Russia, China and Eastern Europe*, Peter Boone, Stanislaw Gomulka, and Richard Layard, eds. (Cambridge, Massachusetts and London, The MIT Press, 1998), p. 5. See also: Joseph Stiglitz, *Whither Socialism* (Cambridge, Massachusetts, The MIT Press, 1994); Marek Dabrowski, Stanislaw Gomulka, and Jacek Rostowski, op. cit.; Stanley Fischer and Ratna Sahay, loc. cit.; Leszek Balcerovicz, "Poland's transformation", *Finance and Development*, vol. 37, No. 3 (September 2000), pp. 14-16; and Gerald Roland, "The political economy of transition", *Journal of Economic Perspectives,* vol. 16, No. 1 (winter 2002), pp. 29-50.

7 "Inflation is a regressive and arbitrary tax, the burden of which is typically borne disproportionately by those in lower income brackets", *A Sourcebook for Poverty Reduction Strategies*, Vol. 2, p.5. See also *Poverty in Transition* …, p. 23.

8 Richard Layard, loc. cit., p. 8.

9 Simon Commander, Andrei Tolstopiatenko and Ruslan Yemtsov, "Channels of redistribution", *Economics of Transition*, vol. 7, issue 2 (July 1999), p. 24.

10 In the last several years, depositors in the Russian Federation, Ukraine and some other CIS countries have started to receive limited compensation on deposits for the losses in the hyperinflation of the early 1990s. However compensation is partial and is limited only to the oldest of surviving depositors.

Private sector investment

With privatization and the sharp reduction of the role of the State in the economy, much of the responsibility for generating growth has naturally shifted to private, including foreign, investment. In this matter, however, the situation in the transition economies is far from satisfactory. The level of investment in most of these countries is less than 20 per cent of GDP. For the CIS countries, the problem is often not a lack of savings, but rather the relatively poor business climate and the low quality of institutional support. Thus, in 1999-2001, domestic savings in the Russian Federation surpassed 30 per cent, while domestic investments were less than 20 per cent, with a good part of the difference explained by capital flight. The business climate in CIS affects the inflow of foreign direct investment (FDI). During the period 1999-2001, in the EU accession countries of Eastern Europe, FDI constituted almost 5 per cent of GDP, or about $200 per capita, while in the CIS countries, the comparable figures were less than 1 per cent of GDP, or less than $40 per capita.[11]

In recent years, investment and the general business climate in many transition economies have improved. According to the extensive survey of enterprises conducted in the transition economies jointly by the World Bank and the European Bank for Reconstruction and Development (EBRD) since 1996, in almost all countries of the region, between 1999 and 2002, economic governance and the general business environment have improved. Progress was particularly significant in the countries of South-Eastern Europe and CIS, partly from the impact of the change in the Government of the former Federal Republic of Yugoslavia and the accession to power of the new leadership in the Russian Federation. However, the overall scores for the quality of the business environment in the countries of South-Eastern Europe and in CIS remain lower than those for the countries of Central and Eastern Europe. On average, the scores for the two former groups of countries in 2002 were equal to those of the latter group of countries for 1999.[12]

11 European Bank for Reconstruction and Development (EBRD), *Transition Report, 2002: Agriculture and Rural Transition* (London, EBRD, 2002), pp. 54-55.

12 Ibid., pp. 22-31.

Income distribution

Over the course of transition, income inequality, measured at the household level, increased rapidly and significantly in almost all of the transition economies. In the Russian Federation and Ukraine, the Gini coefficient of inequality rose to over 45 per cent (see table VIII.2). The rise in income inequality, in its turn, was directly linked to a major increase in wealth inequality, resulting from the way in which the privatization of government assets had been carried out. This was particularly true in resource-rich countries such as Azerbaijan, Kazakhstan and the Russian Federation. Here a whole class of instant millionaires and even billionaires was created, as a result of the highly questionable method by which the privatization of oil and other natural resources had been achieved (see box VIII.2). Measured by the Gini inequality coefficients, the level of inequality in the Eastern European countries was much lower than in the CIS countries: in 1999-2000, the coefficients were in the range of 0.30-0.34, or close to that in the Organisation for Economic Cooperation and Development (OECD) member countries.

Table VIII.2.
GINI COEFFICIENTS IN TRANSITION ECONOMIES, 1987-1998

Country	1987-1990	1993-1994	1996-1998
Eastern Europe	0.23	0.29	0.33
Bulgaria	0.23	0.38	0.41
Croatia	0.36	..	0.35
Czech Republic	0.19	0.23	0.25
Estonia	0.24	0.35	0.37
Hungary	0.21	0.23	0.25
Latvia	0.24	0.31	0.32
Lithuania	0.23	0.37	0.34
Poland	0.28	0.28	0.33
Romania	0.23	0.29	0.30
Slovenia	0.22	0.25	0.30
Commonwealth of Independent States	0.28	0.36	0.46
Armenia	0.27	..	0.61
Belarus	0.23	0.28	0.26
Georgia	0.29	..	0.43
Kazakhstan	0.30	0.33	0.35
Kyrgyzstan	0.31	0.55	0.47
Republic of Moldova	0.27	..	0.42
Russian Federation	0.26	0.48	0.47
Tajikistan	0.28	..	0.47
Turkmenistan	0.28	0.36	0.45
Ukraine	0.24	..	0.47

Source: EBRD, *Transition Report, 2002: Agriculture and Rural Transition* (London, EBRD, 2002), p. 9.

Fiscal policy

The transition to a market economy has led to the significant reduction of the government's role in many economic activities. Between 1989-1990 and 1999-2000, government revenues as a percentage of GDP declined on average from 50 to 40 per cent in Eastern Europe and from 40 to 25-30 per cent in the CIS countries.[13] In most of the transition economies, this decline was accounted for primarily by the reduction in centralized investments and military spending, while spending on social programmes, education and health care expressed as a percentage of GDP remained largely intact.[14] Owing to the transformational recession, however, the actual volume of spending on social protection went down, unless the share of this spending was increased to compensate for the fall of GDP. The reduction of actual spending was particularly deep in the CIS countries, where real GDP dropped in the 1990s by 40-70 per cent.

The difference between Eastern Europe and the CIS countries lay not only in the overall extent of fiscal retreat but also in how it was accomplished. In many Eastern European countries, the reduction of government spending was managed in a relatively orderly manner, while in many CIS countries, this was not the case.[15] In many CIS countries, the effectiveness of the State in coping with poverty was further undermined by the power of special interests, which

13 Vladimir Popov, loc. cit., p. 54; *Transition report, 2002…*, p. 62; and *Transition: The First Ten Years. Analysis and Lessons for Eastern Europe and the Former Soviet Union* (Washington, D.C., World Bank, 2002), p. 47.

14 However, in most Central Asian and Transcaucasian countries of CIS, spending on social protection, education and health care fell in proportion to GDP, often significantly (*Poverty in Transition …*, pp. 94-95).

15 "Instead of completely shutting down some Government programs and concentrating limited resources on the others with the aim of raising their efficiency, some Governments kept all programs half-alive, half-financed and barely working. The political pressures for maintaining services across the board outweighed the need for more selective streamlining of priorities" (*Poverty in Transition.*, p. 36).

Box VIII.2

THE RUSSIAN FEDERATION:
LAND OF BILLIONAIRES?

In the 2003 *Forbes*' list of the world's richest individuals, the Russian Federation boasted 17 billionaires, a figure lower than those of only three countries—the United States of America, Germany and Japan. By the number of its super-rich, the Russian Federation has surpassed such countries as Canada (15 billionaires), the United Kingdom of Great Britain and Northern Ireland (14) and France (13)—countries with a 2002 gross domestic product (GDP) per capita of $25,000-27,000, compared with the Russian Federation's GDP per capita of $4,000 (at the market exchange rate). It has also left China (no billionaires) far behind and, even more tellingly, Brazil. With a population and per capita income very similar to those of the Russian Federation, Brazil has a much longer history of market capitalism, but accounted for only four billionaires.

Almost all the super-rich in the Russian Federation derive their wealth from the control of oil and other natural resources. Unlike the fortunes of billionaires in the mature market economies, which were based on unique entrepreneurial talents such as those of Bill Gates of Microsoft, or on wealth accumulated over several generations, the fortunes of Russian billionaires have been created essentially by government decrees. The largest Russian private companies were not built from scratch; rather, they came into existence as a result of insider-controlled privatizations and rigged auctions of already existing government companies. In effect, all Russian billionaires (and many, if not most of the "ordinary" millionaires) were "nominated" as such by the political decisions of government bureaucrats.

The jury is still out on the longer-term outcome of Russian privatization. Pointing to other countries of CIS, some Russian economists argue that keeping the prize government assets in the hands of the State would have brought about even worse results. However, it is clear that some controversial privatizations contributed to the growth of income inequality in Russia.

Sources: *Forbes*, 17 March 2003; Francisco H. G. Ferreira, "Economic transition and the distributions of income and wealth", *Economics of Transition*, vol. 7 (World Bank), No. 2 (July 1999), pp. 377-410; and Michael Alexeev, "The effect of privatization on the wealth distribution in Russia", *Economics of Transition*, vol. 7 (World Bank), No. 2 (July 1999).

prevented the redistribution of income towards the more vulnerable members of society. For example, while in Eastern Europe spending on pensions and unemployment benefits averaged 10 per cent of GDP, in CIS such spending was only 5 per cent. Continuation of selected price subsidies and the old enterprise-based system of provision of social services helped the poor survive the worst periods of the transition, but, overall, the fiscal policies in the CIS countries failed to perform their social protection function.

Between 2001 and 2003, several CIS countries, in particular the Russian Federation, embarked on the path of fiscal reform, aimed at increasing government revenues and stopping the disorganized fiscal retreat of the Government. In the Russian Federation, the simplification of the tax structure and the introduction of a flat 13 per cent income tax have reportedly brought positive results in terms of increased tax compliance and revenue collection. It remains to be seen, however, if an improvement of the fiscal situation will translate into better-funded and more efficient poverty alleviation programmes.

Trade and foreign exchange policy

Trade liberalization and the removal of currency controls that accompanied market reforms in transition economies were pursued in order to stimulate long-term economic growth. In this way, trade policy would contribute to combating poverty. However in the short-run perspective, an open-trade regime creates not only winners but also losers. The poor depend upon foreign trade as consumers and their welfare increases when the opening up of trade gives them access to foreign goods, services and food supplies that were previously unavailable or too expensive. As producers, the poor who are employed in export or export-related industries also gain from freer trade. At the same time, the poor may lose as producers when the industries in which they have been employed are affected by competition from foreign imports.[16]

In the first years of market reforms, the opening of domestic markets in transition economies to foreign competition inflicted serious damage on domestic industries. Unable to compete with foreign producers, they had to reduce output, employment and/or wages. At the same time, exporters from some transition economies were making hefty profits by taking advantage of sharp differences between the domestic and world prices of raw materials, such as oil, timber and metals. Very soon, protectionist pressures in the transition economies forced the Governments to retreat from the path of full liberalization and to start increasing tariffs and imposing quotas and other forms of import containment and export control. To protect their domestic markets, some countries, such as Uzbekistan, also preserved multiple exchange rates.

The benefits of trade liberalization depend on many factors in the country itself (whether it has a diversified economy, its geographic position and the state of its institutions) and in its trading partners. Costs might also be incurred when liberalizing trade; jobs could be lost in industries competing with imports before new jobs are created.[17]. However, the introduction of low uniform tariffs has proved to be quite effective for some countries. The leader here is probably Estonia, with its uniform zero-level tariffs, similar to those in Hong Kong Special Administrative Region (SAR) of China and Singapore. Kyrgyzstan has also introduced a progressive tariff system with a small dispersion of rates, comparable with those in Chile.[18]

In the field of exchange-rate regulation, a pro-growth, and therefore pro-poor, policy calls for maintaining an undervalued rather than an overvalued real exchange rate vis-à-vis a country's main trade partners. An undervalued exchange rate helps promote exports. Historically, the policy of having an undervalued national currency had helped to spur export growth in South-East Asia and Japan, China and other countries that were successful in overcoming or reducing poverty. At the same time, however, the benefits of an overvalued exchange rate in terms of cheaper imports are enjoyed less by the poor than by the rich, since imported goods constitute a smaller share of the consumption of the poor.[19]

The situation in resource-based economies, such as the Russian Federation, is more complex. Here, the massive inflow of foreign currency from the export of raw materials creates a constant risk of the overvaluation of the national currency—the so-called Dutch disease. In the Russian Federation, the large appreciation of the ruble prior to the 1998 crisis had served as a major drag on growth. As a result, the 1998 devaluation, while disrupting the country's financial system, was nevertheless quite beneficial for economic growth and, overall, was arguably a positive development for the poor. The fact that, in the last few years, the currency has appreciated again in real terms is becoming a major policy concern.

16 "Trade liberalization can be expected to help the poor overall, given the positive association between openness and growth. However, in the short run, liberalization may have a negative impact on some of the poor, depending on their sources of income and the impact of liberalization on the prices of goods and services the poor consume." See Bernard Hoekman and others, "Trade policy". In *A Sourcebook for Poverty Reduction Strategies*, vol. 2…, p. 30.

17 See Joseph E. Stiglitz, "Globalization and Growth in Emerging Markets and the New Economy", *Journal of Policy Modeling,* vol. 25 (2003), p. 513.

18 See Bernard Hoekman and others, loc. cit., pp. 33-34.

19 See Brian Ames and others, "Macroeconomic Issues", in *A Sourcebook for Poverty Reduction Strategies*, vol. 2, p. 9.

TRANSIENT VERSUS CHRONIC POVERTY

The emergence of chronic poverty

Government shortcomings in coping with poverty in the early days of the transition forced people in the poorer transition economies to resort heavily to self-help methods of economic survival. The private response to coping with poverty included increased employment in the informal economy, cultivation of family plots, and heavy reliance on intra-family transfers. Lack of opportunity at home led to massive labour migration to better-off economies of the region and to other countries. As a last resort, large numbers of people engaged in crime and prostitution.

Since the mid-1990s, the poverty situation in the transition economies region has improved, led by an economic recovery in Eastern Europe. Economies of CIS have been growing rather vigorously since the 1998 devaluation of the ruble. However, this general improvement has been accompanied by a concentration of poverty in particular regions and sectors of the economy, and among specific groups of the population. Thus, while the recession-induced "transient" poverty has subsided, the smaller-scale but entrenched pockets of chronic poverty have not disappeared. The emergence of concentrated and acute long-term poverty is a relatively new phenomenon.[20]

Owing to the various levels of poverty, the problems experienced by the leading reformers of Eastern Europe in coping with it are significantly different from those confronting the CIS countries. In the Eastern European countries, in particular the EU accession countries,[21] transient poverty is subsiding now that income levels are surpassing their pre-transition levels and market-based economic growth is being achieved. The goal of the Governments consists largely of improving the existing social protection mechanisms and rooting out the pockets of concentrated poverty. In the poorest CIS countries, the main challenge is to alleviate their acute poverty and to prevent the collapse of the existing health-care and education systems. For other CIS countries, the task consists of reducing the still massive transient poverty via stimulative economic policies while at the same time containing the dangerous increase in concentrated long-term poverty.

At the present time, poverty in transition economies has many unique features (see box VIII.3). Prior to the transition, poverty was largely prevented by Government-guaranteed employment, free health care and education, and heavily subsidized food, housing and utilities. In line with its collectivist ideology, the Government ensured a fairly egalitarian distribution of wages and severely restricted other sources of incomes. At the same time, Governments provided fairly generous social protection systems for children and families. Extensive health and education services were also provided to all households, ensuring a high level of human capital. In addition, most households in transition economies inherited from the centrally planned period valuable physical capital in the form of formerly State-owned apartments complete with a full set of amenities. This made them relatively assets-rich in contrast with comparable households in developing countries. Another feature of the centrally planned economies was the main provision of some of the key services and social protection, such as housing, childcare and social security, by enterprises rather than by the government.

20 Attesting to the recent emergence of this phenomenon is the fact that it was not mentioned as a major problem neither in the comprehensive 1996 World Bank report on the transition economies nor in the 1998 UNDP report on poverty in transition, which stated that there was "little indication as yet" of the emergence of an underclass in the region (see *From Plan to Market…*; and *Poverty in Transition …*, p. 18).

21 The EU accession countries are: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. Eight of them are scheduled to join EU in May 2004. Bulgaria, and Romania are scheduled to be admitted in 2007.

Box VIII.3

MEASUREMENT OF POVERTY IN TRANSITION ECONOMIES

While no one doubts the overall massive increase of levels of poverty in the transition economies, questions exist with regard to its measurement. Owing to such unique features of transition economies as socialized health care and education, subsidized utilities and large intra-family transfers, the measurement of poverty in those economies is more difficult than in developing economies at a comparable level of development. Measurement of poverty in transition economies is further complicated by major fluctuations in output and prices, the large size of the unofficial economy, massive migration of the population, and statistical systems that are still adjusting to the market environment. In the present chapter, the analysis of poverty in transition economies relies primarily on absolute indicators, based on "fixed" poverty lines, usually defined in international dollars. In addition, use has been made of relative poverty indicators, based on "moving" poverty lines, defined by individual countries in proportion to the average wage, or to the average per capita income.

A particularly difficult problem in poverty measurement in transition economies is how to account for the large unofficial sector, estimates of which range between 6 per cent in Slovakia to over 60 per cent in Georgia and Azerbaijan. Government statistical agencies are making increasing efforts to account for the size of the unofficial economy's contribution to GDP. For example, in the Russian Federation, the size of GDP is periodically adjusted upward to include output of the unofficial economy and small family plots. However, a significant part of the unofficial economy escapes government data-gatherers and can be estimated only approximately, based on indirect indicators, such as electricity consumption. Existence of a large unofficial sector is one of the reasons why poverty measurement using household expenditures is more reliable compared with measurement based on reported incomes.

Low income alone cannot convey the overall level of deprivation suffered by the poor. Broader measures of well-being can include degree of equality, access to health care and education, and political participation. The resulting indicators are generally well related, but can show somewhat different trends. For example, indicators combining poverty and inequality show much larger deterioration of well-being in transition economies compared with measures based on poverty alone. This, of course, is explained by the sharp increases in income inequality in transition economies in the 1990s.

For the formerly egalitarian communist societies, the sudden arrival of income disparity was quite painful psychologically. The survey-based "subjective poverty" in these countries increased in the 1990s to much higher levels than did "measured poverty". Thus in Bulgaria in 2001, 73 per cent of the population called themselves poor, compared with 12.8 per cent based on the national poverty line. In a 2002 survey in the Russian Federation, over 50 per cent called themselves poor, roughly twice the headcount based on the national poverty line.

Sources: Simon Johnson, Daniel Kaufman and Andrei Shleifer, "The unofficial economy in transition", *Brookings Papers on Economic Activity*, vol. 2 (1997), pp.159-221; J. Flemming, and J. Micklewright, "Income distribution, economic systems and transition", in *Handbook of Income Distribution*, Anthony Atkinson and François Bourguignon, eds. (Amsterdam, Elsevier, 2000), pp. 843-910; Carola Grun and Stephan Klasen, "Growth, income distribution and well-being in transition countries", *Economics of Transition*, vol. 9, No. 2 (2001), p. 378; Aline Coudouel, Jesko S. Hentschel and Quentin T. Wodon, "Poverty measurement and analysis", in *A Sourcebook for Poverty Reduction Strategies,* vol.1, Jeni Klugman, ed. (Washington, D.C., World Bank, 2002), pp. 27-74; *Bulgaria Poverty Assessment*, World Bank Report, No. 24516 (Washington, D.C., 29 October 2002), pp.3-7; and *Trud,* 11 January 2003.

A significant segment of poverty in transition economies appears to be transient in nature. With a fairly equal distribution of income before the transition and with many families clustered near the poverty line, a large number of people had been pushed below this line when incomes fell. When economies in the region started to recover, the incomes of many of these families recovered to levels above the poverty line, thus making poverty a transient experience for them.

However, along with the decline of transient massive poverty, the transition economies have witnessed the growth of chronic and concentrated poverty.

This came about as a result of several interrelated income differentiation processes linked to regional, sectoral, demographic and other characteristics of the population. As could be expected, different groups of people (urban/rural, educated/uneducated, employed/unemployed/self-employed) fared differently during the transformational recession. Some groups were able to climb out of poverty relatively quickly, while others have remained stuck in poverty since the start of the transition.

In all countries, transient poverty is brought about by unfavourable but temporary *macroeconomic* conditions, such as a decline in overall GDP, hyperinflation or a massive depreciation of the national currency. Wars and other non-economic factors, such as natural disasters, can also cause transient poverty. As opposed to this type of poverty, chronic poverty is primarily the result of microeconomic factors, such as the characteristics of a particular region or industry, or the characteristics of individual household members, such as level of education, professional occupation, age, gender and ethnicity.[22]

A recent study of chronic poverty in several transition economies based on longitudinal surveys of household expenditures concluded that chronic poverty accounts for about one half of the overall poverty headcount.[23] According to this study, in which the poor were defined as being in the bottom 20 per cent of the income or expenditure distribution, about 10 per cent of the population in Hungary, Poland and the Russian Federation can be considered to be chronically poor and thus candidates for the permanent underclass (see table VIII.3).

Sectoral and geographical differentiation of incomes

In the centrally planned era, in addition to making cross-country and inter-republic transfers, central Governments had actively engaged in cross-subsidization at the regional level. The collapse of central planning led to a significant weakening of regional cross-subsidization. Along with the opening of

22 Michael Lokshin and Barry M. Popkin. "The emerging underclass in the Russian Federation: income dynamics, 1992-1996", *Economic Development and Cultural Change,* vol. 47, No. 4 (1999), pp. 822-823. Separating the transient from the chronic components of poverty is fraught with difficulty, as it calls for observation over a long period of time and panel data. Such data are available in comparable format for only just a few of the transition economies. Most measurements of poverty are thus effectively snapshots inasmuch as a poverty per capita count for a particular year does not reveal anything about the previous income status of those registered as poor or about their income situation the following year.

23 This corresponds to a similar proportion found in the study of long-term poverty in China and India. See World Bank, *World Development Report, 2000/2001: Attaching Poverty* (New York, Oxford University Press, 2001), p. 140.

Table VIII.3.
TRANSIENT AND CHRONIC POVERTY: HUNGARY, POLAND AND THE RUSSIAN FEDERATION, 1994-1996[a]

Percentage			
Share of the population	Hungary (income)	Poland (expenditure)	Russian Federation (expenditure)
A. Share of the population based on measured poverty			
Always poor (4 out of 4 rounds)	8.8	5.9	3.4
Sometimes poor (1, 2 or 3 out of 4 rounds)	26.3	31.6	41.9
Never poor (0 out of 4 rounds)	65.0	61.5	54.7
B. Share of the population based on simulations using "underlying" poverty transition problems			
Always poor (4 out of 4 rounds)	9.7	10.7	10.0
Sometimes poor (1, 2 or 3 out of 4 rounds)	22.6	20.1	21.8
Never poor (0 out of 4 rounds)	67.8	69.2	68.2

Source: *Transition Report, 2000* (London: EBRD, 2000), p. 98.

a Based on data from four rounds of national longitudinal household surveys in Hungary, Poland and the Russian Federation conducted in 1994-1996. Panel A shows poverty headcounts directly observed by the surveys. In panel B, headcounts are adjusted to control for the impact of general transitory shocks and to reflect the "underlying" long-term poverty. In every round of the surveys, poverty was defined as being in the bottom 20 per cent of the income or expenditure distribution.

national economies to the outside world, this produced major changes in the fortunes of individual regions, cities and districts. This was particularly true for the regions of the former Soviet Union, many of which lost valuable energy subsidies and other federal aid; but in the course of their transition to the market, even the wealthier transition economies witnessed the emergence of numerous depressed regions within their borders. These were regions that were hit particularly severely by market reforms, such as changes in relative prices, the elimination of subsidies, drops in State orders and increases in transportation costs. Examples include the northern territories and defence-producing regions in the Russian Federation (see box VIII. 4).

On the other hand, the transition to a market economy led to the relative increase in the well-being of most capital cities and the emergence of newly prosperous regions, such as oil-rich western Siberia. Generally, the winners are regions rich in natural resources, with a large population and close proximity to the main economic centres.[24]

The resulting differences in poverty levels can be substantial. For example, a resident of Warsaw is six times less likely to be poor than residents of the rest

[24] See: V. Popov, " Reform strategies and economic performance of Russia's regions", *World Development*, vol. 29, No. 5 (2000), pp. 865-886; N. Mikheeva, "Differentiation of social-economic situation of Russian regions and problems of regional policy" (Moscow, Economics Education and Research Consortium (EERC), 1998); Irina Dolinskaya, *Transition and Regional Inequality in Russia: Reorganization or Procrastination*?, IMF Working Paper, No. 02/169, (Washington, D.C., October 2002, Leonid Fedorov, "Regional inequality and regional polarization in the Russian Federation, 1990-99", *World Development*, vol. 30, No.3 (2002), pp. 443-456; and Simon Commander, Andrei Tolstopiatenko and Ruslan Yemtsov, loc. cit.

Box VIII.4

THE RUSSIAN DEFENCE INDUSTRY: THE CASE OF A SHRINKING GIANT

In the course of the 1990s, the Russian defence industry was hit by the triple shock of severe budget cuts, radical market reforms and the breakdown of traditional economic ties with partners in the other former Soviet republics. Between the peak of the Soviet military build-up of the late 1980s and the lowest point reached in 1996, the share of defence spending in Russian GDP dropped from 15-17 to 3-4 per cent, the military industry's output fell by 80 per cent, and employment in the defence industry fell by two thirds.

Defence industry enterprises are found in the majority of the Russian provinces. However, most of them are concentrated in just a few regions, in particular in Moscow and Saint Petersburg, the Urals and western Siberia.

In the Soviet era, defence enterprises had many advantages in comparison with the rest of the economy: they possessed the highest-skilled personnel, both workers and engineers, and developed the best research and development (R&D) and innovations. Higher wages were the main factor in attracting and retaining better workers. In addition, defence enterprises owned extensive facilities that provided social services—retail outlets, hospitals, kindergartens and summer camps for children, sport stadiums, seaside resorts and libraries.

As a result of the severe reduction of military orders, defence enterprises found themselves in a more disadvantageous position than the rest of the economy. This was reflected in particularly deep cuts in wages, wage arrears, losses of personnel and tension in labour-management relations. During the transition period, some of the social service facilities were closed down or sold off as enterprises were no longer able to fund them.

Throughout the decade of reforms, average wages in the defence industry constituted only 40-60 per cent of average wages and 50-80 per cent of average wages in manufacturing. Among other branches of the economy, only education, agriculture and health care had lower average wages than the defence industry. In recent years, wages in the defence industry have started to catch up with those in other sectors of the economy. However, the gap remains. In 2002, based on a survey of defence enterprises, average wages therein amounted to 3,135 rubles (just over US$ 100 at the market exchange rate) per month, which was equivalent to 60 per cent of the level of average wages in of Poland; the poverty level in Saint Petersburg in the Russian Federation is eight times lower than that in the Russian republic of Tuva.[25] As a result, per capita income disparities among the 89 administrative regions of the Russian Federation are much larger than, for example, disparities among the 50 States in the United States of America, with a coefficient of variation of 51.9 per cent as compared with one of 14.8 per cent for the United States.[26]

In transition economies, rural areas remain poorer compared with urban areas. However, the patterns are different in Eastern European and CIS countries. In most Eastern European countries, the levels of *rural poverty* are significantly (about 50 per cent) higher than the levels in the cities. In the CIS countries, the gap between urban and rural regions is not as pronounced. In some of these countries (for example, Georgia) poverty is actually lower in rural than in the urban areas. The reason for the relatively better situation of rural areas in the CIS countries is a much deeper fall in industrial production in these countries compared with that in the Eastern European countries. In some of the CIS regions, the dire economic crisis in manufacturing made even depressed farming areas appear attractive. In extreme cases, it led to de-urban-

25 *Making Transition Work for Everyone…*, p. 74; and Simon Clarke, "Poverty in Russia", *Problems of Economic Transition*, vol. 42, No. 5 (September 1999), p. 21.

26 Simon Commander, Andrei Tolstopiatenko and Ruslan Yemtsov, loc. cit., p. 34; and Jeni Klugman and Jenine Braithwaite, "Poverty in the Russian Federation during the transition: an overview", *The World Bank Research Observer*, vol. 13, No. 1 (February 1998), p. 39.

Box VIII.4 (continued)

industry, and 80 per cent of the level of average wages in manufacturing.

A low level of wages, however, is only one aspect of the wage problem in the Russian defence industry. Another aspect is persistent wage arrears. Even the most competitive enterprises suffer from this problem. For example, in 2002, wages on average in the Izhmash plant in the republic of Udmurtia producing the Kalashnikov guns were two months in arrears.

As a means of retaining workers while not paying them competitive wages, many defence enterprises continue to rely on enterprise-based social services. By presidential decree, control of all "social infrastructure objects" of defence enterprises was to have been transferred to the municipal authorities by 1997. In reality, the process of transfer has not been completed. By 2003, only part of the social infrastructure had been transferred to municipal budgets, sold or rented out.

Having begun the transformation of their social infrastructure, enterprises realized the importance of some of these properties for retaining personnel and decided to slow or halt the transition altogether. As of 2001, 60-70 per cent of the defence enterprises continued to own medical clinics, cafeterias and libraries; 35-55 per cent of enterprises owned stores, camps for children, recreation facilities, sports stadiums and housing; and about 20 per cent of the defence enterprises owned kindergartens.

Considerable differentiation exists among defence enterprises located in different regions of the Russian Federation. Enterprises located in, or in the vicinity of, the central cities generally enjoy better economic and social conditions than those located in the remote regions of the country, especially the far east, eastern Siberia and northern Caucasus. In the defence enterprises of Moscow and the Moscow region, average monthly wages in 2002 were more than 1.4 times higher than in other regions. This reflects the fact that, in central cities, the labour market is much more vibrant than in the provinces, hence defence industry workers unhappy with their pay or working conditions can simply leave for a better job. In provincial defence enterprises, in particular those based in the so-called closed cities, fewer workers have such an option. Yet, the fact that Moscow has a considerably higher cost of living largely offsets the differences in wage levels measured in real terms.

Sources: Clifford Gaddy, *The Price of the Past: Russia's Struggle with the Legacy of a Militarized Economy* (Washington, D.C., Brookings Institution Press, 1996); Ksenia Gonchar, "Russia's defence idustry at the turn of the century", Bonn International Centre for Conversion, Bonn, 2000; Alexei Izyumov and others, "Market reforms and regional differentiation of Russian defence enterprises", *Europe-Asia Studies,* vol. 54, No. 6 (2002), pp. 959-974; State Committee for Statistics of the Russian Federation, *Living Standards of Population* (available at: http://www.gks.ru/); and Udmurtia, "Weapons producers still suffer from wage arrears", 21 September 2002 (available at http://www.regions.ru/article/any/id/854061.html).

ization, or a reverse flow of urban citizens back to rural areas, which occurred in the Central Asian countries of CIS.[27]

27 Kathryn H. Anderson and Richard Pomfret, "Relative living standards in new market economies: evidence from Central Asian household surveys", *Journal of Comparative Economics*, vol. 30 (2002), p.702.

Conflicts and poverty

The breakdown of the centrally planned system had led to the creation of almost 20 newly independent States, but this was accompanied by numerous national and ethnic conflicts, several of which escalated to fully fledged military conflicts.

Wars and political crises resulted in major dislocations. In the course of the 1990s, close to 50 million people in transition economies were directly affected by wars and disturbances. Of these, 8 million had to flee their homes and became refugees or internally displaced persons (IDPs).[28] Half of these refugees came from within the former Yugoslavia because of the wars fought there, another 1.5 million from wars in Transcaucasus and the rest from conflicts in other CIS countries. Many of these countries have witnessed the formation of an urban underclass of beggars, including migrant children, and the creation of camps of refugees from ethnic conflicts, in, for example, the successor States of the former Soviet Union and the former Yugoslavia.

28 Branko Milanovic, *Income, Inequality and Poverty during the Transition from Planned to Market Economy* (Washington, D.C., World Bank, 1998), pp. 4-5.

By the end of the 1990s, practically all the military conflicts in transition economies had ended or had entered a low-intensity stage. However, the number of IDPs and refugees remains very high. As late as 1999, based on the United Nations estimates, the population of IDPs was 570,000 in Azerbaijan, 279,000 in Georgia and 498,000 in the Russian Federation.[29] The consequences of wars and forced migration will be felt for many years to come. For example, in Azerbaijan in 1999, 75 per cent of IDPs lived in temporary accommodations. In Georgia, one third of displaced families had no regular income several years after resettlement.[30] In Bosnia, families of former soldiers and refugees were found to have a significantly higher risk of being poor.[31]

29 United Nations Development Programme, *Human Development Report, 2001: Making New Technologies Work for Human Development* and addendum, United Nations Development Programme and addendum (New York, Oxford University Press, 2001), pp. 205 and 207.

30 *Making Transition Work for Everyone…*, p. 52; and "Monitoring in Central and Eastern Europe, the Commonwealth of Independent States and the Baltics", (MONEE Project), *Women in Transition*, Regional Monitoring Report, 6 (Florence, Italy, United Nations Children's Fund/International Child Development Centre, 1999), p.11.

31 Marcelo Bisogno and Alberto Chong, "On the determinants of inequality in Bosnia and Herzegovina", *Economics of Transition*, vol. 10, No. 2 (2002), p. 335.

Ethnic-specific poverty

Not all ethnic-specific poverty in transition economies is related to civil conflicts. Groups experiencing peacetime poverty of this type include Roma and ethnic Turks in Eastern European countries and migrant workers from Central Asia in the Russian Federation and other successor countries of the former Soviet Union. Roma, numbering between 7 million and 9 million, are considered the largest ethnic minority in Europe.

In Bulgaria, ethnic minorities constitute less than 20 per cent of the population, but 60 per cent of the poor. The risk of poverty among ethnic Turks is 3.5 times greater, and among Roma more than 10 times greater, than among ethnic Bulgarians (see table VIII.4). Poverty among ethnic minorities is not only wider but also deeper. The poverty gap (the percentage increase in income necessary to bring income up to the poverty line) for the poor among the Roma is 25.9 per cent compared with just 1.1 per cent for the poor among ethnic Bulgarians. The high level of poverty among Roma in Bulgaria and other Eastern European countries has led to a recent initiative spear-headed by the European Commission, the George Soros Open Society Institute and the World Bank. A high-level conference on the subject was held in Budapest in June 2003.

In the Russian Federation, the poorest ethnic minorities are refugees from other CIS countries, IDPs created by ethnic conflicts, such as the Chechen con-

Table VIII.4.
POVERTY BY ETHNICITY IN BULGARIA

Percentage

	Share in total population	Poverty rate of ethnic group[a]	Poverty gap of ethnic group[b]
Ethnic Bulgarians	82.3	5.6	1.1
Turks	7.1	20.9	5.3
Roma	8.8	61.8	25.9
Other	1.8	7.6	1.2
Total	100.0	11.7	3.6

Source: *Bulgaria Poverty Assessment,* World Bank Report, No. 24516, (Washington, D.C., 29 October 2002).

a Percentage of population below the poverty line.
b Difference between the poverty line and the average income of the poor, expressed as a percentage of the poverty line.

flict, and illegal immigrants. International relief groups reported that, as of 2002, there were 110,000 Chechen refugees in the territory of the Russian Federation, of whom up to 20,000 were living in tent cities in the bordering republic of Ingushetia.[32]

The majority of illegal immigrants to the Russian Federation are citizens of other CIS countries. A recent estimate for this category, given by the Ministry of Internal Affairs of the Russian Federation, is 10 million.[33] Of these, a significant part came from Central Asia, in particular from Uzbekistan and Tajikistan. Illegal immigrants are one of the most deprived segments of the population, earning low incomes, living in sub-standard housing and often subjected to persecution and extortion by local businessmen and police.

Household characteristics and poverty

As in most other market economies, the risk of poverty in transition economies is sensitive to age, gender, education, number of children and other household characteristics. In the central planning period, Governments in the region of the transition economies prided themselves on caring for the young and the old alike. The system of old-age pensions and child support guaranteed a low but stable income, while free public education and health care provided for these basic needs. In the course of the transition, these benefits were reduced in absolute terms in some countries. In relative terms, however, the very young lost much more than the old.

The incidence of poverty increased with the number of children in the family. In the Russian Federation, for example, based on the 1997 national poverty line, the poverty headcount was 37 per cent for families with two children, 50 per cent for families with three children and 72 per cent for families with four or more children. In Armenia, based on a 1996 survey, families twice the size of the average registered twice the rate of extreme poverty.[34] Extreme poverty and an increase in the number of dysfunctional families have led to the emergence of a sizeable population of runaway street children. In the Russian Federation, homeless children are estimated to number 1 million, a figure attesting to a situation that can be compared only with the post-civil war period of the early 1920s.

The risk of poverty for older citizens of transition economies is generally lower than for the average citizen. This is particularly true for Eastern European countries. In the course of transition, the share of pensions in GDP in these countries was preserved at the pre-market reform level and, in some countries,

32 *Moscow Times*, 19 December 2002.

33 Newsru.com, 24 October 2001 (http://newsru.com/russia/24Oct2001/nelegaly.html).

34 *Women in Transition…*, p. 10.

actually increased. In most CIS countries, spending on pensions in proportion to GDP was largely maintained. In view of the sharp drop of GDP, this meant a fall in real incomes. However, compared with other groups of the population, pensioners fared relatively well. A recent World Bank study found the poverty risk for pensioners lower than for the population at large in all of the Eastern European countries with the exception of Bulgaria and Croatia. In the CIS countries, the risk of poverty for the elderly was generally higher than the average, but not by a large amount, and in two countries, Turkmenistan and Tajikistan, the risk of poverty was lower.[35] Unlike young people, most retirees in transition economies could rely on accumulated assets, such as apartments and garden plots. In many of the poor families in CIS, pensioners actually share their monetary and in-kind resources with the younger members of their families.

35 *Making Transition Work for Everyone*…, pp. 82-83.

Lack of education is a significant predictor of poverty risk. According to a recent study, people with only elementary education have a risk of being poor that is 20-60 per cent higher compared with the national averages. In contrast, people with a higher education have a lower-than-average probability of being drawn into poverty. This relationship is stronger in the more wealthy Eastern European economies, where returns to education are higher, but it also holds for the poorest economies such as those of Central Asia.

Overall, the links between individual and household characteristics and chronic poverty are stronger in Eastern European countries than in the CIS countries. This indicates the decline in indiscriminate mass transient poverty in the former and the dominance of such poverty in the latter.

EMPLOYMENT, UNEMPLOYMENT AND POVERTY

Because of their inefficiency and disregard for the true costs of production, the pre-transition economies operated under conditions of an apparent labour shortage and claimed an official unemployment rate of zero. In the early period of market reforms, the reduction of output in the transition countries that came about as much of the inefficient, wasteful and unwanted production was eliminated, was more pronounced than the increase in recorded unemployment. The reasons for this included the inertia of the full employment paradigm, the political fear of mass unemployment, the preservation of soft budget constraints in many of the State-owned and newly privatized enterprises, labour hoarding by firms accustomed to labour shortages, and the low geographical mobility of labour.[36]

36 See *World Economic and Social Survey, 2002* (United Nations publication, Sales No. E.02.II.C.1), box IV.2, for the adverse effects of soft budget constraints. See also Janos Kornai, *Highways and Byways*…; Olivier Blanchard, *The Economics of Post-communist transition* (Oxford, United Kingdom, Clarendon Press (1998); Mark E. Shaffer, "Do firms in transition economies have soft budget constraints? a reconsideration of concepts and evidence", *Journal of Comparative Economics*, vol. 26, pp. 80-103; and Vahaly Izyumov, "The unemployment-output trade-off in transition economies: does Okun's law apply", *Economics of Planning* (forthcoming).

By the mid-1990s, however, the legacy of the centrally planned economy had been largely destroyed, thereby weakening the strength of many of the above factors, especially in the countries most advanced in their transition. As a result, several years into market reforms, unemployment in the transition economies rose from less than 5 per cent to 10-15 per cent or more (for selected countries, see table VIII.5). The overall losses of employment were even larger than indicated by the unemployment figures alone, as millions of people withdrew from the labour force altogether. Between 1989 and 1998, an estimated 26 million jobs were lost in the transition economies—13 per cent of the pre-transition total. However, in contrast with the experience of the developed countries, where a drop in employment is generally not accompanied by a drop

Table VIII.5.
OUTPUT, UNEMPLOYMENT, AND REAL WAGES IN SELECTED TRANSITION ECONOMIES, 1991-2001

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bulgaria											
Real GDP growth	-11.7	-7.3	-1.5	1.8	2.8	-10.2	-7.0	3.5	2.4	5.8	4.1
Unemployment rate (percentage)	11.1	15.3	16.4	12.8	11.1	12.5	13.7	12.2	16.0	17.9	17.7
Real wage (1989=100)	68.0	76.7	77.6	63.7	60.2	49.6	40.1	48.1	51.7	48.9	48.7
Czech Republic											
Real GDP growth	-11.6	-0.5	0.1	2.2	6.0	4.3	-0.8	-1.2	-0.4	2.9	3.1
Unemployment rate (percentage)	4.1	2.6	3.5	3.2	2.9	3.5	5.2	7.5	9.4	8.8	8.6
Real wage (1989=100)	68.9	76.0	78.8	84.9	92.2	100.4	102.3	101.0	107.4	108.1	117.0
Poland											
Real GDP growth	-7.0	2.6	3.8	5.1	7.1	6.0	6.9	4.8	4.1	4.0	1.0
Unemployment rate (percentage)	12.2	14.3	16.4	16.0	14.9	13.2	10.3	10.4	13.1	15.1	16.2
Real wage (1989=100)	75.4	73.3	71.2	71.6	73.3	77.9	82.4	85.2	90.1	97.4	102.1
Russian Federation											
Real GDP growth	-5.0	-14.5	-8.7	-12.7	-4.1	-3.6	1.4	-5.3	6.4	10.0	5.0
Unemployment rate (percentage)	..	5.2	6.1	7.8	9.0	10.0	11.2	13.3	12.2	9.8	8.7
Real wage (1990=100)	93.9	63.1	63.4	58.4	42.1	47.7	50.0	37.0	35.8	43.3	51.8

Sources: ECE, *Economic Survey of Europe: 2003, No.1* (United Nations publication, Sales No. E.03.11.E.26); European Bank for Reconstruction and Development (EBRD), *Transition Report, 2002:. Agriculture and Rural Transition* (London, EBRD, 2002), pp. 58, 65-66, 133, 141, 185 and 193; *EBRD Transition Report Update 2001* (London, EBRD, 2001), p. 15; *Making Transition Work for Everyone: Poverty and Inequality in Europe and Central Asia* (Washington, D.C., World Bank, 2000), p. 125; and Goskomstat of Russia (available at: http://www.gks.ru/).

in the real wages of those employed, in many transition economies, real wages also fell as nominal wage increases did not keep up with rapid inflation. This was particularly true for the countries of CIS, where they had declined by 40-50 per cent by the middle of the 1990s. Not only did real wages decline, but they were often paid in considerable arrears, sometimes up to one year.

Rampant inflation and a higher level of macroeconomic instability made workers in CIS countries less capable of defending their real wages than workers in Eastern Europe. Inflation, in particular, was much more severe in the CIS countries, than in Eastern Europe. In the first years of reforms, the largest CIS countries experienced inflation of above 2,000 per cent a year. In Eastern Europe, the worst inflation experience was of the order of 100-200 per cent. Relatively rapid macroeconomic stabilization helped workers in Eastern Europe to partially or fully restore their pre-transition wage levels. Having fallen by about 25 per cent in the period 1989-1991, real wages there have since increased and on average regained 15-20 per cent. In most of the CIS countries, where macroeconomic stabilization took several more years, real wages continued to decline until the mid-1990s.[37] Wages in CIS recovered somewhat in 1995-1997, but dropped dramatically in the wake of the 1998 ruble crisis. Since 1999 they have increased, but still remain much lower than in the pre-transition period, especially if frequent arrears and non-payments are taken into account.

[37] Tito Boeri and Katherine Terrell, "Institutional determinants of labour reallocation in transition", *Journal of Economic Perspectives,* vol. 16, No. 1 (winter 2002), p. 54; and Jan Sveinar, "Transition economies: performance and challenges", *Journal of Economic Perspectives,* vol. 16, No. 1 (winter 2002), p. 18.

Weaker trade unions, the inadequacy of unemployment protection and reliance on enterprise-specific non-wage benefits, such as subsidized housing, health care and childcare, force workers in CIS countries to hold on to low-paid jobs. Low geographical mobility of labour reinforces this tendency. Owing to such obstacles as undeveloped housing markets, high costs of transportation and legal restrictions, millions of workers cannot take advantage of job opportunities in other districts and are stuck with poorly paid jobs or no jobs at all.

CIS countries suffer from another major bottleneck in their labour markets—an inadequate number of small and medium-sized enterprises (SMEs), a situation rooted mainly in the poor legal and tax environments facing such enterprises and the preservation of soft budget constraints and other privileges for larger enterprises.[38] In contrast, in Eastern Europe, where SMEs are treated favourably, these enterprises serve as a major source of new jobs and thus as an important antidote to poverty. As a result, in Eastern Europe, employment and output in SMEs have grown quickly, making this sector the main engine of economic growth. By 1998, enterprises employing 50 workers or less produced 55-65 per cent of GDP in the Czech Republic, Hungary and Lithuania, in contrast with just 10-20 per cent of GDP in Belarus, Kazakhstan, the Russian Federation and Ukraine. The share of SMEs in CIS countries was still low despite the fact that their productivity had been higher than the average in the economy. This is significant as, according to a recent World Bank study, the positive impact of SMEs on overall employment and growth can be felt only after a threshold of 40 per cent in employment and value added is reached.[39]

38 In the first three years of reforms (1992-1994), the number of small businesses increased in the Russian Federation from 268,000 to 897,000. Yet, macroeconomic instability, unfair competition from larger companies and highly unfavourable government policies stopped the growth of the small private businesses, effectively freezing them at the level of 1 million.

39 *Transition: The First Ten Years…*, pp. 39-42.

Unemployment benefits and the minimum wage

The different ways in which the labour market adjusted to the transition—mostly through the reduction of employment in Eastern Europe and through reductions both in employment and in real wages in CIS—resulted from the different labour policies in these two groups of countries and had significantly different implications for poverty.

In Eastern Europe, in particular in those countries more advanced in their transition, from the start, Governments maintained relatively high unemployment benefits. In the CIS countries, on the contrary, unemployment benefits were meagre. For example, in Slovakia, in 2000, unemployment benefits generally ranged between 40 and 50 per cent of the average wage. The duration and coverage of unemployment benefits were also set longer and broader in Eastern Europe compared with CIS countries. For example, benefits had been limited to 24 months in the former Yugoslav Republic of Macedonia, as against a limit of 6 months in the Russian Federation. In Romania, even new entrants to the labour force are eligible for unemployment benefits if they cannot find work.

In the Russian Federation, the minimum wage is less than 10 per cent of the average wage, while unemployment compensation, instead of being based on the average wage before redundancy, is often paid at the minimum wage level.[40] With unemployment benefits being set so low, most unemployed do not even care to register. As a result, registered unemployment in the Russian Federation is about three or four times less than survey-based unemployment. The low level of benefits is only partially explained by limited funding: in the Russian Federation, the Federal Employment Service has recorded a budget surplus for a number of years.[41]

40 Poorly protected from inflation, the minimum wage in the Russian Federation and many other CIS countries had essentially lost its primary meaning and was turned by various Government agencies into a unique accounting unit.

41 *Making Transition Work for Everyone …*, p. 345; and Tito Boeri and Katherine Terrell, loc. cit., p. 72.

Unemployment status is a fairly accurate predictor of poverty in the countries most advanced in their transition. In Poland and Hungary, households headed by an unemployed person are four times more likely to be poor than those headed by an employed person. In Hungary in the mid-1990s, 60 per cent of heads of poor households were unemployed; in Bulgaria, and Poland, 30 per cent; and in Estonia, 24 per cent. However, in CIS, the link between poverty and unemployment is weak. Only 11 per cent of the poor in the Russian Federation and only 5 per cent of the poor in Belarus came from the ranks of the unemployed.[42] The main reason for this seeming anomaly is the extremely low level of wages in CIS, making the difference between the employed and the unemployed less distinguishable there than in Eastern Europe.

Minimum wage legislation in Eastern Europe is different from that in CIS. In Eastern Europe, the minimum wage is set at between 30 and 40 per cent of the average wage, while in the CIS countries, it was allowed to shrink from close to 30 per cent of the average wage in 1990 to less than 10 per cent in 1996 and to less than 7 per cent in 2002.[43]

In principle, the minimum wage should be set at a level that provides the household with an income at least sufficient for its members to reach the national poverty line. For example, in the United States, the minimum wage is set at approximately four times the national poverty line. Thus, one working member in a family of four earning the minimum wage should generate just enough income to keep the family from falling below the poverty line. Even in the countries most advanced in their transition, this condition is met only by those earning the average, rather than the minimum, wage. Thus, in Poland in the mid-1990s, the ratio of the average wage to the official poverty line was almost 3:1. In the Russian Federation and Ukraine, this ratio was just 2:1.[44]

Higher minimum wage and unemployment benefits in Eastern Europe provided a wage floor, which allowed the working population to escape poverty. The costs of this policy were a reduction in the effective demand for labour, and higher taxation. In CIS, in contrast, the absence of the effective wage floor led to real wages dropping well below the poverty line and creating millions of "working poor".

In recent years, policy makers in CIS countries have increasingly recognized that low real wages are a major obstacle to both the struggle against poverty and the broader goal of economic restructuring: low minimum wages have discouraged the shedding of redundant labour and have thereby slowed down the badly needed restructuring of obsolete enterprises. In the Russian Federation, some of the participants in the "minimum wage debate" have called for a national tri-party agreement among labour unions, business and the Government, aiming at a substantial increase in the level of wages in the economy. In exchange for such a commitment, the Government would agree to an across-the-board reduction in taxes, while trade unions would guarantee higher productivity and labour discipline.[45] In 2000-2001, the Government of Slovenia, and employees and employers of both public and private sectors, entered into a "social partnership" agreement over wages. A similar partnership is being negotiated in Croatia.[46] In all such attempts to raise the minimum wage, the disincentive effects on investment and, particularly, FDI must be carefully assessed.

42 Branko Milanovic, op. cit., pp. 98 and 117.

43 Tito Boeri and Katherine Terrell, loc. cit., p. 65; and Russian State Statistical Agency (available at: http://www.gks.ru).

44 Branko Milanovic, op. cit., pp. 97-99.

45 Interview with Dr. Viktor Ivanter, Director of the Institute of Economic Forecasting of the Russian Academy of Sciences in Moscow (available at www.echo.msk.ru).

46 EBRD, *Transition Report, 2001: Energy in Transition* (London, EBRD, 2001), p. 195; and *Transition Report 2002: Agriculture and Rural Transition…*, p. 135.

COPING WITH POVERTY: THE GOVERNMENT'S RESPONSE

The transition from a political, social and economic system based upon centrally planning to one based upon market forces necessitates changes in all aspects of the economy, including the provision of social services and social security. Under the previous system, poverty had been claimed to be largely a non-problem, as employment, basic housing, education and health care were guaranteed and provided by the State. Not only income but also a large proportion of social services were provided by the place of employment.[47]

The recession attending the transformation subjected the old social protection system to a test for which it was totally unprepared. In addition to the shrinking of GDP in all transition economies, there was also a shrinking of the share of the government in the economy. The dual shock of recession and fiscal retreat meant that Governments had to construct an alternative system for delivering social services and for reducing poverty—but with fewer resources. Between 1989 and 2000, in Eastern Europe, the share of aggregate Government expenditures in GDP fell on average from 53 to 42 per cent, while in the CIS countries, it fell from 50 to 26 per cent. In several of the poorest CIS countries, this share fell to a much lower level, for example, to 18 per cent in Georgia.[48] Much of this decline, however, was due to cuts in Government investment expenditures.

The response to the challenge of protecting the population during the transition differed markedly across the transition economies. In the countries most advanced in their transition, Governments played a proactive role in alleviating the shock of transition. In spite of recessionary pressures, the level of social protection was left largely intact, while the system itself was reoriented towards the needs of the market economy. The level of social protection was also largely maintained in some CIS countries, such as Belarus and Uzbekistan. Here, though, little restructuring of the system took place. In the rest of the transition economies, the social protection system was downsized while being reformed on an ad hoc basis. The situation is particularly difficult in several war-torn countries, such as Georgia, where social protection almost disintegrated.

The main components of the Government social protection system are: (a) social security (including pensions and unemployment benefits); (b) targeted welfare (family allowances); (c) untargeted subsidies; and (d) and the provision of health care and education. In addition to social protection, Government can undertake proactive measures to cope with poverty, such as job training and public works.

Pensions reform

Of all social protection programmes, pension programmes have probably survived the transition best. This is particularly true for Eastern Europe, where, in some countries, the share of GDP spent on pensions has surpassed its pretransition level; but even in the poorest transition economies, pensions have played a very important income-stabilizing role for pensioners and their families. As previously discussed, the risk of poverty for pensioners is generally less than or close to that of the population at large and significantly less than for the unemployed or for residents of rural areas.[49]

47 For a description of the pre-reform social protection systems, see, for example, Branko Milanovic, op. cit., pp. 12-19; and *Poverty in Transition…*, pp. 90-93.

48 *Making Transition Work for Everyone…*, p. 132; *Transition: The First Ten Years...*, pp. 81-82.

49 Branko Milanovic, op. cit.; and *Transition: The First Ten Years…*, pp. 39-42.

On average, during the 1990s, public spending on pensions constituted 10 per cent of GDP in Eastern Europe and 5 per cent of GDP in CIS. For individual countries, this proportion ranged from 15.5 per cent in Poland (in 1997) to just 2-3 per cent in Armenia and Azerbaijan (in 1996), Georgia (in 2000), and Tajikistan and Turkmenistan (in 1996) (see table VIII.6).[50] Cross-country comparisons of pension spending have to be treated with caution. While the average retirement age is similar in most countries with transition economies (55 years for women and 60 years for men), other eligibility requirements can be different. In some professional categories, workers in transition economies are eligible to retire at 45 years of age or even earlier. Moreover, the transition

50 *Making Transition Work for Everyone…*, pp. 292-294.

Table VIII.6.
PUBLIC EXPENDITURES ON PENSIONS, 1994-2000

Percentage

Country	Year	Share of GDP	Year	Average pension as proportion of per capita income
Eastern Europe				
Albania	1995	5.1	..	..
Bulgaria	1996	7.3	1995	39.3
Croatia	1997	11.6	..	..
Czech Republic	1999	9.8	1996	37.0
Estonia	1995	7.0	1995	56.7
Hungary	1996	9.7	1996	33.6
Latvia	1995	10.2	1994	47.6
Lithuania	1998	7.3	1995	21.3
Poland	1997	15.5	1995	61.2
Romania	1996	5.1	1994	34.1
Slovakia	1994	9.1	1994	44.5
Slovenia	1996	13.6	1996	49.3
The former Yugoslav Republic of Macedonia	1998	8.7	1996	91.6
Commonwealth of Independent States				
Armenia	1996	3.1	1996	18.7
Azerbaijan	1996	2.5	1996	51.4
Belarus	1997	7.7	1995	31.2
Georgia	2000	2.7	1996	12.6
Kazakhstan	1997	5.0	1996	18.8
Kyrgyzstan	1997	6.4	1994	35.0
Republic of Moldova	1996	7.5	..	..
Russian Federation	1996	5.7	1995	18.3
Tajikistan	1996	3.0	..	..
Turkmenistan	1996	2.3	..	..
Ukraine	1996	8.6	1995	30.9
Uzbekistan	1995	5.3	1995	45.8

Source: *World Development Indicators, 2002*, CD-ROM (Washington, D.C., World Bank, 2002).

economies were often generous in their requirements for disability pensions and so the number of disabled persons among pre-retirement-age pensioners increased. In Poland and Croatia, 60 per cent and 90 per cent, respectively, of those in their first year on a pension are under age 60.[51]

[51] *Poverty in Transition* ..., p. 98; and *Transition Report, 2002*..., p. 183.

To complement their pension incomes, many retired people in transition economies continue to work. Of the total number of pensioners, between 10 and 12 per cent continue to work in the Czech Republic, Poland and the Russian Federation, but only between 4 and 6 per cent in Bulgaria, Hungary, Slovakia and Slovenia. The average rate of employment of pensioners for European OECD member countries is less than 4 per cent.[52]

[52] Alexandre Kolev and Anne Pascal, "What keeps pensioners at work in Russia?", *Economics of Transition*, vol. 10, No. 1 (2002), p.33

While the level of pensions is inadequate in the poorest CIS countries, it is probably unsustainable over the longer run for the richest transition economies. This is all the more true given the demographics in most transition economies. The share of the elderly in the population is increasing more rapidly than that of the employed, making the dependency ratio grow quickly. In the late 1990s, in some Eastern European countries, the number of pensioners approached that of wage earners.

In recent years, most transition economies have started reforming their pension systems. The goal is to emulate the pension systems of some of the developed and developing countries, such as Chile, that have reformed the pension schemes by gradually reducing the pay-as-you-go component of pensions while adding to existing pensions employment-based defined contribution plans and individual private plans. In addition, most of these reforms propose the extension of the retirement age and stricter eligibility requirements. In 2001-2002, the retirement age was increased in Albania from 55 to 60 years for women and from 60 to 65 years for men. Estonia has started its move towards a universal retirement age of 63 years. Extension of the retirement age is a reasonable proposal for the richer Eastern European countries. However, in some CIS countries, such as the Russian Federation and Kazakhstan, by some estimates average life expectancy for men is already below the retirement age.[53] The problems caused by an ageing population are thus fading in significance when set against those caused by high morbidity among the working-age population.

[53] Michael Ellman, "The social costs and consequences of the transformation process", in *Economic Survey of Europe, 2000*, No. 2/3 (United Nations publication, Sales No. E.00.II.E.28), p. 133.

Targeted social protection

Targeted welfare programmes (direct payment to poor families with children, individual housing, utilities and other subsidies) constitute a much smaller part of the social protection system than pensions. In Eastern Europe, spending on targeted assistance ranges between 0.5 and 2 per cent of GDP, while in the CIS countries, it is generally less than 0.5 per cent of GDP (with the exception of Armenia, where this spending is 2 per cent of GDP).[54]

[54] *World Development Report, 2000/2001*..., p. 293.

Owing to the rapidly changing economic situation, the large size of the informal sector and little experience in means-testing, the effective administration of such programmes is difficult. As a result, a significant part of nominally targeted subsidies goes to well-to-do rather than poor households. The waste of resources is particularly large in countries where means-testing is not used at all.

There are, however, several successful examples of targeted welfare programmes in transition economies. One economy with such programmes is Romania, where targeted assistance to families with children is linked to

Table VIII.7.
TARGETING OF CASH BENEFITS IN TRANSITION ECONOMIES, 1996-1997

Percentage

Country	Year	Social assistance	Child/family allowances
Albania	1996	47	..
Armenia	1996	..	25
Croatia	1998	25	28
Estonia	1995	44	40
Hungary	1997	46	20
Kazakhstan	1996	6	24
Latvia	1998	20	29
Romania	1997	79	51
The former Yugoslav Republic of Macedonia	1997	47	5
Uzbekistan	1999	23	..

Source: World Bank, *Making Transition Work for Everyone: Poverty and Inequality in Europe and Central Asia* (Washington, D.C., 2000), p. 298.

Note: The table shows what proportions of general cash benefits assistance and child/family allowances reach the poorest 20 per cent of the population in different countries. For example, in Latvia, Croatia and Uzbekistan, the poorest 20 per cent of households are receiving only between 20 and 25 per cent of total social assistance funds, which reflects poor targeting. In Romania, the poorest 20 per cent of the population receive 79 per cent of total social assistance, which indicates more accurate targeting.

school attendance. In Romania, almost 80 per cent of social assistance funds and over 50 per cent of family allowances reach the poorest quintile of the population, much higher proportions than in other countries (see table VIII.7).

Untargeted subsidies

In transition economies, untargeted subsidies come in the form of controlled prices on public utilities, including electricity, heating, telecommunications, water supply and some other services and goods, such as public transportation and basic food staples. The degree of subsidization varies greatly across different countries. Subsidies are minimal in the countries that are most advanced in their transition, but are very high in the CIS countries, especially in the resource-rich countries, such as Azerbaijan, the Russian Federation and Turkmenistan. In Azerbaijan, for example, electricity and gas subsidies amounted in 1999 to 6.2 per cent of GDP; in the Russian Federation, to 5 per cent of GDP.[55]

55 Ibid., p. 135; and OECD, *Economic Survey: Russian Federation* (Paris, OECD, 2002), p. 20.

All transition economies inherited from the central planning period an extensive utilities infrastructure, providing practically all households with electricity and 50-90 per cent with running water, centralized gas, heating and sewerage systems. Prior to reforms, prices of energy in transition economies were held low, based on plentiful energy supplies from the former Soviet Union. With the break-up of the Council for Mutual Economic Assistance, subsidized energy flows to Eastern Europe ceased, thereby forcing these countries to pay prices at international market levels. At the same time, in most CIS countries, Governments tried to maintain low prices for utilities, claiming this policy to be a form of social protection. The subsidies are financed explicitly by government budget allocations or implicitly by the accumulation of arrears by energy suppliers, as a result of allowing non-payment by customers, and by forgiving the taxes due from energy-using enterprises. In the Russian Federation, subsidies from local governments to large energy using enterprises, ostensibly to maintain employment, amounted, in the mid-1990s, to 4 per cent of GDP. Cross-subsidization is widespread. For example, in the Russian Federation, electricity tariffs for industrial users are approximately double those for households.[56]

56 *Transition Report, 2001...*, p. 98.

Energy subsidies are extremely costly to the transition economies, in terms both of their fiscal impact and of the losses of macroeconomic efficiency. Moreover, the role of these subsidies in helping the poor is highly questionable. Even with prices based upon the true costs of production, expenditures on electricity and heat in most transition economies would constitute a fairly small proportion of the family budget—usually under 5 per cent.[57] In view of the fact that the poor are receiving only a fraction of the resources used to maintain energy subsidies, it can be seen that other, more selective programmes of social assistance are needed.

57 Ibid., p. 99.

Among the alternative methods currently used in transition economies to help the poor pay for their utilities are: (a) lifeline tariffs, where an initial block of energy is supplied free or at a low price; (b) targeted energy subsidies; and (c) general income support. The efficiency of these programmes varies, as it depends upon accurate measurement of income and energy use; but in many transition economies, this measurement is highly imprecise. However, it is clear that the existing system of wasteful across-the-board subsidization prevalent in the CIS countries needs to be reformed.

Public spending on education and health

The role of good education and health in overcoming poverty is hard to overestimate. Universal education and health-care systems were the pride of the centrally planned countries. However, by the time that the centrally planned system had collapsed, the health and education systems were already failing, as shown by the lower life expectancy in those countries compared with the developed countries.

In the course of market reforms, even as GDP fell, most transition economies strove to maintain the level of public spending on education and health care measured as a proportion of their GDP. In some countries, such as Belarus, Latvia, Lithuania and the Republic of Moldova, the share even increased. However, in countries of Caucasus and Central Asia, the share fell (see table VIII.8). However, the transformational recession produced heavy declines in the amounts spent.[58]

58 *Women in Transition...*, p. 16.

In addition to lower spending on health and education, transition economies suffered from problems of low efficiency and a waste of resources. In education, those problems included overstaffing, low capacity utilization, a shift of resources in favour of tertiary education, falling quality of education and growing corruption.

The decline in spending and efficiency has already influenced the quality outcomes and disproportionately affected the poor. Enrolment rates in compulsory basic education and, in particular, in secondary education fell in the 1990s in many CIS countries. In Kazakhstan in 1998, 19 per cent of children aged 6-12 years were not attending school.[59] Between 1989 and 1997, enrolment in general secondary education fell by 15 per cent in Armenia, by 40 per cent in Georgia and by 45 per cent in Tajikistan.

59 *Poverty in Transition...*, p. 72; and *Making Transition Work for Everyone...*, p. 230.

Inequality in access to education has increased. In Armenia and Kazakhstan, the lowest income quintile of the population received less than 10 per cent of

Table VIII.8.
PUBLIC EXPENDITURES ON EDUCATION AND HEALTH AS A PROPORTION OF GDP, 1990, 1998 AND 2000

Percentage

Country	Share in GDP of public expenditure on education		Share in GDP of public expenditure on health	
	1990	1998	1990	2000
Eastern Europe				
Albania	5.9	..	3.4	2.1
Bulgaria	5.2	3.4	4.1	3.0
Croatia	7.2	4.2	9.5	8.0
Czech Republic	..	4.2	4.8	6.6
Estonia	..	6.8	1.9	4.7
Hungary	5.8	4.6	6.0	5.2
Latvia	3.8	6.8	2.7	3.5
Lithuania	4.6	6.4	3.0	4.3
Poland	4.6	5.4	4.8	4.2
Romania	2.8	3.5	2.8	1.9
Slovakia	5.1	..	5.0	5.3
Slovenia	4.8	..	..	6.8
The former Yugoslav Republic of Macedonia	..	4.1	9.2	5.1
Commonwealth of Independent States				
Armenia	7.0	..	..	3.2
Azerbaijan	..	3.4	2.7	0.7
Belarus	4.8	..	2.5	4.7
Georgia	..	5.2	3.0	0.8
Kazakhstan	3.2	4.4	3.2	2.7
Krygyzstan	8.4	5.4	4.7	2.2
Republic of Moldova	5.6	10.2	4.4	2.9
Russian Federation	3.0	3.5	2.5	3.8
Tajikistan	10.0	2.1	4.9	1.0
Turkmenistan	4.3	..	4.0	4.6
Ukraine	5.2	4.5	3.0	2.9
Uzbekistan	9.5	7.7	4.6	2.6

Sources: World Bank, *World Development Indicators,* CD-ROM (Washington, D.C., 2002); and United Nations Development Programme, *Human Development Report, 2001: Making New Technologies Work for Human Development* and addendum (Oxford University Press, New York, 2001), pp. 195-197.

public spending on education, while the top quintiles received 29 per cent and 26 per cent, respectively.[60] In Bulgaria, in 2001, the gap in the enrolment rates between children coming from the poorest and children coming from the richest quintiles of the population was 23 per cent for urban and 45 per cent for rural areas. In the Russian Federation, school enrolment of children aged 17-19 years from low-income families is one third below that of children from the high-income group, while university and college enrolment is one half. In the course of the 1990s, in Moscow State University, the largest university in the Russian Federation, the proportion of non-Moscow-based students dropped from 80 per cent of the total to 20 per cent.[61]

60 *World Development Report, 2000/2001*, p. 80.

61 *Bulgaria Poverty Assignment*, World Bank Report, No. 24516 (Washington, D.C., World Bank, 29 October 2002), p. 110; Milanovic, *Income, Inequality and Poverty during the Transition from Planned to Market Economy…*, pp. 12-19; *Poverty in Transition…*, p. 75; and *Making Transition Work for Everyone…*, p. 232.

Falling enrolments and rising inequality in access to education have long-term consequences: they undermine income-earning opportunities for children of poorer families and thus create a "poverty trap".[62] Proposals for the reforms of education call for increased emphasis on the provision of universal basic education (in particular in the poorer countries of CIS); the reallocation of public funding away from tertiary to primary and secondary education; the reduction of the personnel employed in the public education system; and the consolidation of school infrastructure.[63]

One of the few successful examples of a programme curbing the decline of human capital in the transition economies is the above-mentioned system of targeted family allowances for poor families in Romania which is tied to the school attendance of their children (similar to programmes used in the United States and some other countries). Introduced in 1993, this programme helped to increase school enrolment in Romania from 89.6 per cent in 1992 to 95 per cent in 1997.[64] Largely because of this programme, Romania also achieved the most equitable distribution of public spending on education: the lowest income quintile of the population received 24 per cent of public spending, while the top quintile received 15 per cent.[65]

The decline of the public health-care system also disproportionately affected the poorer transition economies and the poorer segments of the population within them. In Central Asia and Caucasus, health-care expenditures fell in both relative and absolute terms. In Georgia, the fall was from 3 per cent of GDP in 1990 to 0.8 per cent in 2000 (see table VIII.8). Moreover, a lack of structural reforms through which to adjust to the new market environment meant a loss of efficiency and accessibility to health care, in particular for the poor. The main problems of health care include overstaffing, an excess number of hospital beds, longer-than-necessary hospital stays and widespread informal payments from patients for medical services.

A growing problem is inequality in health-care access. In Bulgaria, the lowest income quintile of the population received 13 per cent of public spending on health care, while the top income quintile received 25 per cent. In the Russian Federation, in 1997, 11 per cent of patients could not afford medical treatment and 41 per cent of patients could not afford necessary drugs. In Kazakhstan, the coverage of immunization of children in the top income quintile is over 80 per cent, but for the bottom quintile just 40 per cent.[66]

The disarray in the health-care system contributed to the decline in health indicators. In the poorest regions of CIS countries and in the Balkans, malnutrition, anaemia and iodine deficiency are widespread among children and women. At the same time, tuberculosis, human immunodeficiency virus/acquired immunodeficiency syndrome (HIV/AIDS) and other infectious diseases are assuming epidemic proportions.

The health-care crisis is creating another dangerous poverty trap, as poor health is one of the main obstacles to productive economic activity. Measures proposed to overcome the crisis include: concentrating resources on preventive (rather than curative) primary care; putting the focus on children; consolidating facilities, thereby reducing the number of hospital beds; and rationalizing private payments.[67]

62 For a fuller discussion of the poverty trap, see *World Economic and Social Survey, 2000* (United Nations publication, Sales No. E.00.II.C.1), chap. VI, entitled "Education as a prerequisite of sustained growth".

63 Peter S. Keller and Christian Heller, *Social Sector Reform in Transition Countries*, IMF Working Paper, No. 01/35 (Washington, D.C., IMF, 2001), pp. 21-22; *Poverty in Transition…*, pp. 86-87; and *Transition: The First Ten Years…*, p. 85.

64 For children of age group 6-7 to 14-15, based on UNICEF data and methodology. See: Michael Ellman, loc. cit., p. 130.

65 *World Development Report, 2000/2001…*, p. 80.

66 *Transition: The First Ten Years…*, p. 86; *World Development Report, 2000/2001…, p.* 81; and *Making Transition Work for Everyone…*, p. 259.

67 Peter Keller and Christian Heller, op. cit., pp. 21-23; *Poverty in Transition…*, pp. 57-63 and 87; and *Transition: The First Ten Years…*, p. 85.

COPING WITH POVERTY: THE PRIVATE RESPONSE

As a result of the inadequacy of Government-provided poverty abatement programmes in most of the transition economies, poor families and individuals have borne the brunt of the struggle with poverty. At the start of the transition, people in transition economies were not very well positioned to handle this task, as their knowledge of the rules of the market economy was minimal. Moreover, as mentioned previously, the savings of many people had been wiped out by the hyperinflation of the early 1990s.

Various coping strategies have come into play: the growth of self-employment and of the informal economy; the cultivation of family plots to satisfy food needs; intra-family transfers; internal migration; and emigration to other countries. Each of these strategies has its benefits, and some proved to be more efficient than government transfers in alleviating poverty. For example, it is established that intra-family transfers to the poor are better targeted than similar Government subsidies and thus, for a given transfer of resources, larger gains in welfare are generated.[68] At the same time, many of the private coping strategies lead to socially and economically questionable outcomes such as de-urbanization (migration of urban-dwellers back to farming areas), the growth of the informal economy and the spread of crime.

68 *Bulgaria Poverty Assessment*..., p. 100; and Stanislav Kolesnikov and Ksenia Yudaeva, "Inequality and poverty in post-crisis Russia", *Economic Trends*, vol. 8, issue 3 (August 1999), p. 14.

Self-employment and the growth of the informal economy

Faced with unemployment and/or falling wages, millions of people in the transition economies turned to self-employment. Many of them formed unregistered one-person businesses in activities such as the resale of consumer goods, "shuttle trade" and in-home-based businesses, such as sewing, repairing, cleaning, providing day care and tutoring.[69]

Between 1990 and 1995, the share of GDP produced in the unofficial sector is estimated to have grown from 25 to 36 per cent in Bulgaria; from 12 to 35 per cent in Latvia; from 14 to 19 per cent in Romania; from 22 to 61 per cent in Azerbaijan; from 15 to 42 per cent in the Russian Federation; and from 16 to 49 per cent in Ukraine (see table VIII.9). However, the sector's growth was not universal. In the Czech Republic, Estonia, Hungary and Poland, as well as in the CIS countries of Belarus and Uzbekistan, the informal sector's share in the economy decreased or barely increased.[70]

The different growth patterns of the informal economy underscore differences in the openness and dynamism of labour markets in transition economies. While in those countries that had been more advanced in their transition, the official economy provided increasing opportunities for employment and entrepreneurship, in other transition economies, the lack of these opportunities forced millions of people into the unofficial sector. For example, in the Russian Federation, over 12 million people are self-employed, most in one-person operations. At the same time, the number of officially registered small businesses in the Russian Federation is less than 1 million, compared with 4 million in Poland and over 15 million in the United States. In fact, the total number of small private businesses in the Russian Federation is less than the number of new businesses opening up in the United States every year.

69 Shuttle trade is a term generally applied to describe the massive unregulated and unregistered commerce conducted by hundreds of thousands of individuals in transition economies. It involves buying goods abroad and selling them in the Russian Federation in street markets. In the Russian Federation in the mid-1990s, the turnover of the unregistered shuttle trade had reached an estimated $10 billion, comparable with the total annual revenue from Russian oil exports.

70 Estimates of the size of the informal economy can, by definition, be only approximate. Every such estimate strongly depends upon the assumptions and methodology used. For a discussion see, for example: Simon Johnson, Daniel Kaufman and Andrei Shleifer, "The unofficial economy in transition", *Brookings Papers on Economic Activity,* vol. 2 (1997), pp. 159-221; and Maria Lacko, "Hidden economy—an unknown quantity?", *Economics of Transition*, vol. 8, No. 1 (2000), pp. 117-149.

Table VIII.9.
ESTIMATES OF THE SHARE OF GDP PRODUCED IN THE UNOFFICIAL ECONOMY IN SELECTED TRANSITION COUNTRIES, 1990 AND 1995

Percentage

Country	1990	1995
Eastern Europe		
Bulgaria	25.1	36.2
Czech Republic	6.7	11.3
Estonia	19.9	11.8
Hungary	28.0	29.0
Latvia	12.8	35.3
Lithuania	11.3	21.6
Poland	19.6	12.6
Romania	13.7	19.1
Slovakia	7.7	5.8
Commonwealth of Independent States		
Azerbaijan	21.9	60.6
Belarus	15.4	19.3
Georgia	24.9	62.6
Kazakhstan	17.0	34.3
Republic of Moldova	18.1	35.7
Russian Federation	14.7	41.6
Ukraine	16.3	48.9
Uzbekistan	11.4	6.5

Source: Simon Johnson, Daniel Kaufman and Andrei Shleifer, "The unofficial economy in transition", *Brookings Papers on Economic Activity,* vol. 2 (1997), p. 183.

In addition to self-employment opportunities, the informal economy provides the bulk of second jobs for hire. For example, in the Russian Federation about 70 per cent of such jobs are estimated to be in the informal economy.[71]

Cultivation of family plots and de-urbanization

Widespread ownership of small family plots was one of the features of the centrally planned economies. Rooted in part in ideology (the Marxist dream of abolishing the distinction between the city and the village in the communist society of the future) and in part in practicality, this feature proved to be highly important in helping people to survive the transition back to capitalism. By some estimates, over two thirds of urban residents and practically all rural residents of the successor countries of the former Soviet Union own such family plots. The proportion is probably somewhat lower in Central and Eastern Europe but similar in the Balkans. In the Russian Federation, for a population of approximately 145 million people, the number of such plots in the mid-1990s was estimated at 55 million.[72] The role of family plots as poverty alleviation tools is hard to overestimate. Production from these plots generates 22 per cent of all food consumption in Bulgaria and 20-24 per cent in the Russian Federation.[73]

In some countries, escape to rural labour became a longer-term solution to poverty, leading to resettlement of urban-dwellers in villages. This trend is most visible in the Central Asian republics of Uzbekistan and Tajikistan, in the

71 Byung-Yeon Kim, "The participation of Russian households in the informal economy", *Economics of Transition*, vol. 10, No. 3 (2002), p. 703.

72 Harm Tho Seeth and others, "Russian poverty: muddling through economic transition with garden plots", *World Development*, vol. 26, No. 9 (1998), p. 1612.

73 *Bulgaria Poverty Assessment…*, p. 100; and Simon Clarke, loc. cit., p. 15.

Russian Federation, in Ukraine and in the Balkans. In the first five years of reform, employment in agriculture actually increased in the Russian Federation and Ukraine, as well as in Romania and Bulgaria. Agriculture thus played a buffer role, softening the blow of the transformational recession for the poorest segment of the population.[74]

Migration and emigration

In spite of the relative immobility of labour markets, millions of people in transition economies tried to escape the threat of poverty by moving to other localities or other countries. Migration of people in response to economic and political disturbances was particularly heavy in CIS. During the 1990s, the Russian Federation alone admitted almost 11 million immigrants, almost all of them from CIS.[75] At the same time, in the period 1992-2002, close to 5.4 million Russian citizens emigrated to other countries. The actual number of emigrants and immigrants was probably much larger, as Government agencies have difficulty tracking illegal labour migration.

Illegal migration is widespread in other countries of CIS, as evidenced, for example, by the migration of Belarusians and Ukrainians seeking work in the Russian Federation and Poland, and the migration of Moldovans to Romania and countries of Western Europe as well as other countries. Migration from the countries of Eastern Europe has been less heavy, but still substantial. During the 1990s, between 50,000 and 90,000 people emigrated annually from Bulgaria, and between 10,000 and 20,000 from Poland (on a net migration basis). Characteristically, in this period, two of the richest transition countries, the Czech Republic and Hungary, registered positive net immigration.[76]

The role of intra-family transfers

Intra-family transfers, including remittances from emigrants, have been particularly important in the CIS countries, where government social protection systems proved to be especially weak. Thus in the Russian Federation, based on household surveys, intra-family transfers were received in 1997 by 25.2 per cent of all households and by 31.5 per cent of the poorest quintile of households; in Kazakhstan, similar ratios were 27.5 per cent and 33.8 per cent, respectively; and in Kyrgyzstan 35.5 per cent and 31.7 per cent.[77] In the Russian Federation, intra-family transfers constituted 4.7 per cent of overall household money income in 1993, 7.1 per cent in 1996 and 12 per cent in 1998. These transfers constituted 20 per cent of the income of net recipients of such transfers and from one third to one half of the income of the poorest quartile of all recipients.[78] Characteristically, while in the Russian Federation, in the course of the transition to the market, the role of intra-family transfers increased, in Poland, which had resumed economic growth much earlier, that role decreased.[79] In Bulgaria in 2001, 14 per cent of families received private transfers which amounted to 34 per cent of their average household consumption.

Intra-family transfers are generally better targeted than government assistance. A recent study found that in the Russian Federation, intra-family transfers reduced the overall poverty count per capita by 4 per cent compared with the 1.5 per cent reduction achieved by government transfers.[80] In Bulgaria,

74 Liesbeth Dries and Johan F. M. Swinnen, "Institutional reform and labour reallocation during transition: theory evidence from Polish agriculture", *World Development*, vol. 30, No. 3 (2002), p. 458.

75 *Russian Statistical Annual* (Moscow, Goskomstat, 1991), p. 128; and http://www.gks.ru.

76 *Bulgaria Poverty Assessment…*, p. 102.

77 *World Development Report, 2000/2001…*, p. 144

78 Simon Clarke, loc. cit., p. 30.

79 Jeni Klugman and Jenine Braithwaite, loc. cit., p. 54.

80 Stanislav Kolesnikov and Ksenia Yudaeva, loc. cit., p. 14.

such transfers reduced the poverty rate among receiving households by 16 percentage points and the overall poverty rate in Bulgaria by 2 percentage points.[81]

[81] *Bulgaria Poverty Assessment*…, p. 100.

CONCLUSIONS

Contrary to most expectations, the transition to the market proved to be longer and much more costly in social terms than had been envisaged in many countries at the outset. The transformational recession of the 1990s and a sharp decline in income for many households resulted in massive poverty and deprivation in the region. By the mid-1990s, almost 30 per cent of the 414 million people in the transition economies lived below the $4 a day poverty line in PPP terms.

The increase of poverty was contained in the Eastern European countries that moved most rapidly to a market economy. In these countries, the recession was shorter, income differentiation was not as drastic, and Governments made a concerted effort to provide social protection to the most vulnerable groups among the population, such as pensioners, the unemployed, single mothers and children. In most of the CIS countries, the situation was much more serious and in some countries, such as Armenia, Georgia, the Republic of Moldova and Tajikistan, the overwhelming majority of the population was poor.

While Governments of those Eastern European countries that were most advanced in their transition to a market economy generally achieved an adequate response to the challenge of mass poverty, the policy response of Governments of the CIS countries and other countries of Eastern Europe (such as those in the Balkans) was at best inadequate. To some degree, this government failure was predetermined by the lower level of development, the obsolete structure of the economy and other objective factors. However, policy choices also played an important role. In many of the CIS countries, particularly the resource-rich countries, special interests succeeded in channeling a large part of the already shrinking government funds away from social spending.

Faced with the inability of Governments to protect them from suffering, millions of people in transition economies resorted to private strategies of fighting off poverty. Those included unregistered employment and self-employment, migration to other countries and regions and, in extreme cases, engaging in crime. Thus, while in Eastern Europe, the struggle with poverty was dominated by government action, in CIS, it was dominated by the private response.

More than 10 years after the start of market reforms, all transition economies have returned to the path of economic growth, which has curbed further increases in poverty. However, many challenges remain.

One of these challenges is the emergence of chronic long-term poverty. This form of poverty exists in both the relatively well-to-do and the poorer transition countries and brings with it the risk of the development of a permanent new underclass. Chronic poverty is concentrated in depressed industries, and among specific regions and demographic and ethnic groups, as well as among rural families with many children. For the richer countries of Eastern Europe, the emergence of chronic poverty, some of it acute, is probably the single most important poverty challenge facing Governments and societies.

The use of targeted social protection, relying on successful experiences within developed countries and some early examples of such experiences in transition economies might prove to be beneficial to transition economies in their efforts to combat chronic poverty. Measures would include the development of regional poverty maps, investment in transportation facilities to help depressed regions access new markets and overcome labour-market restrictions and ethnic-specific social programmes. In some cases, more drastic actions may be in order, such as resettling the population of localities, like some of the northern territories and closed military cities in the Russian Federation, where no prospects of sustainable employment exist.

The broad challenge in the labour-market area is to provide people in transition economies with increasing opportunities for gainful and legitimate employment. Here, the policy tasks are different for Eastern Europe and CIS countries. In the former, where labour markets are relatively flexible, this task can be described as one of fine-tuning existing legislation, for example, through the introduction of stricter eligibility requirements for unemployment benefits. In CIS countries, on the contrary, the meagre unemployment benefits and minimum wages have to be increased and tied to a subsistence minimum. Labour markets in CIS would benefit from the removal of administrative and fiscal restrictions on SMEs and the curtailment of implicit subsidies to inefficient large enterprises. Government unemployment agencies might be encouraged to provide more proactive employment services such as job matching and job retraining.

The second generation of reforms in transition economies should include measures aimed at coordinating Government and private responses to poverty. These would include, for example, extending social security to the informal sector and the adoption of migration legislation that would deal with the problem of massive illegal migration.

In the area of social protection, the Governments in Eastern Europe face the task of adjusting existing levels of benefits, such as those of pensions, to the fiscal capacity of the State. This would mean, for example, a switch to multi-pillar pension systems and possible curtailment of unsustainable social security expenditures in countries like Poland and Slovenia, where they constitute a larger share of GDP than in the developed countries. In the CIS countries, the goal is to reduce or eliminate the wasteful across-the board energy subsidies, to lift the share of social security payments in GDP, and to bring the level of individual basic social protection closer to the subsistence minimum.

Some of the Governments of transition economies might find it beneficial to increase the share in GDP of public spending on education and health. A reasonable share is essential for the preservation of human capital, which is the key determinant of the income-generating prospects of the population.[82] The decline in the education and health levels of the population, which is particularly noticeable in the largest CIS countries (Kazakhstan, the Russian Federation and Ukraine,) should be arrested and reversed. Otherwise, poor health and low education will keep millions of young people in these countries in a vicious poverty trap.

The outlook for the eradication of mass poverty is quite encouraging for many of the Eastern European countries. Eight of these countries will join the EU in May 2004 and two others (Bulgaria and Romania) are scheduled to follow in 2007. By the end of the decade, the problem of poverty in these countries will be considerably reduced, with their own efforts being supported by EU.

82 *Poverty in Transition ...*, pp. 36-37.

The prospects for reducing poverty in CIS are much less clear. In the smaller and poorer countries of Central Asia and Caucasus, acute mass poverty will probably subside as their economies continue to recover. However, without the reversal of the extreme inequality of incomes and active policies of job creation, progress in poverty reduction will be slow. The role of international strategies, such as the multilateral "CIS-7" Initiative, can be very important in achieving poverty containment here.

In the largest of the CIS countries—the Russian Federation and Ukraine—much will depend upon the direction of the second stage of reform. To realize their growth potential, the Governments of these countries might consider liberalizing labour and capital markets, encouraging the growth of the SME sector, and eliminating wasteful subsidies to large enterprises. The achievement of these measures, in turn, will depend upon reducing the power of special interests and upon the maintenance of overall political stability.

The promise of a better life and the manifest failings of the centrally planned system led peoples of Eastern Europe and the Soviet Union away from that system, despite all of its security and social guarantees. Now, over 10 years into the transition to the market system, this promise is being fulfilled, but not for all. While some countries of the region are getting ready to join—or rejoin—the developed world, in others a third or more of the population live in poverty. At the present time, the worst is probably over but much remains to be done. Given the right tools and with appropriate government support and policies, millions of well-educated, hard-working people in the transition economies would be fully capable of pulling themselves out of their misery.