Note for ECOSOC Roundtable dialogue on

Growth, poverty reduction and equity: The emerging paradigm

Professor Jayati Ghosh

2 July 2007, Palais des Nations, Geneva

The world economy is currently in the midst of an economic boom, reflected in high commodity prices, increased rates of income growth for a number of developing countries and improved balance of payments for the developing world as a whole as shown in current account surpluses and increased capital flows. These have involved a tendency to more convergence of per capita incomes across the countries of the world than was evident in the previous decades. Yet this boom has also highlighted some major weaknesses in the pattern of growth.

The most important weakness is that high income growth is not generating adequate employment growth, especially of “good quality” employment. This is even true of the fastest growing developing countries such as China and India, where rates of open unemployment are increasing sharply even as GDP growth continues to be high. In other developing countries, employment has stagnated, and everywhere the quality of employment has deteriorated for a large proportion of workers.

Recent economic growth has also been accompanied by sharp increases in inequality in most countries. This has meant that poverty reduction has been much slower than could be expected, given the rate of aggregate growth. New forms of poverty have emerged, especially among unskilled migrants and marginalised groups In general, citizens of the developing world experience greater volatility of incomes, more material insecurity, and reduced access to what used to be called “basic needs” and public services. A critical feature is the persistence of agrarian crisis in much of the developing world, despite a period of relatively high agricultural prices in world trade. The economic boom has also been associated with accelerated degradation of natural resources in the developing world, with adverse long-term consequences.

Many of the problems listed above can be traced at least partly to low and insufficient levels of public expenditure in critical areas such as physical infrastructure, agriculture and rural development, health, sanitation and education. And this reflects the fact that across the developing world, rigid norms of fiscal discipline have imposed deflationary policies upon governments, whereby expenditure in these critical areas becomes constrained.

The international correlate of this is a new pattern of global imbalances. In the past few years developing countries have been providing net resources to the rich countries, particularly the US. Developing country governments increasingly do not spend all their foreign exchange receipts (whether these come through export surpluses or capital inflows or foreign aid) because of the fear of the adverse effects of currency appreciation and the felt need to keep higher levels of foreign exchange reserves to guard against potential financial crises. This is a travesty of the presumed role of international financial intermediation, and amounts to a huge waste of potential resources, which could and should be used to address some of the problems mentioned above.

It is in this context that a review of economic strategies becomes important. The orientation of economic policies must shift towards a focus on the accelerated generation of good quality jobs and improvement of living standards of the bulk of the people. These are the essential factors for inclusive growth and more effective poverty reduction. This requires a slightly different approach towards both long-term development and short-term macroeconomic management.

In terms of long term development strategies, three features are very important. First, public expenditure, and public investment in particular, are crucial in sustaining and expanding the productive base of the country, both for physical infrastructure and human resources. This in turn requires that governments become more willing to raise resources through taxation and more creative in devising ways of doing so. Second, governments must retain the ability to direct some financial flows to sectors that are seen as strategic, important to develop or crucial for livelihoods and employment generation. This can occur through directed credit, special fiscal incentives or other means. Third, institutional conditions, including ensuring more voice to different groups and democratic forms of public accountability, are crucial to ensure that public expenditure is effective.

Macroeconomic policies for the short-term and over the economic cycle also need to change accordingly. Macroeconomic policy needs to be developed within a co-ordinated medium-term framework, so that fiscal, monetary, exchange rate and capital management policies are consistent with growth objectives and public investment strategies. Fiscal sustainability is crucial in the medium term, but there should be some flexibility with respect to fiscal targets, especially when the deficits are the result of productive public expenditure, and during economic downswings. Rigid rules on fiscal deficits in the short run reduce the possibility of effective countercyclical policies.

Putting greater emphasis on public expenditure requires more public resource mobilisation without disproportionately harming the poor or marginalise groups or having regressive effects. This is possible through improving tax administration and enforcement, diversifying sources of tax revenue instead of relying on a single indirect tax such as VAT, relying as far as possible on rule-based and non-discretionary tax instruments which are corruption-resistant and have lower transaction costs, increasing personal income tax collection from the rich, targeting luxury consumption in raising taxes, taxing capital more effectively without affecting investment and using trade taxes creatively and flexibly.

Monetary policy should not only be about price stabilisation and inflation control, but should be an integral part of macroeconomic and overall development strategies. It should aim expanding supply in strategic sectors, improving livelihood conditions in sectors employing a large proportion of the labour force such as agriculture and generating more productive employment by providing institutional credit to small scale producers in all sectors.

Some other preconditions are important for this to be an effective paradigm for economic strategies in the changing context. In open developing economies, management of the exchange rate is critical because it directly affects relative prices and thereby domestic incentives and employment, and can prevent excessive volatility. In this context, managed floats or crawling pegs work best, since they allow governments to adjust the level of the exchange rate to external conditions as well as to the current policy priorities for the domestic economy. Such an overall strategy also requires that financial flows be relatively predictable, or at least not destabilising. This is turn suggests the need to consider forms of capital control that are flexible and can respond to changing internal and external conditions.