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Module 4.

Macroeconomic Policies
and
Poverty Reduction

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FOREWORD

UNDP launched the Technical Support Documents (TSD) series on poverty reduction in 1996 with the purpose of deepening the organization's understanding of poverty-related issues and concerns. The first two volumes in the series, Poverty Definitions and Indicators and From Data Collection to Poverty Assessments, were distributed to Country Offices in the Spring and early Summer of 1996. They attempted to capture state-of-the-art thinking on several poverty-related topics critical for working through how UNDP programming in this field could be developed. The recently distributed third volume, Poverty Measurement: Behind and Beyond the Poverty Line, explains different methodologies used to construct a poverty line and lays out a conceptual framework for measuring poverty from a multi-dimensional perspective.

The present or fourth volume, Macroeconomic Policies and Poverty Reduction, approaches the challenge of poverty reduction from the macroeconomic perspective. It includes a core paper and several supporting articles which help shed light on the implications for macroeconomic policy of the focus on poverty reduction as a central objective of economic policy. It will enhance UNDP staff capacity to dialogue more effectively with national counterparts and development partners on this subject, and to influence our upstream policy support programmes to become more effective in reducing poverty.

Each TSD is composed of articles and papers (many of which have already been published) representing a variety of views and perspectives of academics and development practitioners from universities and research institutes, NGOs and the UN system (including the World Bank). The articles are preceded by an overview of their most salient features. When gaps exist between the literature and UNDP's own thinking on particular issues, an attempt has been made to identify and, whenever possible, fill in those gaps.

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INTRODUCTION

The present Technical Support Document results from the efforts of members of the Social Development and Poverty Elimination Division (SEPED) of the Bureau for Policy and Programme Support (BPPS), UNDP, to determine the implications for macroeconomic policy of the focus on poverty reduction as a central objective of economic policy. The articles are intended to help identify policy options consistent with the focus on poverty reduction from a sustainable human development perspective.

This volume is organized around a core paper by Terry McKinley, "The Macroeconomic Implications of Focusing on Poverty Reduction." The paper addresses key issues for the construction of a macroeconomic framework which can enable a country to carry out effective poverty reduction strategies. The accompanying articles in the volume represent important contributions by economists that touch on key areas of macroeconomic policy which, as Terry McKinley's article points out, have been the subject of debate.

The paper by Prabhat Patnaik, "A Note on the Redistributive Implications of Macroeconomic Policy," uses basic macroeconomic theory to argue that structural adjustment programmes fail to achieve their objectives and only exacerbate inequality and poverty because they presume that the economy always tends to full employment of all resources. A similar assessment is made from a political economy perspective by David Reed and Fulai Sheng in their paper "Macroeconomic Policies, Poverty and the Environment," which discusses the impact of the conventional macroeconomic framework on the environment in light of the mutually reinforcing relationship between poverty and environmental degradation. Keith Griffin presents an analysis of structural adjustment programmes in the paper "Macroeconomic Reform and Employment: An Investment-led Strategy of Structural Adjustment in Sub-Saharan Africa," and advocates a growth strategy based on increased investment together with better allocation of assets, implying a role for the state beyond the conventional "getting the prices right." The role of the state is specifically addressed by Keith Griffin and Terry McKinley in "The Structure of Incentives," which examines the impact of different incentives on economic performance and on poverty, and advocates an activist role for the state in altering the incentive structure to foster human development. Ajit Singh's article "Openness and the Market Friendly Approach to Development: Learning the Right Lessons from Development Experience" examines the role of the state and the extent of integration with the world economy which will foster economic growth, and advocates that the state pursue a dynamic industrial policy and seek "strategic," rather than "close," integration with the world economy. Finally, the comparative study by Azizur Rahman Khan in the paper "Macroeconomic Policies and Poverty: An Analysis of the Experience in Ten Asian Countries" underlines that GDP growth is a necessary but insufficient precondition for poverty reduction, and illustrates how different circumstances and initial conditions existing in a particular country determine the impact of macroeconomic policies.

As a group, these papers should provide a useful basis for dialogue on the best policy mix for a macroeconomic framework conducive for effectively reducing poverty and for achievement of sustainable human development.

OVERVIEW

The present Technical Support Document, Macroeconomic Policies and Poverty Reduction, is intended to provide useful perspectives to UNDP staff engaged in project work with development partners on how macroeconomic policy can impact efforts to reduce poverty. It has become increasingly apparent that poverty reduction strategies which fail to encompass macroeconomic policy are less successful because of the impact, both direct and indirect, which such policies have on efforts to reduce poverty. This volume attempts to draw attention to the effects of the macroeconomic framework on strategies designed to reduce poverty using a sustainable human development approach. Part One consists of a core paper by Terry McKinley, and Part Two includes six supporting articles. This overview provides a brief summary of the salient points in each paper.

"Macroeconomic Implications of Focusing on Poverty Reduction," by Terry McKinley, provides a useful starting point from which to analyse how macroeconomic policies impact poverty reduction. It points out shortcomings of the conventional approach to macroeconomic reform, outlines alternative perspectives, and raises core issues currently under debate. What are the basic determinants of long-term economic growth, how effective are structural adjustment policies in fostering growth, and how efficient is growth in promoting human development and reducing poverty? These are the questions inadequately addressed by the conventional approach to macroeconomic policies.

The article begins with the premise that poverty reduction should be a central concern of development strategy, and asserts that the ultimate objective of macroeconomic policy should be the promotion of sustainable human development, not just economic stability and growth. Macroeconomic policies have inevitable redistributive effects and impact on human development. Yet, conventional thought focuses on economic growth as the solution to poverty and neglects the role of inequality--which serves as a constraint both to poverty reduction and even to growth itself--and ignores the vitally important connection between growth and human development.

While there is no doubt that investment is the driving force of economic growth, the issue is whether investment in the poor is growth enhancing, or at least growth-compatible. From a human development perspective, what matters is not simply the level but also the composition of output, that is, whether the production of goods and services enhances human well-being. Clearly, all other things being equal, rapid economic growth is more effective than slow growth in reducing poverty. Yet, what matters most is the character of economic growth, which is determined in part by the structure of the economy and by government policy. When growth of output is concentrated in economic sectors in which most of the poor labour and this output generates income for the factors of production they possess, this is pro-poor growth--which leads to an improvement in the conditions of the poor proportionately greater than that for the population as a whole.

Just as important as the sectoral composition of growth for the poor is the enabling environment, which determines whether the poor have access to resources and can use them efficiently. Central to this enabling environment is the structure of incentives, which determines whether resources flow to the poor or away from them. The controversial point is whether resources should be explicitly directed to sectors where the poor are concentrated and to factors of production on which they rely. Such a redistribution of assets would ensure that the poor possess the means by which to take advantage of economic growth.

Whether a redistribution of assets is both growth-enhancing and poverty-reducing, and whether the role of the state in such a re-allocation is compatible with maintaining macroeconomic stability, are also issues under debate. The article asserts that economic restructuring, when it is necessary, is most effective when based on expansionary macroeconomic policies that promote growth through increased investment--and investment in the poor in particular. In this context, the state has an important role to play in stimulating greater investment and in strengthening the economic linkages to the sectors where the poor are concentrated. Public expenditure should be re-allocated to promote investment on the poor (human capital development) and by the poor (improving their access to assets), and less emphasis should be given to transfers and social safety nets. Through building up human capital and physical infrastructure, the state can also directly promote economic growth and indirectly stimulate it by fostering greater private investment. Under such conditions, public and private investment are complementary, and redirecting investment to the poor is compatible with maintaining macroeconomic stability. From a human development perspective, altering the general structure of incentives to direct resources to the poor is a viable alternative to the 'neutral' set of incentives advocated by conventional economic theory.

"A Note on the Redistributive Implications of Macroeconomic Policy," by Prabhat Patnaik, critiques the liberalization and structural adjustment programme espoused by the Bretton Woods institutions and uses macroeconomic theory to argue that, contrary to their claims, the policies they advance are inherently detrimental to the poor. Macroeconomic policies (fiscal, monetary and exchange rate policies) affect the distribution of income by both affecting the level of aggregate demand and causing the level of economic activity to be unevenly distributed across social groups. However, the Bretton Woods institutions assert that structural adjustment policies can potentially make everyone better off and any adverse distributional shifts can be compensated for. The article argues that this assertion assumes full employment both before and after the adjustment package. Thus, the position of the Bretton Woods institutions--that macroeconomic policies can be pursued without consideration of their impact on income distribution and that structural adjustment programmes promote efficiency--requires the assumption that a market economy would spontaneously achieve full employment of all resources.

However, the article disputes this implicit claim that structural adjustment would necessarily lead to full employment. Measures undertaken for improving efficiency of resource use often succeed only in reducing the employment of resources. Furthermore, the article asserts that judgements about efficiency cannot be separated from those about income distribution. From this analysis it follows that structural adjustment induces four different types of undesirable

distributional shifts: from workers to producers, from small-scale to large-scale producers, from domestically-owned to foreign-owned businesses, and from businesses engaged in productive activities to financial interests. There is a squeeze on workers, agricultural labourers, poor peasants, petty producers and even small businesses, while there are substantial gains for landlords, large enterprises, especially foreign multinational corporations and, even more importantly, foreign rentiers and portfolio investors. This theoretical analysis thus shows why structural adjustment programmes widen the gap between rich and poor and exacerbate poverty.

"Macroeconomic Policies, Poverty and the Environment," by David Reed and Fulai Sheng, discusses the relationship among macroeconomic policies, poverty and the environment from a political economy perspective, and draws various conclusions based on several country case studies. Viewing poverty as the result of the competition among social groups to gain control over life-supporting assets, it examines the role of macroeconomic policies in aggravating poverty and shaping natural resource use. Environmental problems are a consequence of both direct policy impacts, as well as indirect impacts resulting from the effect of economic reforms on social structures, on poverty and on the functioning of the state. Furthermore, the mutually reinforcing relationship between poverty and environmental degradation is exacerbated by the continuing appropriation of wealth and power by the privileged sectors of society, in part due to their apportionment of environmental assets.

The article asserts that the ensuing concentration of wealth and environmental assets, coupled with the deepening deprivation and environmental vulnerability of impoverished groups, is determined foremost by the political economy at the local level, although the impact of policies at this level is then reinforced by nationally-oriented and international policies. Overall, structural adjustment programmes have tended to widen the gap between rich and poor, and have reinforced and deepened the social relations generating poverty. The reduction of the role of the state curtails its ability to redistribute assets and opportunities, and the resulting expansion of the informal sector often leads to utilization of environmental assets at unsustainable rates. The article concludes that the reinforcement of the political economy of poverty has not only diminished the prospects for social stability and the well-being of the poor, but has also accelerated the poverty-environmental degradation process and led the most vulnerable groups to pursue survival tactics based on rapid natural resource consumption.

Several policy recommendations are made in the article's conclusion. First, reforms should ensure a systematic redistribution of productive assets to the poor. Second, the role of the state should be reformed so that, in addition to establishing a stable macroeconomic framework, it is able to: provide basic public goods and services, guarantee conditions of equity and equal opportunity, and ensure sound management of the natural resource base. Both of these proposals require the strengthening of civil society organizations, those whose origins reside in the economic system's externalization of the social and environmental costs of growth, so that they are able to acquire social and economic power. Third, international cooperation should seek to strengthen those sectors pushed to the economic and political margins of society. Finally, the article concludes that

obliging the economic system to internalize its social and environmental costs is the fundamental challenge for development.

"Macroeconomic Reform and Employment: An Investment-Led Strategy of Structural Adjustment in Sub-Saharan Africa," by Keith Griffin, examines stabilization and structural adjustment policies in the context of sub-Saharan Africa, and suggests alternatives to the conventional ways of thinking. The article asserts that investment to increase productive assets, including the allocation of investment to employment generating activities, is the key to economic stability and growth, but conventional adjustment policies have not generally been successful in achieving these objectives.

While the stated purpose of conventional policies is to restore macroeconomic stability, this need not imply achieving a zero rate of inflation--a condition that would increase inefficiency and reduce the rate of growth. If the rate of inflation is positive but moderate, prices are likely to be more flexible--a crucial condition for a well functioning price system. The article argues that stabilizing the real lending rate of interest at a positive and reasonably high rate is the most important policy to foster growth because it promotes efficiency of investment.

The article outlines three very distinct approaches to bring about structural adjustment, whose purpose is defined as effecting substantial change in the composition of output in order to increase the rate of growth of output, incomes and employment. The conventional path, "adjustment through reallocation," changes the structure of incentives through price liberalization and assumes that changes in the composition of output will occur when the existing stocks of productive assets are reallocated. However, this assumes that the movement of physical, human and natural capital is frictionless, rapid and ensures the full utilization of resources--a normally unrealistic premise in practice. Instead, changes in the composition of output are usually achieved through economic contraction that generates high unemployment and increases poverty. Thus, "adjustment through contraction" has been the norm in sub-Saharan Africa. An alternative third path, "adjustment through investment," is part of a growth strategy designed to achieve adjustment by increasing investment in physical, human and natural capital and improving its allocation. The article advocates this latter strategy, in which the state should play a leading role in mobilizing domestic resources for investment, particularly through labour intensive public investment projects. "Getting prices right" will not suffice for this strategy; rather, new productive assets must be created through more and better allocation of public and private sector investment.

"The Structure of Incentives," by Keith Griffin and Terry McKinley, examines the implications of the structure of incentives for the functioning of markets. The set of incentives in place in a country determines the type, quantity and methods of production. Its structure is determined not only by relative prices, but also by the degree of people's access to markets, barriers to entry and discrimination, and by whether markets are incomplete or even absent (e.g. unpaid women who are either included in the labour market or who produce unpriced goods and services).

Labour markets are often highly fragmented in this way and also tend to be segmented between urban and rural areas, and between formal and informal sectors. The article refers to this condition as a system of labour control, within which the structure of incentives leads simultaneously to an inefficient use of labour and an unequal distribution of income. The result is that a disproportionately large share of the labour force is compelled to seek a livelihood at the bottom of the occupational hierarchy, with a remuneration lower than under a freely functioning (non-fragmented, non-segmented) labour market. Thus, the policy implication is not to raise or lower wages, but to remove labour market restrictions. A similar recommendation is made with regard to the capital market, which is divided into the formal and informal sectors. Limited access to credit at relatively low real rates of interest in the formal sector leads to an inefficient allocation of capital (excessive mechanization) combined with an unequal distribution of income (value-added is shifted from wages to profits and rents), while lack of access to credit in the informal sector leads to excessively labour-intensive methods of production, low productivity and low earnings. Based on this analysis, the government should alter the structure of incentives by working with informal sector institutions to increase the availability of credit and lower its cost, instead of subsidizing formal sector lending through artificially low real interest rates. With regard to natural capital, faulty incentives based on misleading price signals often lead to intensive exploitation of natural resources. Neglect of negative externalities by the private sector and government subsidies to natural resource extraction are the principal factors. Such a set of incentives both implies higher costs to the state and leads countries to follow a comparative advantage based on the intensive use of natural capital rather than human capital. This, in turn, worsens both environmental degradation and poverty.

The article concludes that the state should take an activist role in reforming the structure of incentives in order to foster human development. Simply "getting the prices right" is not enough. In formulating trade strategy, for example, the state should pursue the country's long-run dynamic comparative advantage, recognizing the great potential of developing a skilled, educated labour force able to learn and apply technological innovations. Taking into account the positive externalities generated by human capital formation, the article argues that the state should compensate for the tendency of the private sector to underinvest in human capital by restructuring private incentives or by providing direct public investment.

"Openness and the Market Friendly Approach to Development: Learning the Right Lessons from Development Experience," by Ajit Singh, contributes to the debate between World Bank and heterodox economists regarding integration with the world economy and the role of the state. The article examines two principal policy issues facing developing countries: the desirable degree and kind of openness of a country to the world economy and the role of the state in promoting industrial development. Having abandoned an extreme free market perspective, World Bank economists now argue that developing countries should seek close integration with the world economy and should limit the role of the state to a "market-friendly" approach. The article proposes an alternative approach, based on an analysis of lessons learned from the East Asian economies: developing countries should seek "strategic," rather than "close," integration with the

global economy, and the state should pursue a dynamic industrial policy in order to generate the structural transformations essential to achieve and maintain economic growth.

The article criticizes the theoretical foundations of the World Bank analyses, which hold that maintaining an open economy creates optimal conditions for labour market competition and human capital investment (education) that, in turn, promote technical progress and hence economic expansion. This model assumes full employment of resources and perfect competition--conditions which do not exist in the real world--and ignores the role of demand factors. However, the article contends that an alternative theoretical model is more in accord with the empirical evidence. Such a model recognizes the central role of the change in growth of demand in both the global and national economies, and places importance on establishing an industrial policy through which the state can pursue a strategic course for the country's industrial development within the context of the world economy. Coordinated and viewed as a coherent whole, an industrial policy should include measures to protect the domestic economy and regulate foreign investment, as well as to promote domestic technological development.

"Macroeconomic Policies and Poverty: An Analysis of the Experience in Ten Asian Countries," by Azizur Rahman Khan, compares ten Asian country studies in terms of the relationship between macroeconomic policies and poverty. The article affirms that while both the rate of growth and the distribution of income are affected by macroeconomic policies, whether particular macroeconomic policies reduce poverty depends on the actual circumstances and initial conditions in the country. In addition, macroeconomic policy instruments that help create the capability for overcoming poverty (e.g. increased expenditure on health and education) can often be different from those that contribute to the growth and distribution of current income.

The comparative analysis shows that economic growth is a necessary but insufficient precondition for poverty reduction. Several conditions can lead to the failure of GDP growth to improve the living standards of the poor. The sectoral composition of growth can lead to a concentration of GDP growth in those sectors with less poverty. The distribution between public and personal income can be such that growth in per capita GDP does not automatically mean an equivalent growth in per capita personal income. Also, a sharp increase in inequality can offset the positive effect of a high growth rate of per capita GDP. While macroeconomic policies alone are inadequate to improve income distribution, the extent to which these policies can achieve growth, without aggravating inequality, depends on the circumstances in a particular country.

The article draws certain general conclusions on different types of macroeconomic policies. Measures designed to achieve price stability are usually conducive to poverty alleviation, as long as the pursuit of price stability is not taken to such an extreme that economic growth and targeted expenditure for the poor are adversely affected. Integration with the global economy should also benefit the poor in the long-run, as long as it occurs through an orderly transition to a structure of production that is consistent with a country's resource endowment. Although adverse impacts on certain groups of the poor may result in the short-term from macroeconomic reforms, this is usually

due to an inefficient initial structure of the economy and can be offset through compensatory action to protect those temporarily unemployed.