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**WORKSHOP ON
SECTOR ADJUSTMENT ASSISTANCE
IN THE AFRICA BUREAU**

September 19 - 22, 1989

**Abidjan
Cote d'Ivoire**

and

September 26 - 29, 1989

**Nairobi
Kenya**

**Development Studies Program
and
The Africa Bureau**

1

INTRODUCTION

PURPOSE

The purposes of this workshop are (1) to place the Africa Bureau's NPA within the context of IMF/WB assistance to Africa; (2) to provide theoretical underpinnings of the shift to non-project sector assistance; and (3) to convey to workshop participants the latest thinking in the Africa Bureau on the analytical requirements for the design, implementation, monitoring and evaluation of the Bureau's sector adjustment assistance programs under the DFA.

The workshop is designed to involve A.I.D. managers, program designers, implementors, and evaluators in discussion of these issues. By the end of the workshop, participants should:

- (1) Have a better understanding of why the donor community has shifted part of its portfolio to NPA.
- (2) Be able to see how the Africa Bureau's NPA relates to what other donors are doing in Africa.
- (3) Have a better understanding of the analytical and implementation requirements of NPA.
- (4) Be in a position to assist the Africa Bureau to refine and clarify NPA guidance.

FORMAT

The workshop requires the active participation of those attending. Although there will be a number of sessions in which formal presentations are made, discussion will be an integral part of achieving workshop purposes. The sessions on adjusting policies in specific sectors have been designed to encourage discussion between those with experience with these programs and workshop participants.

READINGS

Readings have been kept to a minimum. Participants are expected to have completed the readings prior to the workshop.

LOCATION AND SCHEDULE

The workshop will take place at the Hotel Ivoire in Abidjan, Cote d'Ivoire, and at the Hilton Hotel in Nairobi, Kenya.

*Accelerated Development
in Sub-Saharan Africa*

An Agenda for Action

The World Bank
WASHINGTON, D.C.

unchanged or has actually declined during this period⁴; countries with a long-established indigenous trading class (most of the nations of West Africa) and those where such a group is smaller and of recent origin; countries which are attempting socialist transformation and those which are following the example of the market economies.

There is, nonetheless, considerable homogeneity within the region. African economies are for the most part small in economic terms, a result of low average incomes and small populations. Of the 45 states in the region, 24 have fewer than five million people. Only Nigeria has a gross domestic product (GDP) greater than that of Hong Kong. African economies are open; foreign trade typically accounts for about a quarter of GDP. They are specialized economies, most of them agricultural, dependent on the export of two or three primary commodities. Even in the mineral-exporting countries, the bulk of the population—rarely less than 70 percent—works in agriculture, and subsistence-oriented production still accounts for half or more of total agricultural output. Only about 20 percent of the population is urban, and modern wage employment absorbs a very small proportion of the labor force—in most countries less than 10 percent.

In addition to these similarities of economic structure, other characteristics are common: the scarcity of educated people, the dominance of land-extensive agricultural systems, and an extreme ethnic diversity and consequent political fragility. All are new states, recently emerged from colonial rule, except Liberia and Ethiopia. All are tropical, with the exception of Lesotho and Swaziland. In almost all, fertility is high and population is growing rapidly—more rapidly than in any other region of the world.

Finally, there is an extraordinary degree of similarity throughout the region in the nature of the policy problems that have arisen, such as in rural development, trade, and industrialization, and in the national responses to them.

4. Angola, Congo, Ghana, Mauritania, Mozambique, Togo, Uganda.

The Report is necessarily selective in its analysis. Many important questions have been treated elsewhere: problems of science and technology, for instance, are treated at length in the *Lagos Plan of Action*, while others, such as higher rates of domestic saving, are likely to follow a resumption of growth rather than precede it. New investment opportunities and growth are the focus of the Report.

The Present Economic Crisis

During the past two decades economic development has been slow in most of the countries of Sub-Saharan Africa.⁵ When, in the mid-1970s, the world economy experienced inflation and recession, nowhere did the crisis hit with greater impact than in this region.

The picture is not uniformly bleak. There are signs of progress throughout the continent. Vastly more Africans are in schools, and most are living longer. Roads, ports, and new cities have been built and new industries developed. Technical and managerial positions, formerly occupied by foreigners, are now held by Africans. Of the 45 countries in the region, nine posted annual growth rates of over 2.5 percent per capita between 1960 and 1979 (see Table SA.1).⁶

But for most African countries, and for a majority of the African population, the record is grim and it is no exaggeration to talk of crisis. Slow overall economic growth, sluggish agricultural performance coupled with rapid rates of population increase, and balance-of-payments and fiscal crises—these are dramatic indicators of economic trouble.

Between 1960 and 1979, per capita income in 19 countries grew by less than 1 percent per year, while during the last decade, 15 countries recorded a *negative* rate of growth of income per capita. And by the end of the 1970s, economic crises were battering even

5. All references to Africa in this Report are to Sub-Saharan Africa unless otherwise specifically noted. See the Introduction to the Statistical Annex for a listing of the countries included.

6. All tables preceded by the letters SA are located in the Statistical Annex. All other tables, such as 1.1, 2.1, 2.2, etc., are in the text.

high-growth countries like Kenya, Malawi, and Ivory Coast—where per capita GNP growth had averaged an annual 2.7 percent between 1960 and 1979—compelling them to design programs, supported by the Bank, to restructure their economies. Output per person rose more slowly in Sub-Saharan Africa than in any other part of the world, particularly in the 1970s, and it rose more slowly in the 1970s than in the 1960s (see Table 1.1).

The tragedy of this slow growth in the African setting is that incomes are so low and access to basic services so limited. Per capita income was \$329 in 1979 (excluding Nigeria) and \$411 when Nigeria is included. Death rates are the highest in the world and life expectancy is the lowest (47 years). Fifteen to twenty percent of the children die by their first birthday, and only 25 percent of the population have access to safe water. Of the 30 countries classified by the United Nations Conference on Trade and Development (UNCTAD) as the poorest in the world, 20 are African. Of the 36 countries listed in the World Bank's *World Development Report 1981* as "low income" (a per capita income of less than \$370), almost two thirds are African.

The economic crisis is especially evident in agriculture, and is reflected in output figures. Export crop production stagnated over the past two decades. A 20-percent increase in production registered during the 1960s was

wiped out by a decline of similar proportions in the 1970s. Consequently, Africa's share of the world market dwindled. As for food crops, while data are uncertain, they leave no doubt about general tendencies. Total food production rose by 1.5 percent per year in the 1970s, down from 2 percent in the previous decade. But since population was rising rapidly—by an annual average of 2.5 percent in the 1960s and 2.7 percent in the 1970s—food production per person was stagnant in the first decade and actually declined in the next. Imports of food grains (wheat, rice, and maize) soared—by 9 percent per year since the early 1960s—reinforcing food dependency. Food aid also increased substantially (see Tables SA.24 and SA.29). Since 70 to 90 percent of the population earns its income from agriculture, the drop in production in this sector spelled a real income loss for many of the poorest.

The deterioration in agriculture and other internal and global factors led to widespread balance-of-payments crises in the 1970s. Current account deficits in the region as a whole rose from a modest \$1.5 billion in 1970 to \$8 billion in 1980. External indebtedness climbed from \$6 billion to \$32 billion between 1970 and 1979, and debt service increased from 6 to 12 percent of export earnings in the same period. Foreign exchange reserves, which were comfortable in 1970, fell sharply. In 1979, reserves could cover only two months' imports

Table 1.1. Sub-Saharan Africa and the World: Basic Data

Countries	Population (millions) mid-1979	GNP per capita average annual growth rate (percent)		Per capita growth 1970-79 (percent)		Adult literacy rate (percent) 1976	Life expectancy at birth (years) 1979	Death rate of children aged 1-4 (per thousand) 1979
		1960-70	1970-79	Agriculture	Volume of exports			
Sub-Saharan Africa	343.9	1.3	0.8	-0.9	-3.5	28	47	25
Low-income	187.1	1.6	-0.3	-1.1	-4.5	26	46	27
Nigeria	82.6	0.1	4.2	-2.8	-2.8	..	49	22
Other middle-income	74.2	1.9	-0.5	-0.4	-3.5	34	50	22
South Asia ^a	890.5	1.5	1.5	0.0	0.6	36	52	15
All developing	3,245.2	3.5	2.7 ^b	0.1	-1.5	57	58	11
Low-income	2,260.2	1.8	1.6 ^b	0.1	-3.1	50	57	11
Middle-income	985.0	3.9	2.8 ^b	0.6	1.9	72	61	10
All industrialized	671.2	4.1	2.5 ^b	0.2	5.2	77	74	1

.. not available.

a. Bhutan, Bangladesh, Nepal, Burma, India, Sri Lanka, and Pakistan.

b. 1970-80.

Source: World Bank data files.

and by 1980 reserves had fallen even lower. Fiscal pressures also intensified in many countries, as indicated by declining real budgetary allocations for supplies and maintenance, growing imbalances between salary and nonsalary spending, and difficulties in financing local and recurrent costs of externally funded development projects.

The crises that evolved in much of the region are particularly disturbing since, during the period from 1960 to 1974, world trade and the world economy in general expanded rapidly, and many less-developed countries elsewhere experienced relatively high growth rates. Now, against a backdrop of global economic recession, the outlook for all less-developed nations—but especially for the Sub-Saharan region—is grim. Although cyclical factors may push prices of some African exports up from their low levels of the recent past, mounting energy costs, slow growth in the industrial countries (which translates into diminished markets for the developing world), and reduced growth of international trade (factors that have plagued the global economy for the last half decade) will make renewed African growth difficult.

In sum, past trends in African economic performance and continued global recession together explain the pessimistic projections for African development in the 1980s. The *World Development Report 1981*, under its most optimistic set of assumptions about the expansion of the world economy, forecasts virtually no growth in per capita income for the continent in this decade⁷; under less favorable assumptions, a negative rate of growth (-1.0 percent per year) is projected for the poorest nations in the region.

These prospects and their political, social, and economic implications are not acceptable either to the countries concerned or to the international community. There is an urgent need to understand what has gone wrong and what must be done—by African governments themselves and the concerned international community—to assure a better future for Africa's people.

7. World Bank, *World Development Report 1981* (New York: Oxford University Press, 1981), Table 1.1.

Sources of Lagging Growth

Africa's disappointing economic performance during the past two decades reflects, in part, internal constraints based on "structural" factors that evolved from historical circumstances or from the physical environment. These include underdeveloped human resources, the economic disruption that accompanied decolonization and postcolonial consolidation, climatic and geographic factors hostile to development, and rapidly growing population. These internal factors are discussed further in Chapter 2.

Growth was also affected by a set of external factors—notably adverse trends in the international economy, particularly since 1974. These include "stagflation" in the industrialized countries, higher energy prices, the relatively slow growth of trade in primary products, and—for copper and iron-ore exporters—adverse terms of trade. External factors are the subject of Chapter 3.

The internal "structural" problems and the external factors impeding African economic growth have been exacerbated by domestic policy inadequacies, of which three are critical. First, trade and exchange-rate policies have overprotected industry, held back agriculture, and absorbed much administrative capacity. Second, too little attention has been paid to administrative constraints in mobilizing and managing resources for development; given the widespread weakness of planning, decisionmaking, and management capacities, public sectors frequently become overextended. Third, there has been a consistent bias against agriculture in price, tax, and exchange-rate policies.

New Priorities and Adjustments in Policy

A reordering of postindependence priorities is essential if economic growth is to accelerate. During the past two decades most African governments rightly focused on political consolidation, on the laying down of basic infrastructure (much of it tied to the goal of political integration), and on the development

of human resources. Relatively less attention was paid to production. Now it is essential to give production a higher priority—without neglecting these other goals. Without a faster rate of production increase, other objectives cannot be achieved, nor can past achievements be sustained. Three major policy actions are central to any growth-oriented program: (1) more suitable trade and exchange-rate policies; (2) increased efficiency of resource use in the public sector; and (3) improvement in agricultural policies.

Exchange-rate and trade policies, addressed in Chapter 4, are especially critical for African economies, which are uncommonly "open." Exports account for a large share of marketed production, and imports constitute a significant share of consumption. Moreover, Africa has more frontiers per square kilometer than any other region, and they are highly permeable. The framework of incentives created by trade and exchange-rate policies is thus especially decisive. With respect to agriculture, for example, overvalued exchange rates discourage local production: farmers obtain less in their local currencies for their export crops, while the price of food imports is reduced. The situation is similar in the industrial sector. Also, direct controls over trade (for example, import bans and quotas), which are widely imposed to deal with balance-of-payments problems, have proved extremely costly to apply, as they require many trained people and an enlarged administrative apparatus. Moreover, they have frequently been ineffective.

Chapter 4 also considers policy issues which bear on the efficiency of resource use in the public sector. When African states won independence, they inherited unevenly developed economies with rudimentary infrastructure. Markets often functioned imperfectly and foreigners dominated trade and most modern businesses. To speed up development and make their economies more "national," the new governments expanded the public sector. It is now widely evident that the public sector is overextended, given the present scarcities of financial resources, skilled manpower, and organizational capac-

ity. This has resulted in slower growth than might have been achieved with available resources, and accounts in part for the current crisis. Without improved performance of public agencies, stepped-up growth will be difficult to achieve. The organization and management of economic activity need to be reviewed to determine how the resources and energies of *all* economic agents can be better mobilized for development—for example, by improving government policymaking institutions and procedures; by giving the public sector's development-related agencies—"parastatals"—clearer mandates and greater management autonomy; by giving wider responsibilities to the small-scale indigenous private sector; by allowing greater scope for decentralized cooperatives; and by defining an appropriate role for larger-scale private capital, domestic and foreign. Many governments have already acted in this area. In Guinea-Bissau, Mozambique, Senegal, Uganda, and Zaïre, among others, governments have decided on efficiency grounds that the scope of private sector activity should be enlarged.

In most of Africa, four out of every five people work in agriculture. It is the main economic sector, generating in most countries 30 to 60 percent of GDP, or even more, if national accounts value it properly. Because of its importance, agriculture is treated at length in the Report. A strategy for faster agricultural growth is set out in Chapter 5. Its main elements are: concentration of resources on smallholders; reform of incentive structures to ensure better prices, more open and competitive marketing systems, and greater availability of consumer goods in some instances; a focus in the medium term on making existing programs work better and on rehabilitation of existing infrastructure, small-scale irrigation, and rural roads; a major effort in research on crops and livestock; and expansion of pest control and related activities to reduce postharvest losses. The strategy also requires careful evaluation of means toward self-sufficiency in food.

One of the pervasive themes of the Report is the critical role of human resources in the

development of Africa. The development of human resources is the subject of Chapter 6: education, training, and health. With respect to education, one basic strategy issue is addressed: how to expand schooling most effectively in the face of severe financial constraints. The training discussion covers a wide range of questions: project-related training; expansion of on-the-job training; the need for special attention to management training; and technical assistance. In the discussion of health sector strategies a number of themes receive attention, including: experimentation with low-cost rural health care strategies and their gradual expansion, taking into account administrative and financial constraints; better use of existing resources through improved planning, policy analysis, and management; mobilization of private as well as public energies; rehabilitation of infrastructure and consolidation of existing health systems; and improving access to potable water and adequate sanitation.

Although expansion of agriculture is necessarily the centerpiece of any production-oriented strategy, opportunities for increasing output also exist in other sectors—energy, industry (manufacturing, utilities, construction), nonfuel minerals, and transport. Policies and programs for these sectors are considered in Chapter 7.

While the focus of the Report is on responses to the economic crisis of the 1980s, certain longer-term problems cannot be ignored. Perhaps the most critical of these is rapid population growth. The six children born on average to an African woman during her childbearing years represent the highest total fertility rate in the world. This high fertility, combined with declining mortality, has effects on agriculture, urbanization, and government spending, which are explored in Chapter 8. This chapter also considers the problems of Africa's rapidly growing cities, and the responses necessary *now* if urban resources are to be effectively marshalled and future urban crises headed off. Problems of soil conservation, reforestation, and fuelwood supply are briefly analyzed, and the chapter concludes with an analysis of the ra-

tionale for regional economic integration—the goal of the *Lagos Plan*—and the desirability of a positive donor role in support of moves toward closer regional economic cooperation.

Policy-related factors receive priority in the Report, because—for many of the countries involved—the prospects for more rapid and sustained economic development are slight without appropriate adjustments. Domestic policies can be altered, although it is recognized that changes of this sort require time and are not easy to achieve. Given a more suitable policy framework and adequate external support, the region's substantial economic potential could be realized. Agriculture, long neglected, could recapture the growth rhythms of the 1960s if the environment were more supportive. Also, some impact of agricultural research should be felt in the next few years; research now under way can yield results by the 1990s. In addition, there is the promise of the continent's largely unexplored minerals, its offshore resources in fish and fuel, and the unharnessed power of its great rivers.

Long-run Strategy Implications

The agriculture-based and export-oriented development strategy suggested for the 1980s is an essential beginning to a process of long-term transformation, a prelude to industrialization. It is not a permanent course for any country, but one that in Africa generates resources more quickly than any alternative and benefits more people. Without these resources, the foundations of future development cannot be established. The list of what must be done is formidable: administrative services have to be extended to the rural areas to increase social welfare and contribute to the building of a sense of national unity; critically needed social and economic infrastructure must be developed; roads must be built and maintained; suitable schooling must be offered to everyone; knowledge about the economy has to be increased by broader and deeper research and by pilot experiments on a wide front; and more people must be trained. Inter-African trade relations have to be de-

veloped and greater cooperation encouraged by means of joint programs. This will build mutual interests and the habit of common efforts, creating a sure basis for increased regional integration, such as is envisaged in the *Lagos Plan of Action*.

A strategy focused on agriculture and exports is thus open-ended, a necessary beginning. It will help generate the resources Africa needs to consolidate its political and administrative forces, educate and improve the health of its people, and find out what will work and what will not. It will bring forth human talent now neglected and uncover physical resources not yet imagined. And it will open the way to a future whose shape we cannot yet see.

Donor Policies

While it is emphasized in the Report that African governments must review their policies and programs if their development objectives are to be achieved, it is also recognized that policy reform is difficult and delicate. In all societies, formidable obstacles prevent quick responses to even the most carefully reasoned calls for change. In some cases, consumers and producers, parastatal managers, civil servants, and industrialists have an interest in maintaining existing policies, however inefficient these might be from a national point of view. Further, reform often involves technical questions fraught with uncertainties. But, perhaps most of all, reform programs always take time. For these reasons and others, African governments will need additional outside assistance, and this matter is discussed in Chapter 9.

The first step for the international community, if it is to assist African countries through the present crisis and help the region realize its potential, is a commitment to larger aid flows in the 1980s. While per capita aid to Africa is already relatively high, the needs are particularly large and pressing when compared with those of most other developing regions which are at roughly the same level of per capita income.

The analysis in the Report suggests that a doubling of aid in real terms by the end of the 1980s, from \$4.9 to \$9.1 billion (from \$4.9 to \$17.8 billion in current prices), combined with an appropriate reorientation of domestic policy, could lead to a regional average annual per capita growth rate of almost 2.5 percent during the remainder of the decade. On the other hand, if the established patterns continue, the overall per capita growth rate will be zero or negative, with alarming possibilities for even steeper downward spirals in some countries.

Additional aid commitments will have to be made *now* if disbursements are to reach required levels by the mid-1980s. These inflows should be targeted to improve efficiency of resource use in the short and medium term. Quick-disbursing balance-of-payments assistance is critically needed in some countries to permit fuller operation and maintenance of existing productive capacity and infrastructure. A focus on completion of existing projects, on making recently completed projects work better, on rehabilitation, and on maintenance will lead to quick increases in output. Productive projects generally should have highest priority.

Both donors and African governments will have to change policies and attitudes if the large increases in aid recommended here are to come about, and if they are to have their desired effects. What is needed is a new kind of social compact, an agreement within the world community that the struggle against poverty in Africa is a joint concern which entails responsibilities for both parties. After all, foreign assistance has played a more substantial role in Africa than in most other developing regions, in terms of aid per capita, share of total investment, technical assistance, and project selection and design. Donors have thus contributed to some extent to the present crisis. Moreover, African states are among the world's newest and least developed. They face special economic problems handicapped by still-acute scarcities of trained and experienced people, fragile political systems, and untested institutions. They are, rightfully, a special concern of the com-

5. POLICIES AND PRIORITIES IN AGRICULTURE

Agriculture is at the heart of African economies. Most of the population earns its livelihood from agriculture. Officially its share of GDP in most countries of the Sub-Saharan region is between 30 and 60 percent. But this is an underestimate, since agricultural output is valued at the prices governments pay to producers, which are below export or import parity prices, and since the value of production in the secondary and tertiary sectors is overstated due to subsidies and protection. Moreover, the transport, processing, and trade sectors depend on the production of agricultural commodities, and incomes earned in this sector provide markets for domestically produced goods and services.

Thus, agricultural output is the single most important determinant of overall economic growth and its sluggish record of recent years is the principal factor underlying the poor economic performance of the countries of this region. For this reason, growth-oriented policies for this sector are crucial for improving overall economic performance. This chapter reviews trends over the last 20 years and then sets forth the main elements of a production-focused rural development strategy.

Trends in Agricultural Development, 1960-80

The crisis in African agriculture is reflected in five trends which evolved over the past two decades:

- the growth rate of agricultural production began to decline and, in the 1970s, was less

than the rate of population growth almost everywhere;

- agricultural exports stagnated, and African shares in world trade declined for many commodities;
- food production per capita was at best stagnant in the 1960s and fell in the 1970s;
- commercial imports of food grains grew more than three times as fast as population, and food aid increased substantially; and
- more of the population shifted its consumption to wheat and rice (as evidenced by the soaring imports of these food-grains), which increased food dependency and created in many countries a mismatch between local production possibilities and consumer demand, since wheat and rice in these countries can only be grown at costs far above import parities.

OVERALL PERFORMANCE

In the 1960s, agricultural production¹ grew in volume by 2.3 percent a year, or roughly at the same rate as population growth. In the 1970s, however, production dropped to about 1.3 percent a year,² while population grew at about 2.7 percent. In the low-income and oil-exporting countries, agricultural growth was the slowest—about 1 percent annually—while the middle-income nations achieved a growth rate in line with that of rural population (which

1. Crops and livestock.

2. See the Statistical Annex for a discussion of some of the problems involved in estimating average growth rates in agriculture.

Table 5.1. Growth of Agricultural Exports^a

Export	Annual growth rates (percent)					
	Sub-Saharan Africa		Oil-exporting countries		Oil-importing countries	
	1961-63 to 1969-71	1969-71 to 1977-79	1961-63 to 1969-71	1969-71 to 1977-79	1961-63 to 1969-71	1969-71 to 1977-79
Thirty main agricultural exports						
Volume	1.9	-1.9	-0.7	-8.6	2.6	-0.7
Unit value	2.3	16.2	3.1	16.8	2.1	16.1
Value	4.3	14.0	2.3	6.8	4.8	15.3
Value of other agricultural exports	4.6	8.9	33.4	-1.6	3.4	9.8

a. Crops and livestock.

Sources: World Bank data and FAO Trade Yearbook tapes.

is estimated to have increased by a little more than 2 percent a year). All groups of countries registered declining per capita production, however, and only eight out of the 39 countries for which data are available (which account for less than 15 percent of the region's population) showed rising agricultural production per capita (see Table SA.25).

While production statistics are highly tentative (particularly for subsistence foods) and must be regarded with caution,³ other evidence substantiates the poor performance in this sector: the mounting domestic food prices in most countries; the steep rise in cereals imports; and the export crop figures, which are more reliable than production statistics and indicate a substantial decline (see Table 5.1).

EXPORT PRODUCTION

By the end of the 1970s, agricultural exports were no greater than in the early 1960s. In fact, a modest rate of increase of 1.9 percent a year in the 1960s was offset by an equal decrease in the 1970s. In terms of volume, the only crops registering gains were coffee, cocoa, tea, sugar, and cotton.⁴ Sisal suffered a

marked drop in response to shrinking world demand. Cattle and meat exports grew steeply in the 1960s, but, following the 1972-74 West African drought, failed to regain their previous levels. Timber also enjoyed a brisk increase in the 1960s, but then stagnated in the next decade. Perhaps the most spectacular decline in exports was in oilseeds—especially groundnuts—which was due to increased domestic demand (in Nigeria, in particular), the disintegration of Zaïre's rural economy, a switch from groundnuts to cereals in a number of countries (Mali, Niger, and Nigeria), and the spread of "rosette" (a plant disease).

As a consequence, Africa's share of world trade declined for most of these commodities. While world trade in those commodities exported by the Sub-Saharan countries grew in volume by 1.8 percent a year, and 3.3 percent in value (constant prices) over the two decades, the growth rates of exports from Africa were zero and 1.8 percent, respectively.⁵

FOOD PRODUCTION

The key crops produced for domestic consumption are millet and sorghum in the Sudan and Sahelian countries, maize in Eastern and Southern Africa, rice in Madagascar and

3. Limitations of agricultural data are discussed in the Statistical Annex.

4. In terms of prices, coffee and cocoa recorded substantial real gains over the two decades, rising by some 5 percent annually relative to import prices, while the relative prices (net barter terms of trade) of the other export crops (when taken together) fell. Consequently, the share of cocoa and

coffee in the total value of agricultural exports increased from one third to nearly two thirds between 1961 and 1979.

5. This applies to the 30 main agricultural exports (crops and livestock), accounting for more than 90 percent of the total. For the volume of total exports, the rate of increase was 1.6 percent a year.

Table 5.2. Growth of Production of Selected Food Crops
(in volume)

Crop	Annual growth rate (percent)					
	Sub-Saharan Africa		Oil-exporting countries		Oil-importing countries	
	1961-63 to 1969-71	1969-71 to 1977-79	1961-63 to 1969-71	1969-71 to 1977-79	1961-63 to 1969-71	1969-71 to 1977-79
Cereals						
Rice (paddy)	4.0	2.9	6.3	10.7	3.8	2.2
Wheat	3.8	-0.2	-1.2	-0.6	4.0	-0.2
Maize	5.2	1.3	5.1	0.9	5.2	1.4
Millet/sorghum	0.9	1.0	0.2	0.7	1.3	1.2
Roots and tubers	2.0	1.8	2.3	1.6	1.8	1.9
Pulses	3.3	1.1	5.2	0.0	2.8	1.4
Groundnuts	0.7	-0.9	-1.2	-14.0	1.7	2.7
Palmoil	1.7	2.2	0.1	2.7	3.7	1.6

Source: FAO Production Yearbook tapes.

parts of West Africa, roots and tubers (cassava, yams, and sweet potatoes) mainly in the forest zone of West and Central Africa, and pulses (cowpeas, in particular) throughout Africa, but largely outside the forest zone. Important oilseeds are groundnuts and palm-oil.

Food production, as measured by the growth of these major crops,⁶ rose by about 2 percent a year in the 1960s (see Table 5.2), or at approximately the same rate as rural population. In the 1970s, however, production increased only by an average of 1.5 percent a year and the drop was sharper among the oil-exporting countries, mainly because of the decline of groundnuts in Nigeria.⁷ In fact, for Africa as a whole in the 1970s, growth of food production was not only well below the increase in total population, but also well below that of rural population.

Where output increased, it was due largely to an expansion of the areas under cultivation. On the other hand, productivity was stagnant, both in terms of land and labor. Yields, which grew in the 1960s (by 2 percent

a year for roots and tubers and close to 1 percent for cereals), stagnated in the next decade. Though yield data are especially weak, they describe general tendencies, and the declining trend in Africa is in marked contrast to those in other developing regions, such as the Indian subcontinent (where, however, much of the growth has come on irrigated land). And while land productivity is not the decisive factor for a thinly populated continent such as Africa, when growth of total food production is compared to that of the rural population, it suggests that labor productivity stagnated in the 1960s and fell in the 1970s.⁸

What is significant is that this decline occurred over a period when the various governments and external sources of finance focused more strongly on food production projects than ever before. Between 1973 and 1980, about \$5 billion in aid flowed into agriculture, \$2.4 billion of which was from the World Bank.⁹ These projects have so far failed to boost output or have been offset by declines in other parts of the food economy.

6. The main items left out are fruits and vegetables (including plantains) and meat and fish, for which data are very patchy and even more uncertain than for the staples discussed below.

7. Excluding groundnuts, the growth rate of food production in the oil-exporting countries would have doubled, from 0.8 percent a year in the 1960s to 1.6 percent annually in the 1970s.

8. The rate of growth of rural population does not take into account the changes in rural population structure, however—in particular, the decreasing proportion of able-bodied males.

9. Most of this aid was for food production; of the total incremental output expected from the assisted projects, export production accounted for only one eighth—or one-third, if crops such as maize and groundnuts (which are both exported and domestically consumed) are included.

Table 5.3. Growth of Imports of Selected Agricultural Commodities, 1961-63 to 1977-79
(in volume)

Commodity	Percent yearly					
	Low- and middle-income countries		Oil-exporting countries		Sub-Saharan Africa	
	1961-63 to 1969-71	1969-71 to 1977-79	1961-63 to 1969-71	1969-71 to 1977-79	1961-63 to 1969-71	1969-71 to 1977-79
Cereals ^a	7.4	6.8	21.5	18.2	9.0	9.5
Wheat	9.3	9.2	26.8	13.3	12.9	10.7
Rice	4.9	7.3	3.7	68.0	4.9	12.1
Maize	8.5	7.6	..	47.3	8.7	5.7
Dairy products ^b	9.8	5.4	..	17.0	7.2	7.2
Sugar	2.1	-0.1	6.0	23.4	2.5	5.8
Meat	1.1	5.4	2.3	33.1	1.3	13.3
Animal and vegetable oils	11.6	5.4	9.1	70.3	11.5	13.0

a. Including those not itemized below.

b. See technical notes for Table SA.29.

Source: FAO Trade Yearbook tapes.

AGRICULTURAL IMPORTS

Food imports grew steadily over the past 20 years, except for sugar (see Table 5.3). Imports of cereals soared by about 9 percent a year since the early 1960s. Commercial imports increased from 1.2 million tons a year in 1961-63 to nearly 5 million tons in 1977-79 (see Table SA.29). If exports of cereals are deducted, net imports averaged about 4.3 million tons during the late 1970s. The fastest growing are wheat and rice, which together rose by about 11 percent a year in the 1970s, the increase partly reflecting Madagascar's shift from a position of net exporter to major rice importer. Cereals imports are heavily concentrated in ten countries: some of the most populous (Ethiopia, Ghana, Nigeria, Sudan, Tanzania, and Zaïre), several smaller ones with a marked European lifestyle in the cities and many expatriates (Ivory Coast and Senegal), and two with a high degree of urbanization (Congo and Zambia). Wheat and rice now account for 82 percent of gross cereals imports and their share is expected to rise further. While this is partly due to lagging growth of domestic food production, it is also the result of the rapid rate of urbanization and of economic policies. Consumption patterns shifted from the traditional staples to wheat and rice, a practice exacerbated by overvalued exchange rates which often make imported cereals the cheapest source of supply. To some

extent, therefore, a low rate of growth of food production may be an effect rather than a cause of rising cereals imports; both factors are related to overvaluation of exchange rates.

FOOD AID

The figures in Table 5.3 actually understate the real hike in imports, since, in a number of countries, food aid is not reported in foreign trade statistics; yet it now accounts for more than 20 percent of total net cereals imports (see Table 5.4). The bulk of the aid consists of wheat and wheat flour (75 percent of U.S. food aid in 1979-80), while maize and sorghum, the staple commodities in many of the countries, constitute only minor shares.

Food aid is targeted to the areas experiencing wars and refugee flows, and to the Sahelian countries (see Table SA.24). It rose from about 800,000 tons in the mid-1970s to more than 1.3 million tons in 1978, because of the poor crop year of 1977-78; and the World Food Program estimates that the volume reached 1.5 million tons in 1980, with pledges for 1981 placed at 1.8 million tons.

SOURCES OF SLOW AGRICULTURAL GROWTH

There is a fairly widespread consensus as to the main factors behind the present rural crisis, although perhaps not on the weight to be attached to each. These include (as discussed in Chapter 2) the disruptions caused

Table 5.4. Food Aid and Commercial Imports of Cereals, 1975-79

Item	1975	1976	1977	1978	1979
<i>Food aid (thousands of metric tons)</i>					
Low-income countries ^a	834.7	648.5	708.2	1,001.0	953.0
Middle-income oil-importing countries ^b	113.2	98.4	147.7	336.9	234.6
Total Africa ^c	957.8	752.0	868.6	1,359.2	1,201.5
<i>Commercial net cereals imports (thousands of metric tons)</i>					
Low-income countries	1,471.8	1,309.7	1,532.9	1,488.7	1,272.0
Middle-income oil-importing countries	646.9	779.5	1,324.0	1,389.9	1,439.1
Total Africa	2,818.3	3,050.5	4,212.6	4,747.2	4,222.6
<i>Total net cereals inflow (thousands of metric tons)</i>					
Low-income countries	2,306.5	1,958.2	2,241.1	2,489.7	2,225.0
Middle-income oil-importing countries	760.1	877.9	1,471.7	1,726.8	1,673.7
Total Africa	3,776.1	3,802.5	5,081.2	6,106.4	5,484.1
<i>Food aid as a percent of total net inflow</i>					
Low-income countries	36.2	33.1	31.6	40.2	42.8
Middle-income oil-importing countries	14.9	11.2	10.0	19.5	14.0
Total Africa	25.4	19.8	17.1	22.2	21.9
<i>Food aid per capita (kilograms)</i>					
Low-income countries	4.9	3.7	4.0	5.5	5.1
Middle-income oil-importing countries	2.2	1.8	2.7	5.9	4.0
Total Africa	3.1	2.4	2.7	4.1	3.5
<i>Total net cereals inflow per capita (kilograms)</i>					
Low-income countries	13.6	11.3	12.6	13.6	11.8
Middle-income oil-importing countries	14.6	16.4	26.6	30.2	28.3
Total Africa	12.4	12.2	15.8	18.5	16.2

a. Includes Comoros and Cape Verde.

b. Includes Djibouti, Equatorial Guinea, São Tomé and Príncipe, and Seychelles, but excludes Zimbabwe.

c. Includes oil exporters; excludes Zimbabwe.

Source: *Food Aid Bulletin*, no. 4 (Rome: FAO, October 1980), Table 2, pp. 8-10.

by wars and civil strife, drought and poor rainfall patterns during the 1970s, and rapid population growth, which pushed cultivation into less productive areas. Agriculture was also neglected for a long time by government and donors, as it was by development theorists. Further, there was a misallocation of investment, notably an excessive emphasis on large-scale government-operated schemes. Also, agricultural and economic policies and institutional frameworks were not conducive to increasing output: official prices were too low; marketing systems too uncertain, inefficient, and uncompetitive; input supplies too irregular; and participation of farmers in rural affairs too limited. The agricultural extension effort was weakened by unfavorable policies, deficient research output, and the organizational deficiencies of the public sector agencies which were responsible for spearheading rural development.

Low agricultural growth rates typify all but a few African countries in recent years (see

Table 5.5). The downward trend is particularly ominous since it has occurred despite major investment efforts and additional use of off-farm inputs (see Table SA.28). The shift in consumption toward wheat and rice is also worrisome because it involves cereals that are more costly to produce than millet, sorghum, and maize, and—except for traditionally grown rice in some countries—have high costs relative to imports of the same products.

Action for Rural Development

A major action program for agriculture, the Food and Agriculture Organization (FAO) Regional Food Plan for Africa,¹⁰ was written in 1978 and endorsed by the Organization for African Unity (OAU) in Arusha (1978), Monrovia (1979), and at the Extraordinary Economic Summit in Lagos (1980). It postulates a growth rate for agricultural production of

10. *Regional Food Plan for Africa* (Rome: FAO, 1980).

14

which affect his willingness to produce and to sell: the level, structure, and predictability of prices; the efficiency, fairness, and stability of marketing arrangements; the availability and prices of off-farm inputs and of consumer goods; and (especially in societies where non-material incentives are stressed) the degree of participation in decisionmaking. While all of these are important, price and marketing policies are the most general, and these will be the center of analysis here.

PROBLEMS OF PRICING POLICY

It is now widely agreed that insufficient price incentives for agricultural producers are an important factor behind the disappointing growth of African agriculture. The importance of price policy comes out strongly in project experience. A recent review of 27 agricultural projects undertaken by the World Bank noted "the almost overriding importance of producer prices in affecting production outcome and production levels, often cutting across the quality of technical packages and extension services. Seven out of nine projects implemented under favorable prices achieved or surpassed their production objectives; 13 of the 18 under unfavorable prices failed to do so."¹³ This idea is also borne out strongly in micro-level studies, which indicate substantial farmer responsiveness to price.¹⁴

Despite this general appreciation of the im-

portance of good prices, export crop producers have been heavily taxed, and prices of food crops have been systematically set at below-market levels for most of the past decade. These aspects of price policy are discussed below.

Pricing of Export Crops. Export crops are heavily taxed; African producers have received only a fraction of the world market prices of major exports. Their tax burden, defined as the ratio of farmgate producer price to economic value at the farmgate, is on average in the 40 to 45 percent range (see Box D). Subsidies on inputs and other services provided by government partly compensate for taxation of cash crops, though they soften the tax impact very little—by 10 to 15 percent in most cases.

Available information does not permit broad generalization about how farmers' relative prices and incomes have changed over time. Data for 12 countries suggest that stagnation or decline was the most general tendency in the 1970s, both for farmer terms of trade and the purchasing power of farmer cash incomes (see Table SA.31). These data provide some confirmation for the view, widely expressed in Africa and outside and implied in the production and population growth data, that farmer real incomes have fallen in many countries in recent years.

Heavy taxation and unfavorable terms of trade do not necessarily have quick and/or observable effects on output trends. But the high level of taxation of export crops through export taxes, marketing board levies, excessive marketing costs, and overvalued exchange rates have kept export production in many countries below what it could have been, and hence contributed to the steep fall in Africa's share in the world market noted earlier (see box on agricultural exports from Tanzania and Ghana in Chapter 4).¹⁵ Since in the case of most export crops African countries

13. *Sixth Annual Review of Project Performance Audits, September 1980*, paragraph 3.71.

14. Hossein Askari and John Cummings, *Agricultural Supply Response: A Survey of the Econometric Evidence* (New York: Praeger, 1976). The literature and common observation indicate that farmers respond strongly to changes in relative prices. The question of aggregate supply response is more nuanced. In the short term, farmers' possibilities are indeed sharply constrained, and they respond to changed incentive structures by switching to the more profitable crops [see Raj Krishna, "Agriculture Price Policy and Economic Development" in H. Southworth and B. F. Johnston (eds.), *Agricultural Development and Economic Growth* (Ithaca, New York: Cornell University Press, 1967), especially pp. 505 ff]. In the longer run, a more congenial set of marketing conditions will motivate them to invest in equipment, to hire labor, to work harder, and to find other ways of breaking those "constraints" which derive from inadequate motivation rather than from inadequate technology.

15. See also John Levi, "African Agriculture Misunderstood: Policy in Sierra Leone," *Food Research Institute Studies*, vol. 13, no. 3 (1974).

Box D: "Taxation" of Export Crops

A good measure of the degree to which crops are taxed is the "Nominal Protection Coefficient" (NPC), defined as the price paid to the producer divided by the amount he would have received had he sold his crops at the world price minus transport, marketing, and processing costs. An NPC value of more than one means that the crop is being subsidized; and the more it is above one, the bigger the subsidy. An NPC of less than one indicates taxation; the lower it is below one, the heavier the tax. The table at right shows NPCs for major crops in 13 countries, representing more than half the region's population.

The actual level of taxation of export crops is higher than shown in two important respects. In the first place, the economic farmgate value of these crops has been derived on the basis of actual marketing costs. These costs are, in most cases, those of monopolistic agencies working without competitive pressure, and thus are generally inflated. If the marketing cost of an efficient marketing system were used instead, the economic value of crops would be higher and the degree of implicit taxation even greater. The level of taxation is also higher than shown because the NPCs do not reflect the influence of overvalued currencies, which reduce the proceeds of exports in terms of domestic currency. Taking into account the effect of an overvalued currency, producers in a number of countries listed in the table received less than half the real value of their crops in recent years.

have distinct comparative advantages, this implies a loss of growth opportunities for the economy as a whole.

Pricing of Food Crops. In most African countries producer and consumer prices for basic foodstuffs are legally controlled. Governments have dual policy objectives in setting and regulating their prices. They want to provide adequate incentives for increasing food production, and they seek to protect the interests of consumers at the same time.¹⁶ In practice, the objective of ensuring a regular supply of staples at "affordable" prices for consumers has been the dominant criterion in most countries. This is accomplished in various ways: producer prices are fixed at below market levels; subsidies are provided by selling imported foods at below landed

16. See *Lagos Plan of Action*, paragraph 33.

Nominal Protection Coefficients of Selected Export Crops

Crop	1971-75	1976-80
Cocoa		
Cameroon	0.37 (2) ^a	0.45 (2)
Ghana	0.47 (5)	0.40 (4)
Ivory Coast	0.36 (2)	0.38 (1)
Togo	0.50 (5)	0.25 (4)
Coffee		
Cameroon (Arabica)	0.72 (2)	0.60 (2)
Cameroon (Robusta)	..	0.36 (1)
Ivory Coast	0.68 (1)	0.36 (1)
Kenya	0.94 (1)	..
Tanzania	0.80 (5)	0.59 (4)
Togo	0.42 (5)	0.23 (4)
Cotton		
Cameroon	..	0.79 (1)
Ivory Coast	0.79 (1)	1.05 (1)
Kenya	1.07 (1)	..
Malawi	0.68 (5)	0.75 (2)
Mali	0.55 (2)	0.44 (4)
Senegal	0.65 (2)	..
Sudan	0.78 (2)	0.60 (1)
Togo	0.62 (5)	0.79 (4)
Upper Volta	..	0.79 (1)
Groundnuts		
Malawi	0.70 (5)	0.59 (2)
Mali	0.57 (2)	0.43 (4)
Senegal	0.48 (4)	0.66 (4)
Sudan	0.85 (3)	0.67 (1)
Zambia	0.70 (5)	0.71 (4)
Maize^b		
Kenya	0.96 (1)	1.33 (1)
Malawi	1.68 (5)	1.34 (2)
Zambia	0.72 (5)	0.78 (4)
Sesame		
Sudan	0.83 (1)	0.59 (1)
Upper Volta	..	0.88 (1)
Tea		
Kenya	0.89 (1)	..
Tobacco		
Malawi	0.42 (5)	0.28 (2)
Zambia	1.09 (5)	0.88 (4)
Wheat^b		
Kenya	..	1.43 (1)

.. not available.

a. Figure in brackets indicates number of observations (years).

b. Maize and wheat have been alternately exported and imported in these countries.

Source: World Bank data.

costs; food imports are encouraged when domestic food price levels rise; and imported foods are given an implicit subsidy because of currency overvaluation.

In most instances over the past decade, official food prices in African countries have

been set "too low"; prices in parallel markets are often two to three times as high. The official prices have thus been only partially effective; producers have been able to sell part of their marketings at the free market prices and most consumers have been forced to buy at open market prices. This happens despite the existence of state marketing organizations that are frequently endowed with legal trading monopolies—especially in grain trading. While direct price effects on production are thus diluted, the policy of setting low official producer prices undoubtedly has negative effects on farmer incentives to produce and to sell basic foods.

The effect of government import policies is in many cases much more important than low controlled prices of staples. Imported wheat and rice are now becoming steadily cheaper than domestic staples because of the overvaluation of many African currencies. Moreover, intent on keeping urban food prices low, many governments have in recent years had periodic recourse to massive injections of food imports, thereby causing sharp reductions of domestic prices (see Box E). These policies, which stimulate wheat and rice consumption and discourage producers of substitutable local cereals, have been reinforced by food aid, which has been maintained at consistently high levels after a brief reduction in the mid-1970s. Relative price changes favorable to domestic staples have been checked, and urban preferences for wheat and rice reinforced.

These pricing policies are widely attributed in the scholarly literature as well as in donor circles to an urban bias among policymakers. But a balanced assessment has to recognize the constraints at work, and the conflicts of objectives involved. Policymakers in Africa are fully aware that the raising of producer prices for export crops would stimulate production and is in general therefore a desirable objective. But they are also aware that other objectives may be sacrificed. Thus, the "taxes" levied on export crops are a principal source of finance for public sector activities; for non-mineral economies there is no other important domestic source. Moreover, the scope for higher producer prices is obstructed on two

Box E: Nigerian Food Imports

Government trade policy in Nigeria has had a particularly strong influence on prices for major staples. Wheat and flour imports grew from 400,000 tons in 1975 to 1.3 million tons in 1978, and then declined to an estimated 1.0 million tons in 1980. Rice imports have grown even faster: volumes increased elevenfold between 1976 and 1978—from under 50,000 tons to over 550,000 tons—then dropped sharply due to import restrictions. In October 1979, licenses were issued for only 200,000 tons for 1980. Prices tripled by September of that year. The Government responded to this surge in rice prices by lifting import quotas on rice, cereals, and flour. The same pattern had occurred earlier: in 1979, wheat and flour prices fell markedly as a result of big increases in imports.

In short, the sharp increases in imports in recent years help explain the fall in prices in 1979 while later import restrictions fueled their recovery in 1980. Government trade policy, particularly for rice, has changed frequently in recent years as indicated in the table below.

Summary of Rice Trade Policy

Prior to April 1974	66.6% tariff
April 1974–April 1975	20% tariff
April 1975–April 1978	10% tariff
April 1978–June 1978	20% tariff
June 1978–October 1978	10% tariff
October 1978–April 1979	Imports in containers under 50 kilograms banned.
April 1979	Imports in containers 50 kilograms and above under restricted license.
September 1979	Six-month ban imposed on all rice imports.
January 1980	Import licenses issued for 100,000 tons.
October 1980	Rice placed under general import license—no quantitative restrictions.

Erratic trade policy not only has had a dramatic effect on price levels, sending confused price signals to producers, but also has increased the risk to traders who market domestic supplies.

sides: overvalued exchange rates mean that the foreign currency obtained from exports is converted into a relatively small amount of domestic currency, making it difficult for governments to pay higher producer prices. And on the domestic marketing side, marketing margins absorb large shares of total proceeds, reducing the share available to producers.

Finally, a positive price policy for export crops might lead to reduction—at least in the short run—in food crop production, and this would have consequent effects on food self-sufficiency objectives.

Similar conflicts of objectives—real or supposed—underlie food price policy deficiencies. Abundant worldwide experience in the past decade certainly indicates that the political risks involved in raising food prices are hardly negligible. Moreover, there exist genuine concerns over the impact of higher food prices on real incomes and the nutritional status of the poor. To see food price policies solely in terms of political will or commitment is too simple.

It is true, nonetheless, that the price policies described above have proved self-defeating. The policy of attempting to control prices and supplies of foodstuffs has, by and large, succeeded in securing only a limited supply of low-priced (and often low-quality) foodstuffs for a relatively small group of urban consumers. It has increased farmers', and traders', risks in producing and marketing food surpluses. It has failed to stabilize and indeed has actually destabilized supplies over the course of the year. Further, through its effects on farmers' supply response, it has probably resulted in a higher overall level of food prices than would have pertained without government attempts to control supplies.

Reliance on imports, moreover, is creating a potentially very costly structural dependence on wheat and rice. These now account for 82 percent of net commercial cereals imports, wheat alone for nearly half the total. Projections of Africa's cereals import requirements in 1990 vary from 6 million to 28 million tons, depending on the assumptions used. Most estimates cluster around 11 million to 12 million tons, most of which would be wheat and rice. This is a conservative estimate since the 1981 imports may already be 6 million to 7 million tons (including nearly 2 million tons of food aid). Except in Sudan, Ethiopia, the East African Highlands, and parts of Southern Africa, wheat cannot be grown or can be grown only at prohibitive costs. Rice can be grown in a wider range of countries, but often

only at high cost. It can be grown efficiently under rainfed conditions or in small-scale schemes in swamps or riverine valleys while large-scale irrigation schemes are extremely costly both in terms of initial investment and recurrent costs. Therefore, import substitution of these crops, where technically feasible, will preempt a substantial proportion of investible resources. Since urban consumers would be the main outlet for these cereals, ambitious rice and wheat production programs will reinforce the traditional bias against the rural populations. In addition, this trend toward rice and wheat consumption, unchecked by suitable pricing policies, will maintain the traditional rainfed cereals (and roots and tubers) in the position of inferior goods, reducing the extent and stability of their markets.

PROBLEMS OF MARKETING AND INPUT SUPPLY

The central problem in marketing and input supply is the very general tendency to give too large a set of responsibilities to public sector institutions, and too few to other agents—individual traders, private companies, and farmers' cooperatives. It is the major manifestation of the organization and management problem discussed in the preceding chapter.

Marketing Agencies. Export crops are almost everywhere in Africa marketed by state trading organizations; often they use "licensed buying agents," private traders, to help in village-level purchases. Government monopolies also exist in many countries for food crop purchases, though these are generally less well organized than export-crop marketing and are in most cases unable to purchase more than a minor share of marketed output.

The performance of the export crop marketing agencies is of major importance in several respects. First, their degree of efficiency affects the share of export proceeds that can be paid to producers. Because of long distances and the frequently difficult problem of

access, the cost of marketing tends to be high even under conditions of efficient marketing operations.¹⁷ Second, the crop marketing agencies are the major point of contact between peasants, the money economy, and the state bureaucracy. Unless the marketing transactions are done fairly and efficiently, there are high risks of peasant disaffection from both the bureaucracy and the market economy.

Serious inefficiencies characterize the operation of most marketing agencies. Some of these arise from problems found in almost all parastatals—overmanning, inadequate non-salary budgets, and management scarcities. There are also inefficiencies peculiar to the export crop parastatals due to the lack of competition. And there are additional problems in these agencies when marketed volumes stagnate or decline: decreasing turnover is compensated by higher overhead per unit, the producer price being the residual. The result is an upward spiraling of costs and a parallel downward spiraling of exports. Classic examples of this are groundnuts in Mali and several export crops in Tanzania.¹⁸

In food-crop marketing, parallel marketing channels exist in many countries of the region; the legal and official marketing agency coexists with a semiclandestine private trading sector. This is most often the situation with respect to foodgrains. In these markets, attempts at controlling marketing and prices are most extensive but they are effective to varying degrees. In countries importing wheat, price controls are often fairly effective for flour and bread; for rice, the degree of control depends primarily on the share of paddy grown in government-controlled schemes. For domestic cereals, the share of official trade in

marketed production may be as high as 25 to 50 percent (in some East African countries), or as low as 1 to 2 percent. Price and marketing controls are conspicuously absent for roots and vegetables, no doubt because of the problems and risks associated with the perishability of these crops. Most governments do not put much trust in the private sector's ability to cope with the task of providing stable supplies of food to the urban masses, although private traders handle the bulk of the trade almost everywhere. In most cases private traders are tolerated openly or tacitly as indispensable partners but are not allowed to work in an economic environment that would enable them to realize their full potential. The uncertainties associated with the ambiguous position of private trade and traders discourage full-time involvement in food marketing, investment in transport and storage, and a systematic approach to developing an adequate supply network.

Official marketing agencies are responsible for collection, transport, sometimes processing (as with rice), and distribution to the wholesale and sometimes even retail level. But producer prices and consumer prices are fixed by government with little regard to the actual cost of collection and distribution. Marketing agencies are also not always or not fully reimbursed for losses incurred in the process. Several of them have accordingly accumulated large deficits reflecting operational inefficiencies and the cost of government-imposed subsidization of consumers. In several cases, deficits have reached striking proportions, given the rather modest quantities of foodstuffs controlled by these agencies. Some agencies are passive, buying whatever small quantities are offered to them at official prices in postharvest periods when market prices are low, or during bumper crop years, buying all they can pay for. Others exercise varying degrees of compulsion, occasionally bordering on outright requisition.

Input Supply. Input distribution agencies are another part of the rural marketing system that has contributed to the poor performance of agriculture. Unless farm inputs are made

17. In Kenya, for instance, charges for marketing, storage, transport, and administrative overheads averaged 34 percent of the f.o.b. border price for maize, 23 percent for wheat, and 48 percent for rice during the 1972-79 period—and the agency in question is not regarded in Kenya as a particularly inefficient marketing institution.

18. See Frank Ellis, *A Preliminary Analysis of the Decline in Tanzania Cashewnut Production 1974-79: Cases, Possible Remedies and Lessons for Rural Development Policy* (Economic Research Bureau, University of Dar es Salaam, December 1979).

Table 5.6. Relative Frequency of Government and Private Sector Control in the Procurement and Distribution of Agricultural Inputs, 39 Countries

Item	Percentage of countries			
	Fertilizer supply	Seed supply	Chemicals supply	Farm equipment supply
Government control ^a	64	61	47	42
Private sector control ^a	11	11	17	22
Mixed government and private sector involvement	25	28	36	36
Total	100	100	100	100

a. Procurement and distribution activity is considered "private" if more than 80 percent of it is in the hands of the private sector, and "government" if more than 80 percent of it is in the hands of the public sector.

Source: World Bank data files. (See Table SA.32 for country-specific information.)

available to farmers on a regular basis and at the right time, there is little chance that agricultural production and productivity will move forward.¹⁹ Unfortunately, there are only a few countries in Africa where this important condition is fulfilled. Procurement and distribution of inputs is another field monopolized by governments or parastatal agencies. In more than 60 percent of African countries, governments reserve full control of the procurement and distribution of fertilizer, seeds, and most other services as well (see Table 5.6). The motives for entering this field are similar to those advanced for government involvement in food crop marketing: inputs are seen as vital commodities that should not be left to the care of the private sector, which is regarded as exploitative and unreliable. Policymakers also frequently perceive a need to subsidize the service provided, which is a rationale for monopolizing its distribution.²⁰ Many officials also believe that only by public distribution will inputs be made available to the remote areas that private trade is assumed to neglect because of low profitability. While this may be true in some cases, it is mainly the policy of panterritorial pricing—fixing of-

19. Input supply involves more than just the provision of fertilizer and seeds. It can include the supply of farm equipment, fencing and building materials, tractor hire services, and spare parts.

20. Subsidies need not involve monopolization. The market mechanism can be used. But most officials do not believe that markets work well enough to be utilized this way. They believe, in this case, that subsidies granted to importer-wholesalers or to private traders would not be passed along to farmers.

official prices of inputs uniformly for the entire territory without regard to actual transport costs—which impedes private trade from effectively competing in remote areas.

There is no a priori reason why government agencies should not be able to fulfill the input supply functions efficiently, but due to the structural problems besetting many public agencies—scarce management, lack of incentives, conflicting objectives, overstaffing, and lack of control—they have rarely succeeded in meeting the rigorous requirements of their clients—input delivery at the right time, at the right place, and in the right amounts.

Government agencies have failed to meet these needs because they have difficulties in adapting bureaucratic, financial, and administrative procedures to commercially oriented operations. For example, they fail to buy inputs on a phased basis because they are geared to the time of release of funds from the budget, and these are not necessarily the optimal times. Likewise, pay scales and hiring and promotion procedures tend to be similar to those in government. This leads to reduced individual initiative, unwillingness to make quick and independent decisions, and consequent efficiency losses.

The absence of competition in input supply also leads to a lack of innovation. Inputs are ordered in routine fashion without regard to location-specific requirements. A recent study in Senegal has revealed considerable scope for savings in fertilizer cost to farmers, notably by tailoring the nutrient content more closely to their needs, by eliminating ineffective elements, by reducing transport cost

through higher concentration, and by determining optimal dosage and composition on economic rather than on technical grounds. Such adjustments, and the supply of inputs in variable package sizes convenient for farmers, would be introduced more readily and on a broader base in a system leaving more scope for private sector participation in input supply.

The general problems outlined above are exacerbated by the common practice of government, subsidization of inputs, in particular fertilizer. This has a number of negative consequences. First, in monopolistic input distribution systems the funds budgeted for input subsidies limit the total amount of fertilizer made available; under the budgetary constraint that many countries experience, the actual amount of inputs that can thus be purchased remains far below the quantity desired by farmers at the subsidized price. Therefore, rather than supplying more farmers than can be served under private trade conditions, governments end up serving considerably fewer. Second, since the quantity delivered remains well below the level of demand, price is driven up and, in spite of the subsidy, some users may pay as much as—or conceivably more than—they would under free-market conditions. Third, even where the input distribution agency has a source of finance independent of the budget (such as bank credit or sufficient working capital as equity), subsidization ties its operation to the budget year, causing delays in procurement and untimely delivery to farmers.²¹

Reform of Price, Marketing, and Input Supply Policies

While there is not much disagreement with the general propositions that higher producer prices would stimulate production and sales, or that marketing systems should become more

21. Many of the problems and symptoms associated with the distribution of subsidized inputs also apply to rural credit institutions administering heavily subsidized credit.

efficient, pushing beyond these propositions is not easy because the problems are complex and involve broad aspects of development strategy. For example, the appropriate level of producer prices, the relationship between prices of export crops and food crops, and between prices of individual crops in each category are all a function of a government's development goals and social policy objectives. Nonetheless policy changes are needed and the directions of change are discussed in the following paragraphs.

EXPORT CROPS

Trade data for the 1970s and the level and trend of export taxation suggest that in many countries there is scope for increasing producer prices for export crops. The slow growth of world demand for many primary commodities is not a valid argument to the contrary as long as Africa does not even maintain its market share. Higher producer prices in real terms would stimulate production directly. It would also allow elimination of most of the subsidies on inputs, equipment, credit, or water that now hamper the distribution of these commodities and services and distort the allocation of resources.

Four objections to a high price export crop policy were noted earlier: the need for government revenues; the limited freedom for maneuver on producer prices due to overvalued exchange rates; high marketing costs; and the conflict that develop with food self-sufficiency objectives.

With respect to government revenue, a number of observations are in order: first, revenue preservation should take second place to the need for maintaining or increasing the pace of export production; second, reduced taxes should raise export levels so that higher volumes would to some extent compensate for the reduced rates; finally, and even more significantly, higher producer prices should still leave scope for taxing some of the "rent elements" prevailing for some crops—coffee, cocoa, tea, and even cotton.

The exchange rate issue has to be confronted directly or indirectly, as noted in Chapter 4. In many cases, lagging export

Toward
Sustained Development
in
Sub-Saharan Africa

A Joint Program of Action

THE WORLD BANK
Washington, D.C.

1. The Deepening Crisis

No list of economic or financial statistics can convey the human misery spreading in sub-Saharan Africa. A special study by the United Nations Children's Fund (UNICEF), "The Impact of Recession on Children," has documented how children have been the victims of economic decline. In Zambia's poorer northern regions, height-for-age ratios have fallen in all age categories under fifteen years. Child mortality in sub-Saharan Africa was 50 percent higher than the average of developing countries in the 1950s; now it is almost double the average. Moreover, despite the surges in food imports and food aid, an estimated 20 percent of Africa's population still eats less than the minimum needed to sustain good health. The number of severely hungry and malnourished people is estimated to have increased from close to 80 million in 1972-74 to as many as 100 million in 1984.

The illustrative scenarios in the World Bank's *World Development Report 1984* suggest that, even with some fundamental improvements in domestic economic management, per capita incomes in sub-Saharan Africa will continue to fall during 1985-95. In the more pessimistic scenario, GDP is expected to grow at 2.8 percent a year and population at 3.5 percent, involving an annual fall in per capita GDP of 0.7 percent. On this basis, real African incomes in 1995 will be so low that between 65 and 80 percent of the people will be living below the poverty line, compared with roughly 60 percent today.

Political instability is also claiming more victims. Africa now has around 2.5 million refugees; twenty years ago there were 400,000. One in every 200 Africans is a refugee. The African continent, with less than a tenth of the world's population, has more than a quarter of the world's 10 million refugees. This number does

not include economic refugees or people displaced within the borders of their own country. Many women and children are often forced through circumstance to move; some children move alone to cities and do their best to survive, untended. In every case, the poor are depending on the poor.

In many African countries people are having to do without any public services, as governments concentrate their resources and energies on sheer economic and political survival. Features of modern society to which many Africans have been exposed are withering: trucks no longer run because there are no spare parts and roads have become impassable; airplanes no longer land at night in some places because there is no electricity to light the runway. While philosophically committed to self-sustaining growth, self-reliance, and regional cooperation, Africa finds itself without the means to generate and share its resources. It is against this human and political background that the economic and financial analysis which follows in this report must be read.

Of course sub-Saharan Africa is not monolithic. It has great diversity, which must be kept in mind throughout this report in which regional generalizations are inescapable. For instance, low-income semiarid countries, (Burkina Faso, Chad, The Gambia, Mali, Mauritania, Niger, and Somalia) represent only 8 percent of the population of sub-Saharan Africa. Even including other countries with difficult natural environments—such as Burundi, Lesotho, Rwanda, and Senegal—the total population is about 39 million, only 13 percent of sub-Saharan Africa's population, and less than half that of Bangladesh alone. At the other extreme, oil exporters in Africa are middle-income countries. They have a per capita income several

times the average for low-income countries and represent about 30 percent of sub-Saharan Africa's population and about 50 percent of its GDP. Another group includes countries such as Botswana, Ivory Coast, Kenya, Malawi, Mauritius, and Swaziland, representing about 10 percent of the region's population. Over the past two decades, they have achieved significantly faster growth in per capita incomes than the low-income average but since the late 1970s have run into problems. The rest (about half) of sub-Saharan Africa's people live in countries such as Benin, Ghana, Guinea, Liberia, Sierra Leone, Sudan, Tanzania, Togo, Uganda, Zaire, and Zambia. These countries are relatively well endowed with natural resources but have had low or negative per capita growth since 1970. It is important to keep such variety in mind while discussing past developments and future prospects, as well as external assistance requirements.

Accelerated Decline in Per Capita Output

Since the recession of 1980-82, the world economy has started to recover. In 1983, gross national product (GNP) in industrial countries rose 2.3 percent, after a fall of 0.1 percent in 1982; in developing countries, growth picked up from 1.1 to 1.3 percent. World trade, which had declined by 2.5 percent in 1982, grew by 2 percent in 1983; dollar prices of nonoil primary commodities, which had been falling since 1981, climbed by 7 percent in 1983.

However, while sub-Saharan countries' growth suffered along with others during 1980-82, the recent recovery seems largely to have bypassed sub-Saharan Africa, even in those countries with the best earlier records. For oil importers, per capita output fell by 0.9 percent in 1981 and 1.7 percent in 1982, but there was no recovery in 1983—per capita output fell by a further 2 percent. Neither did oil exporters benefit from the 1983 recovery. Their per capita output fell about 11 percent in the two years 1981-82 (see table 1.1) and a further 7 percent in 1983. For sub-Saharan Africa as a whole, per capita output in 1983 was 11 percent below the 1980 level, more than offsetting all of the very modest gains of the 1970s.

Agriculture fared somewhat better, until 1982.

Table 1.1. *Growth of Per Capita GDP in Sub-Saharan Africa, 1960-83 (annual percentage change)*

Country group	1960-70	1970-80	1981	1982	1983 ^a
Low-income countries	1.5	-0.9	-1.9	-2.5	-0.3
Low-income semiarid	-0.1	0.6	-0.9	-2.5	-0.7
Low-income others	1.8	-1.1	-2.1	-2.5	-0.3
Middle-income oil importers	1.5	1.2	0.6	-0.7	-3.4
Middle-income oil exporters	1.1	1.6	-6.7	-4.7	-7.3
Total	1.3	0.7	-4.0	-3.3	-3.8

a. Estimated.

Between 1980 and 1982, Africa's food production is estimated to have increased by about 2 percent a year, somewhat faster than in 1970-80. The strongest growth was in wheat, sorghum, pulses, and sugar; oilseeds, with the exception of palm oil and palm kernels, continued to fall. Even at these growth rates, however, per capita food production was declining, and the accelerated pace of food imports in 1980-82 suggests that agricultural growth may have been overestimated. Cereal imports totaled 9.25 million tons in 1982, implying that one in five people in sub-Saharan Africa (the equivalent of its entire urban population) is now fed by imports. While few countries prevented a decline in per capita food production, those that did included two of the most poorly endowed countries: Niger and Rwanda. The countries with large agricultural potential, such as Nigeria, Sudan, Tanzania, and Zambia, suffered the sharpest falls in per capita food production. Imports are making many countries increasingly dependent on wheat and rice, which are difficult to grow economically in Africa.

The worst drought in fifteen years has recently hit large parts of sub-Saharan Africa. It started in 1982 in southern Africa and extended to the Sahelian zone in 1983; particularly in southern Africa, it appears to be continuing into the 1984 season. Based on estimated shortfalls in cereal production, the Food and Agriculture Organization (FAO) has identified a group of twenty-four "most seriously affected" (MSA) countries, which are the focus of current international efforts on food aid and emergency

relief.¹ Food production in the MSA countries declined by 15 percent between 1981 and 1983; preliminary estimates indicate that it may fall further in 1984. Senegal's groundnut and cereal production are estimated to have fallen 40 percent below normal levels.

Even more serious than the drought's immediate impact on food supplies are its medium-term effects on plantation crops and livestock. In Ivory Coast, coffee production in 1983 may have been less than half the normal average, and cocoa and oil (palm and coconut) production declined by 10 to 20 percent. In Ghana, cocoa production will be 17 percent lower than the recent average; bush fires, made worse by drought, may have burned about 10 percent of total cocoa acreages. Cattle losses have been substantial in Botswana, Mauritania, and Zimbabwe. Experience shows that, to rebuild cattle herds, four to five years of good rainfall are normally required.

Faced with this devastation, the international community has launched massive programs of assistance. The FAO has estimated total cereal requirements for the MSA countries at 3.3 million tons. Thirty bilateral and international agencies, including those from Australia, Canada, Denmark, France, Germany, Italy, Japan, the Netherlands, the United Kingdom, the United States, the EC, and the World Food Program (WFP), have pledged 2.3 million tons. Additional contributions, notably from the U.S. Agency for International Development (USAID), are expected to help close the gap. However, considerable problems remain over transporting and distributing the food.

Industry has suffered serious setbacks, which in many countries have come on top of years of industrial decline or stagnation. In the majority of sub-Saharan countries, manufacturing (as a percentage of GDP) was lower in 1980 than in 1970. In several cases the slide has been accelerated since then. Even among the countries that did expand industry up to 1980, several (such as Ivory Coast, Malawi, and Nigeria) have experienced setbacks. In most cases industrial weak-

nesses, partly due to poor quality of investment, have been prolonged by difficulties in macroeconomic management and by falls in imports, locally produced raw materials, construction, and domestic incomes. In several cases, industry has also been harmed by disrupted or deteriorating transport. Across the continent utilization rates in manufacturing have been falling, in extreme cases going as low as 25 to 30 percent.

Deteriorating External Environment

The international economic environment has been difficult for all developing countries during the last four years. While world trade has stagnated and commodity prices have declined, many developed countries have increased protectionist barriers for goods from developing countries; for sub-Saharan Africa restrictions on sugar and livestock imports have been particularly damaging. These external factors have aggravated the long-term economic deterioration in Africa.

For export crops, Africa's total volume expanded by about 1 percent a year over the 1980-82 period—an improvement over the decline during 1970-80. However, for most crops, the fall in world market shares that started in the 1970s continued in the 1980s. These declines have occurred in commodities in which Africa has a comparative advantage and which are likely to remain its main potential source of foreign exchange earnings. Africa's market share of oilseeds has fallen steeply, caught between rising domestic demand and inadequate incentives to export; so has that of tea, bananas, cotton, and coffee. Some progress was made in tobacco, sugar, and sorghum. Given the slow growth in world demand projected for primary exports over the next decade, African countries can expand their exports only if they can utilize their comparative advantage effectively and increase their share.

On top of stagnant or declining exports, the terms of trade also fell. Between 1980 and 1982, prices of nonoil primary commodities declined by 27 percent in current dollar terms. The loss of income due to deterioration in the terms of trade was 1.2 percent of GDP for sub-Saharan Africa; middle-income oil importers suffered

1. These countries are Angola, Benin, Botswana, Burkina Faso, Cape Verde, Central African Republic, Chad, Ethiopia, The Gambia, Ghana, Guinea, Guinea-Bissau, Lesotho, Mali, Mauritania, Mozambique, Sao Tome and Principe, Senegal, Somalia, Swaziland, Tanzania, Togo, Zambia, and Zimbabwe.

Table 1.2. *Changes in Terms of Trade and the Associated Loss of Income in Sub-Saharan Africa, 1980-82*

Country group	Percentage change in terms of trade between 1980 and 1982	Associated loss of income in 1982 over 1980 ^a (percentage of GDP)
Low-income countries	-14.5	2.4
Low-income semiarid	-2.6	0.5
Low-income other	-16.0	2.6
Middle-income oil importers	-11.1	3.0
Middle-income oil exporters	1.8	-0.5
Total	-4.7	1.2

a. Calculated by multiplying the percentage of decline in terms of trade by the share of exports in GDP. Minus sign denotes income gain.

the biggest loss (3 percent of GDP), oil exporters had a slight gain (0.5 percent of GDP), and low-income countries a loss of 2.4 percent of GDP (see table 1.2). For 1983, preliminary data suggest no significant improvement in Africa's terms of trade.

The Debt Servicing Problem

During the last four years, debt servicing has surfaced as a major problem in sub-Saharan

Africa. During this period, twenty-three of the thirty-one reschedulings in the Paris Club were for thirteen sub-Saharan countries, and eleven countries have also restructured their commercial debt. Even countries such as Ivory Coast and Nigeria, which benefited from the commodity price boom in the 1970s and had, until recently, a high credit rating, are facing serious problems in meeting their debt service. Both bilateral and commercial debt for Ivory Coast were rescheduled recently, and discussions on converting about half of the Nigerian trade arrears to medium-term debt were started in December 1983, with a tentative agreement reached in May 1984. For sub-Saharan Africa as a whole, financial arrears (largely on trade transactions) exceeded \$8 billion at the end of 1983, \$5 billion of which was Nigerian.

The estimated total of Africa's disbursed public and publicly guaranteed medium- and long-term debt at the end of 1982 was over \$48 billion, the majority of it on nonconcessional terms. IMF credits totaled about \$4 billion and short-term credits about \$7 billion (see table 1.3).

Debt servicing payments are scheduled to increase dramatically in the near future: on the existing public and publicly guaranteed medium- and long-term debt alone, they are due to rise from \$4.1 billion in 1981 and \$5.0 billion in 1982 to \$9.9 billion in 1984 and an average \$11.6 billion a year in 1985-87. These

Table 1.3. *External Public Debt and Projected Debt Service Burden in Sub-Saharan Africa (amounts in US\$ billions)*

Country group	Public and publicly guaranteed medium- & long-term debt (PPG/MLT)			Short-term credit end-1982	IMF credit end-1982	Debt service 1985-87 ^b			
	Outstanding & disbursed end-1982	Annual growth (percent) 1972-82	Debt service ratio (percent) 1982 ^a			PPG/MLT		Total	IMF
Low-income semiarid countries	3.0	22	16	0.1	0.1	0.7	0.3	1.0	0.2
Low-income others	17.1	19	16	1.0	1.6	4.4	2.4	6.8	1.5
Middle-income oil importers	17.1	24	18	2.6	2.2	6.7	2.9	9.6	1.8
Middle-income oil exporters	10.8	24	10	3.5	(.)	12.3	5.1	17.4	..
Total	48.1	22	13	7.1	4.0	24.0	10.7	34.7	3.5
All except oil exporters	37.3	21	17	3.7	4.0	11.7	5.5	17.3	3.5

a. Debt service as a percentage of exports of goods and nonfactor services.

b. On existing debt alone.

increases will occur in a wide spectrum of countries. One of the worst affected is Sudan, where external debt at the beginning of 1983 was estimated to be \$7 billion—more than seven times Sudan's export earnings in 1983. Without relief, its estimated debt service in 1983 amounted to \$1.1 billion, slightly more than its total export earnings. Even if arrears currently outstanding were consolidated and rescheduled on 1983 Paris Club terms with a 10 percent interest rate, Sudan would face debt service ratios averaging 80 to 90 percent for the rest of the 1980s. Countries such as Central African Republic, Madagascar, Somalia, and Zaire face similar difficulties. At the other end, some economies, such as Nigeria, should be able to adjust in order to meet the sharp rise in their debt service burden. In between are countries such as Gabon, Kenya, and Malawi, whose debt service profile is flatter but will nonetheless be a significant burden.

There are a number of reasons for the sharp rise in debt service requirements. The reschedulings in the last few years, mostly on conventional terms, gave short-term relief, but at the expense of increasing the debt service burden from 1984 onward. For a number of major debtor countries, such as Zaire and Sudan, previously rescheduled amounts, generally not eligible for rescheduling, represent more than a third of the total payments on public debt scheduled for 1985–87. In many sub-Saharan African countries, significant increases in assistance are going to be needed to replace IMF loans falling due. Taking the IMF loans outstanding at the end of 1983, repurchases and charges will total \$0.9 billion in 1984 and \$3.5 billion during 1985–87.

When Africa's arrears are taken into account, its debt service outlook is even more dismal. Servicing obligations in 1984 would jump about 30 percent if all arrears were repaid in that year. Unless corrective measures are taken, the external resource position of sub-Saharan Africa is likely to become disastrous in the next few years.

External Capital Flows

External capital flows to sub-Saharan Africa have been quite high. Between 1970 and 1982,

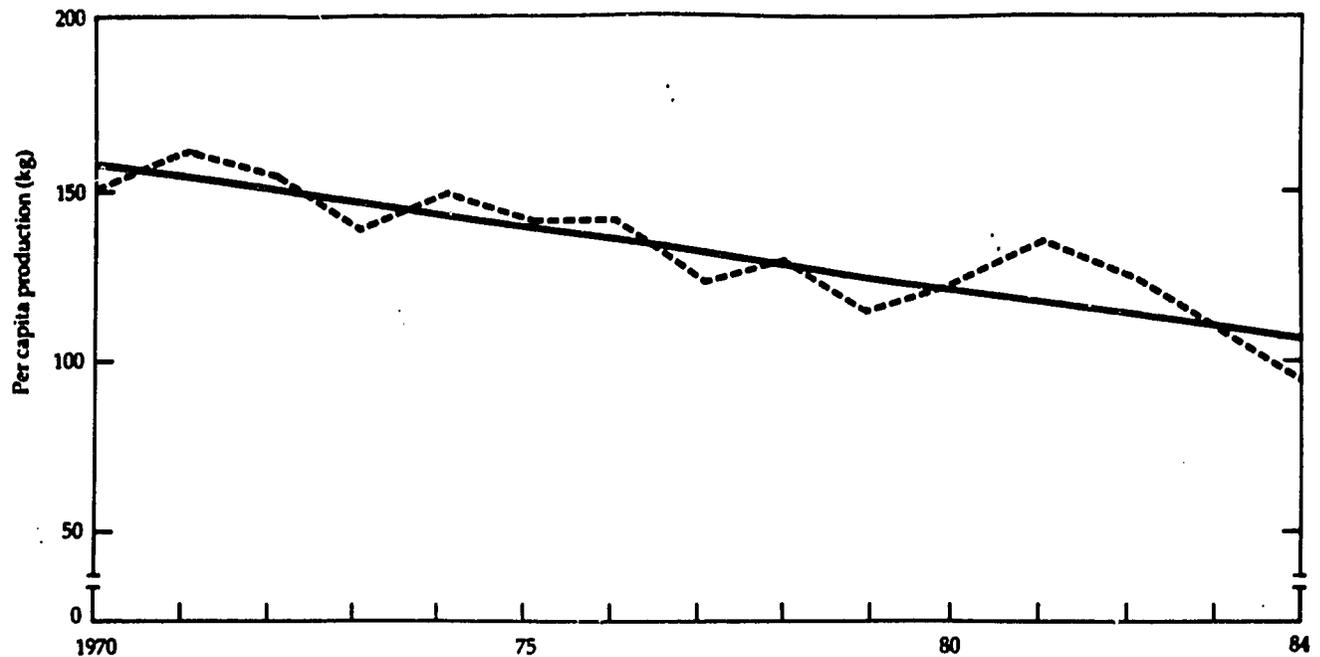
official development assistance (ODA) per capita increased in real terms by 5 percent a year, much faster than for other developing countries. In 1982, ODA per capita was \$19 for all sub-Saharan African countries and \$46 per capita for the low-income semiarid countries—compared, for instance, with \$4.80 per capita for South Asia. Aid finances 10 percent of gross domestic investment in Africa as a whole, but up to 80 percent for the low-income semiarid countries and over 15 percent for other low-income countries. For some countries, ODA finances not only all investment, but also some consumption. During 1980–82, however, ODA levels stagnated, even though sub-Saharan Africa's share in the total increased from 21 percent in 1980 to 24 percent in 1982. Net flows from private sources declined sharply (by about 50 percent) with the decline particularly marked for oil-importing countries.

However, import capacity did not decline by a corresponding amount, because of funding by the IMF, which provided net flows of \$2 billion between 1980 and 1982, mainly to oil importers. In addition, external reserves were drawn down by \$10 billion (\$1 billion for oil importers). As a result, the total current account deficit increased from 3 percent of GNP in 1980 to about 9 percent in 1982 for sub-Saharan Africa (and stayed around 9 percent for oil importers). Data for 1983 are not yet available, but tentative estimates suggest that sub-Saharan Africa's import capacity declined significantly, the result of declining export earnings, falling capital inflows and export earnings, less finance from the IMF, and the exhaustion of foreign reserves.

The Long-term Nature of the Crisis

Pressing as the current problems are, it is important to emphasize that they are not short term. They are part of a long-run unfavorable trend, best illustrated by putting the current food crisis in longer perspective. Figure 1.1 shows annual grain production per capita in 1970–84 for the twenty-four countries most seriously affected by drought, together with the long-term trend. The trend line shows a fall of about 2 percent a year. It passed below what might be considered a minimum for a healthy diet (of 140 kilograms per capita, the figure

Figure 1.1. Per Capita Grain Production in Twenty-four African Countries Affected by Drought, 1970-84



Source: Based on Food and Agriculture Organization (FAO) data, except that the 1984 figure is a projection using data from FAO, the U.S. Agency for International Development, and the U.S. Department of Agriculture.

implied by current FAO estimates of consumption needs) in about 1975 and has continued falling since then. Even in the comparatively good year of 1981, production per capita was only 135 kilograms. In 1984, for the first time, production is expected to fall below 100 kilograms per capita. Yet that 1984 projection is only 12 percent below the trend line; the trend line itself will hit the projected 1984 level as early as 1988. The amount by which the 1984 estimate is below the trend line is almost exactly the same as the amount by which output in 1981 was above it. It is difficult to avoid the conclusion that Africa's food production does not deviate dramatically from the trend line; the declines of the past provide a depressing foretaste of what lies ahead.

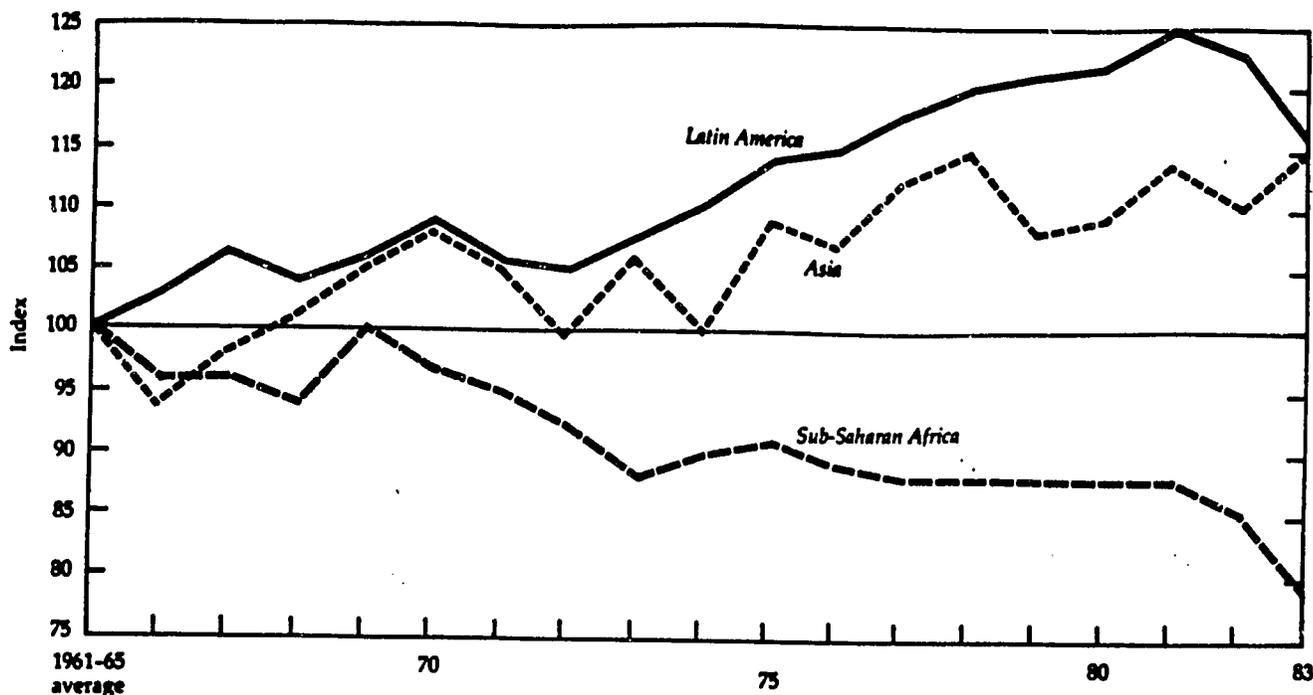
What is true for the drought-affected countries is true for sub-Saharan Africa as a whole. Of all the major regions of the developing world, sub-Saharan Africa has had the slowest growth in food production and the fastest growth of population during the past twenty years. It is the only region where food produc-

tion is losing the race with population growth (see figure 1.2).

Such realities naturally cause pessimism. Yet analysis of development in sub-Saharan Africa and elsewhere suggests a basis for hope. A generation ago, it should be remembered, the prospects of Korea were regarded as dismal;² ten years ago Bangladesh was regarded as a basket case; and about twenty years ago the establishment of the International Development Agency (IDA) was inspired by tales of woe in the sub-continent. In sub-Saharan Africa, economic growth in the 1960s was quite respectable, and

2. As noted in the Pearson Commission report, published in 1969, "For nearly a decade South Korea seemed doomed to permanent dependence on foreign aid with *no possibility* of achieving a high growth rate from its own resources. Critics could point to almost every abuse in the catalogue. There was serious corruption, there was inflation, the aid dialogue was most acrimonious, and exports of the country's own products were low" (emphasis added). L. B. Pearson and others, *Partners in Development* (New York: Praeger, 1969), p. 345.

Figure 1.2. *Index of Per Capita Food Production, 1961-65 to 1983*
(1961-65 average = 100)



Source: Based on data provided by the U.S. Department of Agriculture.

observers saw several reasons to expect further rapid development.³ Even in the 1970s, growth in several African countries (Botswana, Cameroon, Ivory Coast, and Malawi) was significantly faster than the world average. The history of economic development has been full of surprises. The evidence is overwhelming that, with the right combination of external assistance and domestic policies, countries can turn around, often in less than a decade. One essential step in that process is clear-headed analysis of experience, identification of

strengths and weaknesses, and designing of policies suitable to each country's circumstances.

Appendix

The tables that follow on pages 16-20 present the basic data on macroeconomic developments since 1960 and external resource flows to sub-Saharan Africa during 1979-82.

3. In *The Economics of African Development* (New York: Praeger, 1967), by Andrew M. Kamarck, it was projected that sub-Saharan Africa could grow at 7 percent a year during the 1970s and beyond: "Of the mineral producers, Gabon, Guinea, Liberia, Zambia, Nigeria, Congo (Leopoldville), and Rhodesia already clearly have the potential to reach or surpass a 7 percent GNP rate of growth. Congo (Brazzaville), with potash and possibly bauxite and iron-ore deposits; the Sudan, a very large and practically unexplored area; and Ghana, if it handles its opportunities from the

Volta power and aluminum project wisely—may also belong in this select group. Most of the other African countries depend mainly on agricultural exports, and here the external constraints apply. But this still does not mean that particular countries cannot be successful—especially if others, by mishandling their affairs, open up the opportunities to get a bigger share of a limited market. Among the more likely candidates for such success are the Ivory Coast, Kenya, Uganda, and the Sudan."

Adjustment Programs in Africa: The Recent Experience

By Justin B. Zulu and Saleh M. Nsouli
with case studies by
Nur Calika and Lelde Schmitz



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I Introduction

This paper reviews recent experience of African countries in the design and implementation of adjustment programs supported by use of Fund resources.¹ The aggregate analysis covers primarily 1980 and 1981, while the case studies include results through the end of 1983. The paper is divided into seven parts. The first part outlines the economic background leading to the emergence or aggravation of financial imbalances in Africa before 1980. The second part reviews the role of the Fund in financing and adjustment. The third part examines the objectives of programs supported by use of Fund resources. Against this background, the fourth part analyzes the design of programs. The fifth part assesses the experience in implementing adjustment programs, with a view to determining the reasons for the difficulties that these countries encountered. The sixth part provides case studies of the recent adjustment programs of Somalia and Mali, which were supported by use of Fund resources. The conclusion summarizes the study's main findings.

Economic Background

The economic and financial problems facing African countries before 1980 were manifested in sluggish economic growth, rising inflation rates, and widening deficits on the current accounts of their balances of payments. Economic growth, which averaged about 5 percent during 1974-76, fell to about 2 percent during 1977-79. Accordingly, during this period, per capita real income declined. The rate of inflation, which picked up from about 10 percent in 1973 to an annual rate of about 16 percent during 1974-76, continued to increase, averaging more than 18 percent during 1977-79. The combined current account deficit rose from about US\$4 billion in 1974 to about US\$7 billion

¹ Unless otherwise noted, the countries discussed in this paper are those covered by the African Department of the International Monetary Fund. They exclude Egypt, the Socialist People's Libyan Arab Jamahiriya, Sudan, and South Africa. The paper does not attempt to draw a distinction between stand-by and extended arrangements. Rather, it focuses on the calendar year during which adjustment programs were implemented.

a year during 1975-77, and widened still further, reaching nearly US\$10 billion annually during 1978-79. These deficits were, for the most part, financed by foreign borrowing, while countries attempted to contain the reduction in reserves in absolute terms. As a result, external debt increased dramatically. It rose from US\$15 billion at the end of 1974 to US\$45 billion at the end of 1979. The debt service ratio more than doubled, rising from 8.0 percent in 1974 to 16.6 percent in 1979 (Table 1). Even so, international reserves as a proportion of goods and services declined from 13.4 percent of annual imports in 1974 to 10.0 percent in 1979.

Contributory Factors

These deteriorating economic conditions reflected a number of external and domestic factors. During this period, the international economic and financial environment tended to affect African countries negatively. Following the sharp increase in oil prices in 1973-74, industrial countries experienced a sharp decline in economic activity accompanied by a substantial acceleration in the rate of inflation. These factors tended to reduce the demand for exports from African countries and to contribute to a softening in export prices, while prices of imports from industrial countries increased considerably. Furthermore, increases in oil prices directly affected the import bill of African countries. With a reduced demand for exports, declining terms of trade, and an inelastic demand for imports, African countries faced widening current account deficits. Some resorted to direct import restrictions, which resulted in shortages of consumer goods as well as intermediate and capital goods. The shortage of consumer goods tended to fuel domestic inflationary pressures, while the shortage of intermediate and capital goods contributed to a slowdown in economic activity.

The adverse international economic environment also affected domestic financial policies, which were not promptly adapted to the emerging situation. In particular, many countries were already embarked on ambitious public investment programs and were rapidly

Table 1. Africa: Selected Economic Indicators, 1973-83¹

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
	(Percent)										
Economic growth	2.39	6.27	2.75	5.85	1.80	2.20	2.80	4.50	7.90	0.30	-1.40
Inflation	9.86	17.07	15.84	16.63	19.40	15.90	19.40	20.10	23.60	16.90	16.70
Terms of trade	8.30	7.63	-12.19	7.00	18.10	-8.70	2.40	-2.50	-4.30	-4.10	-5.60
Ratio of external debt to GDP	24.90	25.87	27.50	32.82	35.80	36.60	38.00	35.70	41.50	49.50	59.60
Debt service ratio	...	8.00	9.50	9.50	11.90	15.50	16.60	17.40	19.70	23.70	25.10
	(Billion U.S. dollars)										
Current account	-4.50	-4.00	-7.20	-6.50	-6.60	-9.40	-9.90	-12.90	-14.00	-12.50	-10.80
Net official transfers	1.10	1.50	1.70	2.00	2.30	2.50	2.90	3.30	3.30	3.20	3.30
Net capital inflows	3.80	2.60	4.90	4.40	5.00	6.40	6.60	8.40	8.40	7.90	5.70
Overall balance of payments	0.50	0.30	-0.60	-0.10	0.70	-0.40	-0.30	-1.20	-2.30	-1.40	-1.80
Total outstanding debt	11.60	14.75	18.40	23.40	30.80	36.90	45.30	50.90	55.50	62.50	66.30

Source: International Monetary Fund, *World Economic Outlook: A Survey by the Staff of the International Monetary Fund*, Occasional Paper No. 9 (Washington, April 1982); and Fund staff estimates.

¹ This table follows the Fund's *International Financial Statistics* classification of the African countries. These include all the African member countries, except Algeria, Egypt, Nigeria, and the Socialist People's Libyan Arab Jamahiriya, which are classified under different headings. In this table, South Africa is also excluded.

expanding government current expenditures. In a number of countries, improving prices of primary products in the late 1960s and early 1970s had contributed to an increase in government revenues and export proceeds that allowed for such expansion. With the tapering off in demand for such exports and the decline in the terms of trade, budgetary receipts started to lag behind the growth in expenditures. This led to a widening in budgetary deficits, which were increasingly financed by domestic bank borrowing and external borrowing. The expansion in credit to the government sector, accompanied in some instances by an accommodating stance on credit to the private sector, in-

creased the pressures on domestic prices and the balance of payments.

Rather than dealing with the roots of the problems, countries generally focused on their symptoms. Price controls were intensified, consumer subsidies were increased, producer prices were kept low, and administrative controls on imported goods were widened in scope. Many countries also retained exchange rates that were incompatible with financial stability. Under the circumstances, parallel markets for goods and foreign exchange widened, generating considerable distortions and slowing down economic activity.

II The Role of the Fund

In view of mounting economic and financial imbalances, a number of African countries worked closely with the Fund to design and carry out appropriate adjustment programs during 1980-81.² At the beginning of 1980 there were 12 stand-by arrangements. The total amount approved under these arrangements was equivalent to SDR 455.2 million. Several arrangements expired and new arrangements were approved during 1980. At the beginning of 1981 there were 11 stand-by and 3 extended arrangements for a total of SDR 1.8 billion. With the increase in extended arrangements and the approval of new stand-by arrangements in 1981, the numbers of stand-by and extended arrangements in effect at the end of 1981 were 13 and 6, respectively, with the total amount committed reaching a record SDR 4.3 billion. Purchases nearly doubled in 1980 and more than doubled in 1981, reaching a record SDR 1.7 billion (Tables 2 and 3).

The number of African countries that adopted adjustment programs supported by use of Fund resources during this period was relatively limited. Many, however, resorted to financing rather than adjustment. This was reflected in a sharp increase in debt servicing. It is, therefore, essential to review the difference between financing and adjustment, and, in this regard, the role of the Fund in the adjustment process.

Adjustment Versus Financing

When a country faces an external sector disequilibrium, this is manifested in a rise in its current account deficit, requiring it to resort to increased external borrowing to finance the disequilibrium. If the disequilibrium resulted from permanent factors and if a country were not to take the necessary measures to adjust, this *financing* would have to continue indefinitely. As the external debt rises, a country would eventually reach a point where its ability to service the debt would be impaired, undermining its credit-

² See Guitián (1981), Kanava-Thanan (September 1981), Makulou (1982, 1983), and Nsouli (1982).

worthiness. Under such conditions a country would lose its ability to continue to finance an external sector disequilibrium. Failure to adjust would force a country to impose strict controls on imports. The resulting import shortage would exacerbate underlying inflationary pressures. In developing countries that depend heavily on imported intermediate manufactured and capital goods, import controls would cause economic activity and investment to suffer and lead to a sharp fall in economic growth.

Thus, financing alone will not solve a disequilibrium. Financing only magnifies and postpones dealing with the problem and, in due course, leads to a greater disruption of the economy than if adjustment were undertaken promptly. Accordingly, the choice is not between adjustment and financing but between promptly initiating a gradual and orderly adjustment process, on the one hand, or being faced with abrupt and disorderly adjustment, on the other. The costs to the economy are too high in the latter case, in terms of the rising debt burden, the emergence of large distortions, and the abrupt shock to the economy when financing ceases. Yet many African countries followed the latter path. The role of the Fund is to avoid such disruptions and minimize the costs of adjustment by providing, preferably at an early stage, the necessary financing to ensure a smooth and gradual process of adjustment.

Duration of Adjustment

From the short survey of the economic problems facing African countries, it is clear that the extent of the imbalances has increased, requiring a more concerted adjustment effort. The Fund has recognized that the deep-seated structural problems and the magnitude of these imbalances require longer periods of adjustment. The question of the length of time over which adjustment should take place, other things being equal, is crucial. If a very short time period is set for attaining equilibrium, adjustment could prove costly to a country, because it would require a rapid deflation of the economy. At the other extreme, stretching out

II • THE ROLE OF THE FUND

Table 2. Africa: Stand-By Arrangements and Arrangements Under Extended Fund Facility, 1979-83

(In millions of SDRs)

	Stand-By (SBA) and Extended Facility (EFF)	Date of Approval	Expiration Date	Amount Approved	Amount Purchased ¹	Undrawn Balance
1979						
Congo	SBA	April 25, 1979	April 24, 1980	4.00	2.00	2.00
Egypt	EFF	July 28, 1978	June 30, 1980	425.00	75.00	350.00
Gambia, The	SBA	Nov. 2, 1979	Nov. 1, 1980	1.60	—	1.60
Ghana	SBA	Jan. 10, 1979	Jan. 9, 1980	53.00	32.00	21.00
Kenya	SBA	Aug. 20, 1979	Aug. 19, 1981	122.48	—	122.48
Liberia	SBA	March 21, 1979	March 20, 1980	9.25	9.25	—
Malawi	SBA	Oct. 31, 1979	Dec. 31, 1981	26.34	3.06	23.28
Mauritius	SBA	Oct. 31, 1979	Oct. 30, 1981	73.03	20.00	53.03
Rwanda	SBA	Oct. 31, 1979	Oct. 30, 1980	5.00	—	5.00
Senegal	SBA	March 30, 1979	March 29, 1980	10.50	10.50	—
Sierra Leone	SBA	Nov. 2, 1979	Nov. 1, 1980	17.00	7.50	9.50
Sudan	EFF	May 4, 1979	June 30, 1980	200.00	30.00	170.00
Togo	SBA	June 11, 1979	Dec. 31, 1980	15.00	—	15.00
Zaire	SBA	Aug. 27, 1979	Feb. 26, 1981	118.00	20.00	98.00
Total				1,080.20	209.31	870.89
Total (excluding Egypt and Sudan)				455.20	104.31	350.89
1980						
Central African Republic	SBA	Feb. 15, 1980	Feb. 14, 1981	4.00	4.00	—
Egypt	EFF	July 28, 1978	June 30, 1980	425.00	75.00	350.00
Equatorial Guinea	SBA	July 1, 1980	June 30, 1981	5.50	3.00	2.50
Gabon	EFF	July 27, 1980	Dec. 31, 1982	34.00	—	34.00
Kenya	SBA	Oct. 15, 1980	Oct. 14, 1982	241.50	60.00	181.50
Liberia	SBA	Sept. 15, 1980	Sept. 14, 1982	65.00	18.40	46.60
Madagascar	SBA	June 27, 1980	June 26, 1982	64.50	10.00	54.50
Malawi	SBA	May 9, 1980	March 31, 1982	49.90	22.00	27.90
Mauritania	SBA	July 23, 1980	March 31, 1982	29.70	8.90	20.80
Mauritius	SBA	Sept. 5, 1980	Sept. 4, 1981	35.00	15.00	20.00
Morocco	EFF	Oct. 8, 1980	Oct. 7, 1983	810.00	147.00	663.00
Senegal	EFF	Aug. 8, 1980	Aug. 7, 1981	184.80	41.10	143.70
Somalia	SBA	Feb. 27, 1980	Feb. 26, 1981	11.50	6.00	5.50
Sudan	EFF	May 4, 1979	May 3, 1982	427.00	151.00	276.00
Tanzania	SBA	Sept. 15, 1980	June 30, 1982	179.60	25.00	154.60
Zaire	SBA	Aug. 29, 1979	Feb. 26, 1981	118.00	98.40	19.60
Total				2,685.00	684.80	2,000.20
Total (excluding Egypt and Sudan)				1,833.00	458.80	1,374.20
1981						
Ethiopia	SBA	May 8, 1981	June 30, 1982	67.50	44.00	23.50
Gabon	EFF	June 27, 1980	Dec. 31, 1982	34.00	—	34.00
Ivory Coast	EFF	Feb. 27, 1981	Feb. 22, 1984	484.50	176.70	307.80
Kenya	SBA	Oct. 15, 1980	Oct. 14, 1982	241.50	90.00	151.50
Liberia	SBA	Aug. 26, 1981	Sept. 15, 1982	55.00	33.00	22.00
Madagascar	SBA	April 13, 1981	June 26, 1982	109.00	39.00	70.00
Malawi	SBA	May 9, 1980	March 31, 1982	49.90	40.00	9.90
Mauritania	SBA	June 1, 1981	March 31, 1982	25.80	10.30	15.50
Mauritius	SBA	Dec. 21, 1981	Dec. 20, 1982	30.00	7.50	22.50
Morocco	EFF	March 9, 1981	Oct. 7, 1983	817.10	136.50	680.60
Senegal	SBA	Sept. 11, 1981	Sept. 10, 1982	63.00	15.70	47.30
Sierra Leone	EFF	March 30, 1981	Feb. 22, 1984	186.00	33.50	152.50
Somalia	SBA	July 15, 1981	July 14, 1982	43.10	25.90	17.20
Sudan	EFF	May 4, 1979	May 3, 1982	427.00	251.00	176.00
Tanzania	SBA	Sept. 15, 1980	June 30, 1982	179.60	25.00	154.60
Togo	SBA	Feb. 13, 1981	Feb. 12, 1983	47.50	7.25	40.25
Uganda	SBA	June 5, 1981	June 30, 1982	112.50	77.50	35.00
Zaire	EFF	June 22, 1981	June 21, 1984	912.00	175.00	737.00
Zambia	EFF	May 8, 1981	May 7, 1984	800.00	300.00	500.00
Zimbabwe	SBA	April 8, 1981	April 7, 1982	37.50	37.50	—
Total				4,722.50	1,525.35	3,197.15
Total (excluding Sudan)				4,295.50	1,274.35	3,021.15

Table 2. (concluded) Africa: Stand-By Arrangements and Arrangements Under Extended Fund Facility, 1979-83

(In millions of SDRs)

	Stand-By (SBA) and Extended Facility (EFF)	Date of Approval	Expiration Date	Amount Approved	Amount Purchased ¹	Undrawn Balance
1982						
Gambia, The	SBA	Feb. 22, 1982	Feb. 21, 1983	16.90	16.90	—
Guinea	EFF	Feb. 27, 1981	Feb. 22, 1984	484.50	292.14	192.36
Ivory Coast	SBA	Dec. 1, 1982	Nov. 30, 1983	25.00	11.50	13.50
Kenya	SBA	Jan. 8, 1982	Jan. 7, 1983	151.50	90.00	61.50
Liberia	SBA	Sept. 29, 1982	Sept. 28, 1983	55.00	5.00	50.00
Madagascar	SBA	July 9, 1982	July 8, 1983	51.00	30.60	20.40
Malawi	SBA	Aug. 6, 1982	Aug. 5, 1983	22.00	10.00	12.00
Mali	SBA	May 21, 1982	May 20, 1983	30.40	25.40	5.00
Morocco	SBA	April 26, 1982	April 25, 1983	281.30	196.90	84.40
Senegal	SBA	Nov. 24, 1982	Nov. 23, 1983	47.30	6.00	41.30
Somalia	SBA	July 15, 1982	Jan. 14, 1984	60.00	15.00	45.00
Sudan	SBA	Feb. 22, 1982	Feb. 21, 1983	198.00	70.00	128.00
Togo	SBA	Feb. 13, 1981	Feb. 12, 1983	47.50	7.25	40.25
Uganda	SBA	Aug. 11, 1982	Aug. 10, 1983	112.50	50.00	62.50
Total				1,582.90	826.69	756.21
Total (excluding Sudan)				1,384.90	756.69	628.21
1983						
Central African Republic	SBA	April 22, 1983	April 21, 1984	18.00	4.50	13.50
Ghana	SBA	Aug. 3, 1983	Aug. 2, 1984	238.50	143.10	95.40
Ivory Coast	EFF	Feb. 27, 1981	Feb. 22, 1984	484.50	446.00	38.50
Kenya	SBA	March 21, 1983	Sept. 20, 1984	175.95	129.80	46.15
Liberia	SBA	Sept. 14, 1983	Sept. 13, 1984	55.00	28.00	27.00
Malawi	EFF	Sept. 19, 1983	Sept. 18, 1986	100.00	10.00	90.00
Mali	SBA	Dec. 9, 1983	May 31, 1985	40.50	10.00	30.50
Mauritius	SBA	May 18, 1983	Aug. 17, 1984	49.50	24.75	24.75
Morocco	SBA	Sept. 16, 1983	March 15, 1985	300.00	30.00	270.00
Niger	SBA	Oct. 5, 1983	Dec. 4, 1984	18.00	6.80	11.20
Senegal	SBA	Sept. 19, 1983	Sept. 18, 1984	63.00	31.50	31.50
Somalia	SBA	July 15, 1982	Jan. 14, 1984	60.00	51.25	8.75
Sudan	SBA	Feb. 23, 1983	Feb. 22, 1984	170.00	144.50	25.50
Togo	SBA	March 4, 1983	April 3, 1984	21.40	19.41	1.99
Uganda	SBA	Sept. 16, 1983	Sept. 15, 1984	95.00	44.00	51.00
Zaire	SBA	Dec. 27, 1983	March 26, 1985	228.00	—	228.00
Zambia	SBA	April 18, 1983	April 17, 1984	211.50	76.50	135.00
Zimbabwe	SBA	March 23, 1983	Sept. 22, 1984	300.00	37.50	262.50
Total				2,628.85	1,297.61	1,331.24
Total (excluding Sudan)				2,458.85	1,153.11	1,305.74

Source: International Monetary Fund, Treasurer's Department.

¹ Cumulative purchases under the arrangement from date of approval.

the adjustment period indefinitely would avoid dealing with the problem and result in a situation very close to that of pure financing. Between these two extremes, there is an optimal trajectory defining a time span that will minimize the economic costs of adjustment. Although in practice it is extremely difficult to determine such a trajectory with any significant degree of precision, every Fund-supported program attempts to place the economy concerned on such a trajectory, within the constraints of available information.³ Be-

³ For a discussion of the relative income costs of adjustment of different trajectories defined by various policy approaches, see Nsouli and Ishiyama (1979).

cause in many developing countries the lack of foreign exchange may impede the country from following such an optimal adjustment path, the Fund can provide and help mobilize the necessary financing. It is these considerations that underlie the repeated emphasis by the Fund's Managing Director that financing and adjustment must go hand-in-hand.

The guidelines on conditionality, which were reformulated in 1979, emphasize that there is a need to encourage members to adopt corrective measures at an early stage of their balance of payments difficulties; that, in many cases, periods of adjustment longer than those normally associated with one- or two-year stand-

5
759

II • THE ROLE OF THE FUND

Table 3. Africa: Purchases and Repurchases from the Fund, 1979-83

(in millions of SDRs)

	1979		1980		1981		1982		1983	
	Pur-chases	Repur-chases ¹								
Benin	—	—	1.94	—	—	—	—	—	1.80	—
Burkina Faso	—	—	—	—	—	—	—	—	—	—
Burundi	9.50	—	—	—	—	—	—	—	—	4.80
Cameroon	—	11.39	—	12.85	—	8.48	—	2.95	3.00	0.50
Central African Republic	—	2.38	5.85	4.39	17.00	3.07	2.40	0.60	5.70	0.30
Chad	—	1.24	—	2.18	7.10	5.43	—	—	3.30	—
Comoros	—	—	0.48	0.48	0.30	—	—	—	—	—
Congo	2.00	1.14	—	5.34	—	6.75	—	—	3.30	—
Djibouti	—	—	—	—	—	—	—	—	—	—
Egypt	—	51.22	—	78.93	—	77.92	47.03	43.92	—	2.70
Equatorial Guinea	—	0.24	9.53	—	7.20	0.85	1.26	1.27	1.40	—
Ethiopia	36.00	—	—	—	66.10	—	23.50	2.25	—	18.00
Gabon	7.50	—	—	—	—	—	—	1.99	—	7.50
Gambia, The	—	3.52	1.60	—	9.00	—	16.90	2.24	0.90	2.60
Ghana	44.63	22.93	—	9.65	—	9.65	8.47	4.83	275.00	15.40
Guinea	2.97	4.40	—	1.10	0.58	5.01	15.91	4.57	4.70	—
Guinea-Bissau	1.10	—	—	—	2.35	—	—	0.28	0.40	0.40
Ivory Coast	—	—	12.22	—	328.70	—	115.43	—	167.80	—
Kenya	86.25	30.59	60.00	6.98	30.00	7.17	150.38	16.89	132.60	43.00
Lesotho	—	—	—	—	—	—	2.02	—	—	—
Liberia	29.75	—	18.40	2.40	47.54	2.16	64.41	—	62.00	10.30
Madagascar	—	3.73	39.20	1.51	39.00	7.43	57.73	5.39	15.20	3.70
Malawi	22.07	0.76	24.38	0.93	30.00	.36	14.69	12.62	34.20	10.30
Mali	—	1.75	5.10	2.25	—	2.25	25.38	1.06	17.60	1.80
Mauritania	—	0.89	19.40	6.71	10.30	6.94	18.76	3.69	2.10	4.40
Mauritius	27.97	—	35.00	—	68.00	11.00	28.01	5.49	31.60	14.50
Morocco	—	23.20	184.50	67.35	192.76	53.40	433.28	32.50	134.80	23.30
Niger	—	—	—	—	—	—	—	—	30.80	—
Nigeria	—	—	—	—	—	—	308.71	—	77.40	—
Rwanda	—	—	—	—	—	—	—	—	—	—
São Tomé and Príncipe	—	—	—	—	—	—	—	—	—	—
Senegal	14.75	8.74	43.25	6.36	57.74	6.36	53.17	13.33	37.00	10.50
Seychelles	—	—	—	—	—	—	—	—	0.70	—
Sierra Leone	7.50	7.27	9.50	9.22	33.70	9.22	5.13	5.28	23.60	2.00
Somalia	—	—	6.00	—	25.88	—	37.00	4.75	47.40	—
Sudan	83.15	33.70	142.80	34.70	165.55	19.03	71.85	30.15	193.00	41.60
Swaziland	—	—	—	—	—	—	4.28	—	10.00	—
Tanzania	34.00	13.03	40.00	25.03	15.90	26.34	1.74	11.12	6.10	25.10
Togo	—	—	16.58	—	7.25	—	—	—	21.90	—
Tunisia	—	—	—	24.00	—	—	—	—	—	—
Uganda	10.58	8.00	37.50	10.00	122.50	10.31	85.00	1.51	112.70	11.90
Zaire	20.00	31.47	78.40	65.45	194.60	103.78	131.61	22.07	130.30	10.40
Zambia	100.00	26.29	50.00	44.03	359.30	47.32	41.50	86.20	188.40	113.60
Zimbabwe	—	—	32.49	—	37.50	—	—	—	153.60	—
Total	539.72	287.88	874.12	421.84	1,875.85	436.23	1,765.55	316.95	1,940.30	378.60
Total (excluding Egypt and Sudan)	456.57	202.96	731.30	308.21	1,710.30	339.28	1,646.67	242.88	1,747.30	334.30

Source: International Monetary Fund, *International Financial Statistics*.

¹ Repurchases include only those relating to outstanding purchases.

by arrangements are required; that a flexible approach to the treatment of external borrowing in adjustment programs needs to be adopted; and that due regard has to be given to the domestic social and political objectives, the economic priorities, and the circumstances of members, including the causes of their balance of payments problems. Within these general guidelines, considerable flexibility in applying conditionality has been maintained. Greater emphasis has also been given to providing increased financing to

countries over sufficiently long time periods, while formulating programs that pay considerable attention to supply-oriented policies, which meet the development aspirations of developing countries and which reduce the burden of adjustment.⁴ These considerations are fully reflected in the programs adopted by the African countries during 1980-81.

⁴ See Guitián (1981), Makalou (1982, 1983), and Nsouli (1982).

III The Objectives of Programs

The general objectives of adjustment programs supported by use of Fund resources are summarized in the Fund's Articles of Agreement. These objectives include:

To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy. (Article I, Sec. ii)

... to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members. (Article I, Sec. vi)

While the Fund provides resources in support of policies designed to carry out an appropriate adjustment program, a primary concern of African countries that adopted programs supported by use of Fund resources was the achievement of a sustainable level of economic growth. The key to such sustainability, however, was the achievement of domestic and external financial stability. If a country had high levels of domestic inflation, reflecting excess demand pressures, savings and investment would be discouraged, leading to a drop in economic growth. Similarly, if a country faced continuous external imbalances, the ensuing shortage of foreign exchange could result in a curtailment of important imported inputs and capital goods; in addition, the distortions arising from a disequilibrium exchange rate could undermine both the export- and import-competing industries. The sustainability of economic growth thus also would be impaired. Accordingly, in the design of these programs, an important prerequisite for a sustainable rate of economic growth was the achievement of domestic and external financial stability.

Domestic and external financial stability are interrelated. A high rate of inflation reflects excess demand pressures, which are also manifested in the external sector. Similarly, a low rate of inflation cannot be sustained indefinitely with an external deficit because, in due course, the inflow of goods and services would have to be curtailed, leading to an acceleration in inflation. Hence, if a sustainable external financial

position is reached, it follows that a sustainable position of domestic financial stability has also been reached. This interrelationship is further seen in the fact that a country's current account position is the mirror image of, and is definitionally equal to, the difference between domestic investment and national savings.

The countries under consideration had external current account deficits that were symptomatic of the fact that domestic investment far exceeded national savings. These deficits were generally financed by foreign borrowing. Such an external position did not, in itself, imply that the external position was not sustainable. That depended on the magnitude of the underlying variables. A current account deficit can reflect either a high level of consumption or a high level of investment. If foreign borrowing is used to finance consumption, the productive capacity of the economy will not necessarily increase sufficiently to service the debt. In contrast, if the borrowing is used to finance investment, and the marginal return is equal to or exceeds the cost of borrowing, the current account deficit can become sustainable if other conditions are met. The following definition can be used: A sustainable external sector position denotes a current account position associated with a consumption and investment pattern that is consistent with the growth of debt-servicing capacity.

In most of the programs under consideration, accordingly, the three basic and interrelated objectives were generally to promote economic growth, to reduce inflation, and to improve the current account position over the medium term. Chart 1³ shows the emphasis given to economic growth in the programs under consideration. Most programs aimed for an increase in economic growth during the program year as compared with the previous year. Nearly all programs attempted to hold annual inflation to about 15 percent. However, as shown in Chart 2, nearly the same number of programs allowed for an increase in inflation over the previous year as programs that tried to reduce inflation. This may have reflected a certain degree of realism as to how much, if at all, inflationary pressures

³ Charts 1-14 are in Appendix I.

38

could be controlled in one year, particularly if cost-push elements were relatively important determinants.

Although all programs did not attempt in one year to narrow the current accounts (Chart 3) or, for that matter, overall balance of payments positions (Chart 4), the emphasis generally was on improving these indicators. In supply-oriented programs, in particular, an expanded level of investment financed by external assistance could involve an increase in associated imports, which would contribute to a short-term wid-

ening of the current account deficit. Such investment could be viewed, however, as contributing to the productive capacity of the economy and as encouraging increased exports or reduced imports over the medium term.

In sum, these diverse quantitative targets for the key objectives confirm that Fund-supported programs have tailored adjustment to the particular circumstances of the country.

IV Instruments and Policy Design

Although there is general agreement on the objectives, each program is designed differently. There is no such thing as a "typical" Fund-supported adjustment program, although many articles have been written attempting to describe such programs by pointing out the commonality of objectives and instruments. The objectives and instruments, however, are limited and are clearly common to most countries. A program involves setting specific quantitative objectives and selecting the proper mix of instruments as well as deciding the degree to which each instrument will be used. In this sense, because no two countries share the same economic conditions, no two Fund-supported programs are alike. Each program addresses the specific problems of the country concerned, takes into account the macroeconomic relationships imposed by the institutional framework, and sets the quantitative targets for the instruments selected.

With these caveats in mind, it is possible to discuss in general the policy areas that recent Fund-supported programs in Africa covered. Because the problems of these countries are deep-rooted and structural, the policies emphasized supply-oriented measures designed to bring about structural changes. At the same time, financial policies were designed to reinforce the supply-oriented measures.⁶

Domestic Structural Policies

Because economic growth depends largely on the level of domestic capital formation, provided that investment is allocated efficiently, the programs incorporated measures to strengthen the development planning process. In this regard, the Fund relied mostly on the expertise of the World Bank. In addition, with a view to improving resource allocation, mobilizing domestic savings, and encouraging private sector investment, the programs paid close attention to pricing policies. Many of the countries maintained extensive systems of price controls and subsidies. Such policies

temporarily masked inflationary pressures, led to shortages, and contributed to a misallocation of resources. Furthermore, to the extent that low agricultural producer prices were maintained, agricultural production suffered. To mitigate the impact of price controls and subsidies on the economy, the programs attempted to deal with the roots of inflationary pressures, namely the imbalances between demand and supply.

As can be seen from Chart 5, in the programs under consideration, close attention was paid to maintaining or increasing the ratio of savings to gross domestic product (GDP). In some countries, this ratio was expected to decline, owing in many instances to an expected reduction in "enforced" savings that resulted from liberalized trade. In contrast, investment ratio targets, compared with the previous year, show a wider dispersion (Chart 6). In some countries, an immediate increase in investment would have contributed to expanded production and, hence, supply-oriented adjustment. In others, however, investment was pushing against the limits of the absorptive capacity of the country and/or was contributing to a rapid accrual of external debt. In such countries, the programs aimed at containing investment to more realistic levels.

In most of the countries, public sector enterprises played an important role in production. The rationale for these enterprises was that, at the early stages of economic development, the private sector was not in a position to undertake a number of economic functions. Over the years, public enterprises in several countries incurred substantial losses, which were borne directly or indirectly by the central government budget. In the context of a number of these programs, the authorities reviewed carefully the operations of public enterprises. Invariably there was a consensus that these enterprises have to operate efficiently. Their operations were, in a number of cases, streamlined. In other cases, where the public enterprises were not considered viable on efficiency grounds, their operations were phased out. Clearly, public enterprises could not be judged solely on the grounds of profitability, as a number of these enterprises provided vital social

⁶ See Makalou (1982, 1983) and Nsouli (1982).

services. However, the costs for such services should be specifically provided for in the budget; profit-oriented public enterprises should not be called upon to perform such a role. In setting up adjustment programs, the Fund has assisted the authorities in focusing on the implications of the position of public enterprises for production and financial management.

The government sector, through both its current and capital operations, has played a dominant role in the economies of most African countries. In many of the countries, revenues did not fully cover expenditures. Consequently, the governments resorted to domestic and foreign borrowing to finance their budgetary deficits. Financial stability could not be restored without first tackling the excessive expansionary impact of fiscal policy. Fund-supported programs, therefore, devoted considerable attention to measures which could improve the fiscal positions.

On the revenue side, a number of programs included tax measures designed to expand the domestic revenue base and increase the elasticity of the tax system. Improvements in tax collection procedures in most countries also contributed considerably to higher revenues. On the expenditure side, the emphasis was on limiting the growth in current expenditures by strengthening administrative expenditure controls, reducing new government hiring, restraining salary adjustments, and reducing the expansion in real administrative expenditures. Capital expenditures generally were assessed against the availability of resources and carried out within the context of the macroeconomic framework of the development plan.

Fiscal Policies

The thrust of fiscal policy in Fund-supported programs in Africa can be seen in Charts 7-9. Most countries set a goal of increasing the proportion of government revenue (excluding foreign grants) to GDP. However, where economic conditions did not allow for an immediate increase in the program year, the revenue ratio was expected to drop (Chart 7). In most of the countries, the domestic revenue ratio was under 25 percent, but the ratio of expenditure to GDP was generally in excess of 25 percent. Accordingly, while in a few programs the expenditure ratio was targeted to increase, there was invariably an attempt to bring about a reduction in the ratio of expenditures to GDP (Chart 8). Because of the attempt to increase revenues and contain expenditures, nearly all programs aimed at reducing the ratio of the government deficit (excluding grants) to GDP (Chart 9).

In many of the countries, monetary policies critically depended on fiscal developments; the expansion of domestic credit generally was contingent upon the level of credit used by the central government to finance the budgetary deficit. The flexibility in conducting monetary policy, therefore, was generally limited to controlling credit to the private sector to offset partially the impact of the expansion in credit to the government sector. Not surprisingly, the government sector, in certain instances, tended to crowd out the private sector. As a result, the private sector was unable to secure adequate credit to carry out its activities. A more restrained fiscal policy stance would generally allow the monetary authorities to follow a more flexible credit policy toward the private sector and help promote economic growth.

Monetary Policies

Charts 10-13 show the diversity of monetary policies under Fund-supported programs. Nearly as many programs allowed for a higher rate of net credit growth to the government as allowed for a lower rate (Chart 10). However, in countries where credit to the private sector had grown at about 10 percent or less in the previous year—and these constituted the majority of the program countries—the programs tried to increase the growth rate of private sector credit. This was broadly reflected in the overall net domestic credit growth target. Generally, countries that had a net credit expansion in excess of 20 percent in the preceding year planned to reduce that to about 20 percent or less. Those with a rate of less than 20 percent aimed for an expansion rate greater than in the previous year. The domestic liquidity growth targets, reflecting the interdependent targets of domestic credit growth and changes in net foreign assets, do not allow for any significant generalizations; the rate of growth was expected to increase and decrease in nearly the same number of countries (Chart 13).

Within the context of monetary policy, the interest rate structure plays an important role in domestic resource allocation, the process of financial intermediation, the promotion of domestic savings, and the level of investment. The tendency has been, in many of these countries, to follow a low interest rate policy. This adversely affected their economies, because it tended to result in misallocation of resources and in financial disintermediation. In the context of high international interest rates, low interest rate policies may have resulted in a tendency for outward capital flows and a failure to attract private sector capital from abroad, although, admittedly, private capital flows depend on factors besides the interest

rate. In formulating programs, the interest rate policy was reviewed to determine the most appropriate interest rate structure. In numerous programs, domestic interest rates were revised.

External Sector Policies

With regard to external sector policies, the programs focused on three main issues: restrictions on current international transactions, the exchange rate policy, and external debt. Restrictions on international current transactions are usually implemented because of imbalances that have led to shortages of foreign exchange at the prevailing exchange rate. The detrimental effects of such restrictions have already been discussed. Their phased removal, as imbalances declined, was an important element of the programs under consideration.

The exchange rate is one of the important instruments that can aid in the adjustment process. An inappropriate exchange rate generates cost-price distortions that have a negative effect on the consumption-investment mix as well as on the export-import mix and tends to reduce the profitability of export- and

import-competing activities in the country. Such factors are detrimental to economic growth. The appropriateness of the exchange rate level, therefore, was carefully reviewed in the context of the programs under consideration.

Several countries took steps to adjust exchange rates. Those that took such action supported it with appropriate financial and economic policies to reinforce its contribution to the adjustment process. Somalia, for example, devalued its currency by 150 percent in domestic currency terms during 1981-82. Uganda also devalued its currency by about 100 percent over the period May 1981-June 1982. Both Somalia and Uganda introduced dual exchange rate systems on a temporary basis.

Given the importance of external borrowing for achieving a sustainable external debt position, Fund-supported programs aimed at containing the debt burden at levels compatible with the debt-servicing capacity of the country. In countries that had accumulated external payments arrears, the programs provided for the gradual elimination of these arrears. As can be seen from Chart 14, most programs attempted to avoid a significant increase in the ratio of external debt to GDP.

V Performance Under Programs

Performance under programs is difficult to assess insofar as the assessment depends on the yardstick selected. Guitián (1981) discusses the problem in detail, focusing on three yardsticks: (1) the performance that would have been achieved without a program; (2) the performance in the previous year or series of previous years; and (3) the targets of the programs.

The first yardstick is essentially a hypothetical situation, about which it would be hard to reach a consensus. The second yardstick addresses mainly the question of whether there has been an improvement or deterioration from the previous year or years. The third assesses the performance against the targets of the program. Without entering into a detailed discussion of the relative merits of the yardsticks, in this part we shall assess the performance of countries against two yardsticks: (1) the targets of the program, and (2) the previous year's performance.

These quantitative yardsticks are not sufficiently adequate in giving an idea of the contribution to adjustment of the measures taken. A number of measures tend to improve economic conditions only gradually, so that their effect can only be fully realized over the medium and long term. Other measures tend to bring about important qualitative changes—such as the removal of bottlenecks or the enhancement of financial intermediation—that are not easily measurable. Furthermore, there are numerous other factors at work so that it is, at times, difficult to isolate the positive effects of measures taken. Accordingly, the analysis that follows should be cautiously interpreted.

Achievements Versus Targets

Charts 1a–14a⁷ provide an idea of the achievements compared with the targets. The results generally indicate that in many cases the performance fell short of targets. In most countries, economic growth was below target levels, although there are a number of exceptions where the performance exceeded the tar-

⁷ Charts 1a–14a are in Appendix II.

gets (Chart 1a). Results on reducing inflation, as measured by the consumer price index, were mixed. Nevertheless, most countries were close to targets and succeeded in keeping inflation below 20 percent (Chart 2a). Most countries fell short of achieving the targeted improvement in their current account positions as a proportion of GDP, as can be seen from Chart 3a. About half of the countries met their goal with respect to the overall balance of payments position as a proportion of GDP. Thus, as far as the objectives of programs are concerned, there was generally a shortfall in economic growth, inflation targets were attained or nearly attained in most programs, and the external sector current account targets were achieved in about a third of the cases.

Turning to policy indicators, the ratios of savings and investment to GDP were generally close to targets.⁸ With regard to fiscal policy, revenues (excluding grants) as a proportion of GDP were, in most cases, close to target. However, the ratio of expenditure (excluding grants) to GDP was generally exceeded. Because of this, in most countries the budgetary deficit (excluding grants) as a proportion of GDP was considerably exceeded. The rate of growth of net credit to the government, accordingly, generally did not conform to targets. Furthermore, credit to the private sector was exceeded in numerous cases. Reflecting these developments, net domestic credit growth exceeded the targets in about half the countries. In most, domestic liquidity growth was, therefore, considerably above target. Insofar as external debt is concerned, the data indicate that nearly all countries exceeded the targets.

Achievements Versus Previous Year

Given these deviations from targets, Charts 1b–14b⁹ show how countries performed relative to the previous year. In terms of economic growth, there was a considerable improvement in a number of countries

⁸ The dots on the zero point of the target axis in the charts indicate that no targets were set.

⁹ Charts 1b–14b are in Appendix III.

but a decline in most. Inflation worsened in just over half the countries. In the external sector, neither the current account position nor the overall balance of payments as a ratio of GDP appears to have improved or worsened significantly in most countries.

With regard to policy indicators, there were no major changes in the savings and investment ratios. Government revenue as a ratio to GDP increased in most countries, while government expenditure as a ratio to GDP remained unchanged or declined in most countries. Accordingly, the budgetary position (excluding grants) improved in the majority of cases. On the monetary front, net credit growth to the government sector remained about the same as the previous year or declined in most cases. Credit growth to the private sector for most countries, however, was nearly equal to or exceeded the previous year's rates. Overall net domestic credit expansion was mostly nearly equal to or less than the previous year's. Chart 13b suggests that, in most cases, domestic liquidity increased at a faster rate. The external debt ratio as a proportion of GDP increased for virtually all countries.

From these diverse results it is hard to generalize whether in a one-year period there was an improvement or deterioration in the economic situation of the countries adopting Fund-supported programs. The results seem to be almost evenly divided. It is, therefore, essential to examine the reasons for these deviations. Table 4 provides information on objectives, as indicated by economic growth, inflation, and the current account position, as well as on two key financial policy instruments—the budgetary deficit (excluding grants) as a proportion of GDP and the rate of growth of net domestic credit. Table 4 shows a close correlation between attaining program objectives and observing the quantitative policy instruments. In 14 programs where either or both of the 2 policy instruments were observed, 2 or 3 objectives were attained. In 9 programs where the policy instruments were not observed, 2 or more of the objectives were not attained. Accordingly, we find a close correlation in 23 of the programs. Only in 7 programs is a relationship not clear.

Factors Affecting Implementation

There are several reasons why certain programs could not be implemented or, in rare instances, where the measures were implemented, the targets could not be reached. These factors are essentially the following: unforeseen developments, difficulties in mobilizing strong political support, limitations in the administrative infrastructure, overly ambitious program expectations, and delays in inflows of development assis-

tance. Notwithstanding such problems, a number of countries readapted their policies and successfully carried out their adjustment programs.

By far the most important factor resulting in unsuccessful implementation of programs was unforeseen developments. Even in instances when the program could be judged "successful," the success was limited by unforeseen factors. For example, in Liberia a higher-than-expected increase in oil prices caused losses in the energy-intensive iron ore sector. This, in turn, contributed to a fall in tax revenue, which made attaining the budgetary target more difficult. In addition, the increase in interest rates abroad contributed to pressures on both the budgetary and the external sector positions. A soft world coffee market caused a shortfall in export receipts for Madagascar. In Malawi, the failure of the maize crop resulted in an increased demand for imported maize. Compounding this problem was the increase in international interest rates that also contributed to budgetary and balance of payments pressures. Implementation of the Fund-supported program in Mauritius was adversely affected by two factors: a higher oil bill, owing to increases in international prices, and cyclones, which damaged the sugar crop and caused exports to decline sharply.

While Morocco was implementing its adjustment program, the world demand for phosphate fell. This led to a shortfall in Morocco's phosphate export receipts. At the same time, Morocco's agricultural output fell, owing to drought. Higher-than-anticipated international interest rates also added to the budgetary and external sector imbalances, while the appreciation of the U.S. dollar resulted in an increase in the domestic subsidy of basic consumer goods.

In Senegal, performance under the Fund-supported program was affected by drought. Sierra Leone also suffered from a weakening of export prices and unexpectedly high levels of rice imports made necessary by unfavorable weather. In Tanzania, export prices turned out to be lower than projected. Togo's export performance suffered because of shortfalls in both the quantity and the price of exports. In Zaïre, export prices took a turn for the worse at the same time that capital inflows fell short of expectations. Zambia's performance was affected by two developments: the sharp decline in copper and cobalt prices—its two main exports—and an increase in debt service payments, owing mostly to higher international interest rates. In Zimbabwe, a landlocked country, a disruption of the transport system had a severe impact on the implementation of the program.

The second most important reason for unsuccessful programs was the difficulty that governments encountered in mobilizing sufficient political support for their adjustment efforts. This is most apparent with regard

Table 4. Africa: Indicators of Performance Under Fund-Supported Adjustment Programs, 1980-81

	Objectives									Instruments						Two or Three Objectives Attained	One or Two Instruments Attained	Objectives and Instruments Simultaneously Attained ¹
	Economic Growth			Inflation			Ratio of Current Account Deficit to GDP			Ratio of Budgetary Deficit (excluding grants) to GDP			Net Domestic Credit Growth					
	T/P	A/T	A/P	T/P	A/T	A/P	T/P	A/T	A/P	T/P	A/T	A/P	T/P	A/T	A/P			
Central African Republic	G	N	L	G	N	G	G	N	G	L	N	G	G	N	G	N	N	N
Central African Republic	G	N	L	L	A	L	G	A	L	L	N	G	L	A	L	A	A	A
Equatorial Guinea	—	—	—	—	—	—	—	—	—	—	—	—	G	N	G	—	N	—
Equatorial Guinea	—	—	—	—	—	—	—	N	—	—	N	—	L	A	L	—	A	A
Ethiopia	G	N	G	—	—	G	G	A	G	—	—	G	G	A	G	—	A	A
Gabon	G	N	L	L	A	L	G	N	G	L	A	L	L	A	L	N	A	X
Gabon	G	N	G	G	N	G	L	N	G	L	A	L	L	G	A	L	N	X
Gabon ²	G	A	G	G	N	G	G	A	G	G	A	G	G	A	G	A	A	A
Gambia, The	G	N	G	G	A	L	L	A	L	G	N	G	L	N	L	A	N	X
Ivory Coast	L	N	L	—	—	L	L	A	L	L	A	L	L	N	L	A	A	A
Kenya	G	N	G	L	N	G	L	A	L	L	N	G	G	N	G	N	N	N
Liberia	—	—	—	G	A	L	—	—	L	L	N	G	—	—	L	A	A	A
Liberia	—	—	G	L	A	L	—	—	L	L	N	G	G	A	L	A	A	A
Madagascar	G	N	L	L	N	G	L	N	L	L	N	L	L	N	L	N	N	N
Malawi	L	N	L	L	N	G	L	N	G	L	N	G	L	A	L	N	A	X
Malawi	G	N	L	L	A	L	L	N	L	L	N	G	L	A	L	N	A	N
Mauritania	—	—	G	—	—	L	G	A	L	L	N	G	G	A	L	A	A	A
Mauritania	—	—	L	—	—	L	L	A	L	L	N	L	G	A	L	A	A	A
Mauritius	L	N	L	L	N	L	G	N	G	L	A	L	G	A	G	N	A	A
Mauritius	G	A	G	L	A	L	L	A	L	L	A	L	L	N	L	A	A	A
Morocco	G	N	L	G	N	G	L	N	L	G	N	G	G	A	G	N	A	X
Morocco	G	N	L	G	N	G	L	N	G	L	N	G	G	N	G	N	N	N
Senegal	L	N	L	G	A	L	L	N	G	—	—	—	L	N	L	N	N	N
Senegal	G	N	G	G	A	G	G	A	G	L	A	L	G	A	G	A	A	A
Sierra Leone	G	N	L	G	N	G	L	N	L	L	N	G	L	A	L	N	N	X
Sierra Leone	L	N	L	L	A	L	L	N	G	L	N	G	G	N	G	N	N	N
Somalia	—	—	—	L	N	G	—	—	—	—	—	—	L	N	L	—	N	—
Somalia	—	—	—	L	N	G	—	—	—	—	—	—	L	N	L	—	N	—
Tanzania	—	—	—	—	—	L	—	—	—	—	—	—	—	L	N	L	A	A
Togo	G	N	L	—	—	G	L	N	L	—	—	L	—	—	L	N	—	—
Togo	L	N	L	L	N	G	L	N	G	—	—	L	—	—	L	N	—	—
Uganda	G	A	G	L	N	G	G	A	G	L	N	G	G	A	G	A	A	A
Zaire	L	A	G	L	A	L	—	N	—	G	N	G	—	—	G	N	N	X
Zambia	G	N	G	G	A	G	L	N	G	L	N	L	L	N	G	N	N	N
Zimbabwe	L	A	L	G	A	L	L	N	G	L	A	L	L	N	G	A	A	A
Greater than One (G) or Attained (A)	18	5	12	12	13	17	9	11	15	5	8	17	16	16	17	14	20	14
Less than One (L) or Not Attained (N)	8	21	18	15	14	16	18	18	14	21	19	12	15	15	18	16	13	9

Code: G = Greater than one

N = Not attained

L = Less than one

A = Attained

T/P = Ratio of target to previous year

X = Targets attained but instruments not attained, or vice versa

A/T = Ratio of actual outcome to target

A/P = Ratio of actual outcome to previous year

Source: International Monetary Fund.

¹ In some instances, where information was incomplete, assessments based on various indicators were used. This column indicates whether targets and instruments in the previous two columns were simultaneously attained.² This line covers the third year of Gabon's extended arrangement, which started in 1980.

to the implementation of fiscal policies. The governments of the Central African Republic, Ethiopia, Equatorial Guinea, Kenya, Madagascar, Malawi, Morocco, Senegal, Sierra Leone, Togo, Zaïre, and Zambia found it difficult to keep to the level of expenditures outlined in their programs. Furthermore, in a number of countries revenues fell short of expectations either because necessary tax measures were delayed or because improvements in tax collection enforcement could not be carried out as expected.

Related to the last point is the question of the administrative capability of countries to implement measures that are necessary for adjustment. In most countries this is particularly apparent in the case of fiscal measures, where improvements in expenditure control and revenue collection could not be effected, even where the government appeared to be determined to bring about such improvements. In a number of programs it was also expected that action would be taken to improve the position of public enterprises. The expected improvements did not materialize, mainly because of the limited administrative capabilities of the government to effect the requisite changes.

Another factor was the appropriateness of the targets set out in the programs. In some instances the requisite policies were observed, but the targets were not attained. Interestingly, there are virtually no cases where the targets were attained without the observance of the requisite policies. In some cases, the macro-economic interrelationships may have been different from those assumed in the initial design of the program. In other cases, data limitations may have resulted in errors in economic forecasting. Some targets may also

have been too optimistic in light of the constraints operating in the economy.

Finally, in a few cases there were either delays or shortfalls in net inflows of development assistance. In this group the notable examples are Mauritania, Kenya, Sierra Leone, and Tanzania.

Performance Criteria

Certain indicators were used in the course of implementation to determine whether the programs were progressing satisfactorily. Whenever these indicators deviated from targets, the Fund and the country would consult on whether additional measures were needed to keep adjustment on track. These indicators, usually referred to as performance criteria, included net credit to the government sector and net domestic credit or net domestic assets. In addition, in many countries quantitative limits were set on nonconcessional external loans contracted and on external payments arrears. In rare instances, where it was deemed applicable, subceilings were set on credit to the private sector, as were limits on external payments arrears, the ratio of the government budgetary deficit to GDP, and domestic government payments arrears. The programs also provided that there be no intensification of restrictions on payments and transfers for current international transactions, nor on imports for balance of payments purposes. The programs also set dates for reaching understandings about future policies and performance criteria.

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47

3

Fiscal policy for stabilization and adjustment

The fiscal crisis facing most developing countries—and the related problems of external debt, inflation, and recession—have called new attention to the importance of sound fiscal policy. Although country circumstances vary greatly, fundamental principles of fiscal management apply everywhere. This chapter describes these principles and then applies them to three different issues: the debt troubles of the middle-income countries, the problem of cycles in commodity-exporting economies, and the task of adjustment in the severely resource-constrained economies of Sub-Saharan Africa.

One of the most important aspects of fiscal policy is the management of the public sector's deficit—the excess of its spending over its revenue (see Box 3.1). Deficits in themselves do not automatically imply macroeconomic problems. If the use of public resources is sufficiently productive, future income can be generated to cover the servicing costs of any debts incurred. If expenditures rise owing to temporary factors, such as wars or natural disasters, then deficits may be justified as a way to spread the cost over several years. Deficits can be more easily absorbed by countries with high rates of domestic private saving and well-developed capital markets. Thus a relatively high deficit need not cause problems in an efficient, high-saving economy, whereas in a low-saving, highly distorted one, even a small deficit might be destabilizing. A prudent fiscal policy can therefore be defined as one that maintains the public deficit at a level that is consistent with other macroeconomic objectives: controlling inflation, promot-

ing private investment, and maintaining external creditworthiness.

Fiscal policy and macroeconomic performance

The extent to which any given public sector deficit can be reconciled with broader macroeconomic goals depends largely on the way it is financed. A deficit must be funded by the private sector lending the government some of the excess of its saving over its own investment, by foreigners lending part of their savings, by printing money, or by some mixture of the three (see Box 3.2). Too great a strain on any of these sources of finance can create macroeconomic imbalances. Overreliance on domestic borrowing may mean high real interest rates and falling private investment. Overreliance on foreign borrowing can cause appreciating real exchange rates, widening current account deficits, unsustainable external indebtedness, and dwindling foreign exchange reserves. Overreliance on money creation may prompt higher inflation. Viewed from the alternative perspective of production and expenditure, an increased fiscal deficit is an additional claim on the supply of goods. The only ways to meet this extra claim are by importing additional goods from the rest of the world (that is, increasing the current account deficit), by driving up domestic inflation and interest rates to make the private sector buy fewer goods, or by increasing domestic production.

Figure 3.1 illustrates the link between fiscal deficits and current account deficits in four countries. Since the surplus of private saving over invest-

Box 3.1 Measuring the public deficit

The correct way to measure the public sector deficit depends on the purpose. The most obvious objective is to measure the net claim on resources by the public sector; this in turn influences the external deficit, inflation, domestic interest rates, and employment.

A useful indicator would then be the public sector's net use of financial resources, the *public sector borrowing requirement* (PSBR). The PSBR represents the total excess of expenditure over revenue for all government entities, all of which must be financed by new borrowing net of repayment of previous debts. It is also called the "consolidated public sector deficit." Expenditure includes wages of public employees, spending on goods and fixed capital formation, interest on debt, transfers, and subsidies. Revenue includes taxes, user charges, interest on public assets, transfers, operating surpluses of public companies, and sales of public assets. Expenditure does not include amortization payments on government debt or accumulation of financial assets, while revenue does not include the drawdown of cash reserves.

The PSBR is the most comprehensive deficit measure, but it can be misleading in some circumstances. In countries with a high rate of inflation, part of the borrowing by the public sector is offset by the decline in the real value of their existing debts. A fraction of the interest payments by the public sector then compensates creditors only for the loss in the real value of the debts; it does not represent a real interest cost to the government. Sometimes the debt principal is explicitly indexed to inflation, in which case the indexation inflates the PSBR. Another measure of the public sector deficit for these cases is the change in real debt. The *operational deficit* is defined as the PSBR minus the inflation correction part of interest payments; it is sometimes called the "inflation-corrected" deficit. The difference can be significant. In 1985 in Brazil the inflation correction component of the indexed domestic debt was so large that the PSBR was 27.1 percent of GDP, while the operational deficit was only 3.5 percent of GDP.

The interest paid on debt is a result of past deficits

rather than current behavior. A measure of the current policy stance might therefore exclude all interest payments, yielding the *primary deficit*, also called the "non-interest deficit." The primary deficit measures how current actions improve or worsen the public sector's net indebtedness, and it is important for evaluating the sustainability of government deficits. Although fiscal deficits can be run indefinitely, the primary balance must eventually become positive to cover at least part of the interest on current debt. If public revenue and the economy as a whole grow faster than the real interest rate, then even the primary balance can remain in deficit. However, it is generally not possible in the long run to always grow faster than the interest rate. The relation between these deficit concepts is shown in Box figure 3.1.

The public sector should include the central government, provincial and municipal governments, decentralized agencies, and state-owned enterprises. Conventional deficit measures often include only the central government. This can give a very misleading picture when other public entities are running large deficits or surpluses. Even in comprehensive measures the public financial intermediaries are often excluded because of their special role as financing agents. On occasion these intermediaries, especially the central bank, have run large losses. These are sometimes called the "quasi-fiscal deficit." They usually arise because the central bank assumes the exchange rate or portfolio losses of private banks (see Box 3.3) or because the central bank directly engages in subsidized lending. The deficit of public financial intermediaries has macroeconomic effects similar to the deficits of other public entities; they should therefore be included in the overall PSBR. Measurement difficulties are formidable, however. Such losses are often omitted unless they are too large to ignore.

Another correction to the deficit is to remove the effect of temporary factors: the deviation of domestic income, commodity prices, and interest rates from their long-run values, and events such as tax amnesties. Sales of government assets could also be excluded,

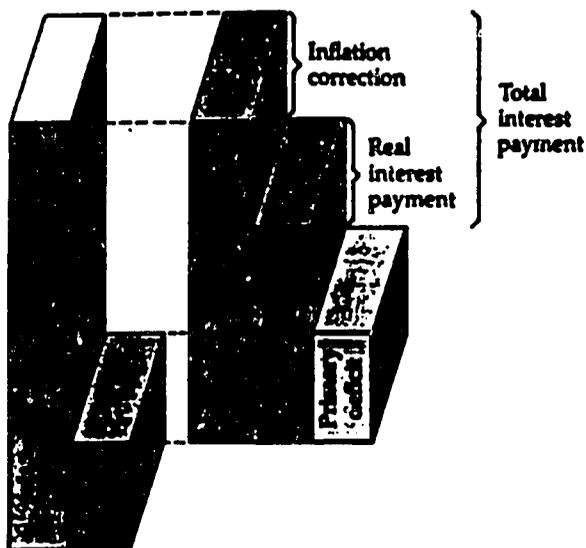
ment often cannot cover additional public deficits, these spill over in varying degrees as bigger current account deficits. Higher international interest rates and lower commodity prices also add directly to both types of deficit in many countries. So while foreign borrowing permits the fiscal deficit to expand without undue pressure on domestic inflation and interest rates, the buildup of external debt makes countries more vulnerable to external events such as global recession, falling commodity

prices, and sudden changes in the cost and availability of new foreign lending. If fiscal expansion is unsustainable, the continued accumulation of external debt only delays an adjustment that is all the more severe for being postponed.

Fiscal deficits and inflation

Governments can choose to finance their fiscal deficits by creating money, that is, by printing and

Box figure 3.1 The relation between different deficit concepts



since they are really financing deficits rather than contributing revenue. The result would be the *structural deficit*, that is, the deficit likely to persist unless corrective measures are taken.

All of these deficit measures provide their own insight into the economic impact of government finance. The PSBR measures the need for domestic or external financing (see Box 3.2). The operational deficit removes some of the distortions caused by high inflation. In debtor countries the primary deficit indicates the public sector's current contribution to debt difficulties. During times of abnormal commodity prices or domestic income, the structural deficit gives a picture of the long-run position.

spending currency. By issuing currency, governments are able to claim real resources; this claim is known as seignorage. The sum of currency holdings by the public and by banks is known as the money base, since it is the basis for monetary transactions performed with cash, checking accounts, savings accounts, and other types of monetary assets. Because the demand for monetary assets keeps increasing in a growing economy, the government can to a limited extent finance itself

through expanding the money base without causing inflation. When the rate of new money creation exceeds the growth in demand for money, however, inflation can result. (In countries where the currency is freely convertible, foreign exchange reserves might also be lost as people exchange the unwanted domestic money for foreign currency.) Individuals are, in effect, taxed by inflation because the real value of their money holdings falls: part of the government's seignorage then becomes an implicit "inflation tax." Banks holding reserves against deposits also face this tax, which they usually pass on to depositors in the form of lower interest rates on deposits. Inflation created by the printing of money may carry an extra fiscal benefit because it reduces the real value of domestic government debt. (When inflation is anticipated, however, nominal interest rates rise in advance to compensate bondholders for the inflation tax.)

Seignorage—the government's ability to claim resources in return for issuing currency—is usually limited by the demand for real money balances, which typically falls as inflation rises. Beyond a certain point an increase in money creation, and thus in the rate of inflation, may actually decrease seignorage if the demand for money falls sharply enough in response. Countries that have relied frequently on money creation as a form of public finance typically have a very low rate of money holdings. Brazil and Israel, for instance, have had modest levels of seignorage on currency—thanks to their low ratios of currency holdings to GDP—despite very high inflation (see Table 3.1). Only countries with extremely high rates of inflation—for example, Argentina and Bolivia—have temporarily generated seignorage on currency of more than 3 or 4 percent of GDP, but such seignorage rates are not sustainable.

Inflation, therefore, is often a fiscal phenomenon: it is caused by governments with no alternative source of deficit finance resorting to money creation at a higher rate than the growth in money demand. Any hope of controlling inflation without reducing government deficits is then in vain. Excessive reliance on money creation is particularly risky if the inflation itself worsens the deficits, because expenditures keep pace with rising prices while revenues do not. This means that still more money creation becomes necessary—further worsening the inflationary spiral.

To counteract the inflationary pressures of money creation, governments sometimes raise the reserve requirements on bank deposits. This in effect requires banks instead of the general public to

50

Box 3.2 What is a "prudent" fiscal deficit?

One way to decide whether a public deficit is "prudent" is to determine whether financing it is consistent with the government's other macroeconomic objectives—external creditworthiness, growth of private investment, and control of inflation, for example. To do this, financing must be broken down into its components. A good starting place is the identity stating that the sum of all investment in the economy must be equal to the saving available from both residents and foreigners (see Box figure 3.2, top). Foreign saving is the excess of foreigners' income from the domestic economy over their spending in it. This is equal to the current account deficit in the balance of payments. Private saving is equal to GNP minus taxes and private consumption, which gives the private component of gross national saving. Public saving is the excess of public current revenues over current spending, and the public deficit can therefore be defined as public investment minus public saving. The first identity can thus be rewritten as shown in Box figure 3.2, bottom. A public deficit must be balanced by a domestic private sector that saves more than it invests and/or by an external current account deficit. The "prudence" of the public deficit depends on the level of private saving, the desired level

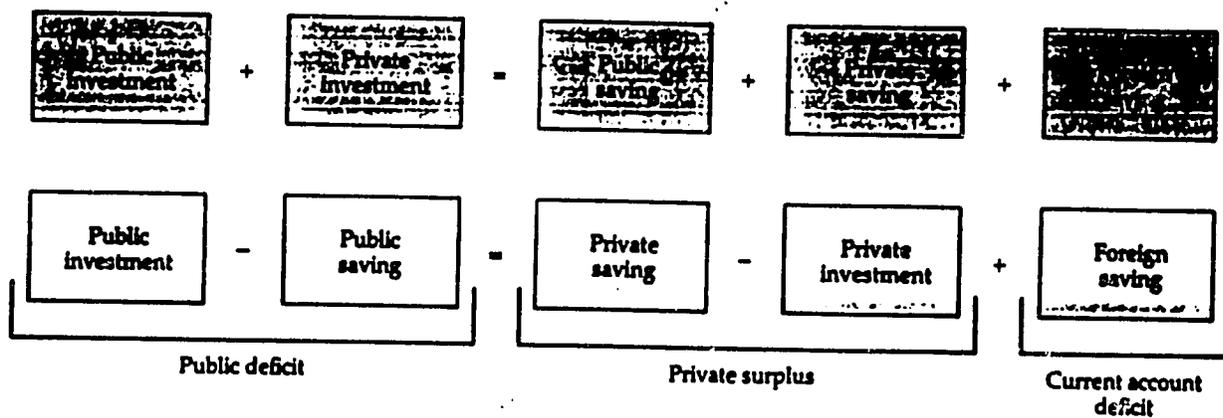
of private investment, and the desired current account deficit.

The financial flows corresponding to both the external current account deficit and the private surplus are also important. The amount and type of foreign and private lending will determine whether the public deficit is consistent with other macroeconomic goals, as described below.

External creditworthiness is sometimes defined as maintaining an acceptable ratio of gross external debt to exports. This is because exports determine the ability to service debt; a permanently increased debt-export ratio could impair creditworthiness. This suggests that public external debt should grow at the same rate as exports over the long run. Temporary increases in commodity exports should not lead to more public borrowing for the reasons discussed in the section on commodity export cycles in the text. If access to voluntary foreign lending has already been interrupted because of excessive borrowing in the past, then it makes sense to aim for a lower debt-export ratio, implying that the growth of debt should be held below the growth of exports.

The usual objective in managing foreign exchange

Box figure 3.2 The savings–investment identity and the financing of a public deficit



hold currency, so that the money base—but not the overall supply of money—expands. Alternatively, the financial system may be required to hold large amounts of government bonds in its portfolio at artificially low interest rates. While increased reserve or portfolio requirements avoid the inflationary effects of monetary expansion, the resulting

increase in the spread between deposit and loan rates hinders domestic financial intermediation. Savers react to the poor returns on deposits by storing their wealth in property or by taking it abroad. The squeeze on bank loans restricts domestic investment and forces investors to turn abroad for funds.

reserves is to maintain an adequate ratio of reserves to imports of goods and services. Deficits can be prudently financed by running down reserves only to the extent that reserves remain over this target. As imports grow, additional reserves have to be accumulated; the financing available from this source could therefore be negative.

Printing money to finance a deficit can result in inflation to the extent that it exceeds the growth in demand for money at the current level of prices. Higher reserve requirements are one way to avoid that result, but they widen the spread between deposit and loan rates, and can therefore be inconsistent with other objectives of efficiency in domestic financial markets and greater private investment.

Nonmonetary domestic borrowing from the banking system or from the nonbank private sector should be consistent with the macroeconomic objective of promoting private sector investment. One guideline is to avoid an increase in the share of public borrowing in domestic credit provided by the banking system. Another approach would be to target public domestic borrowing at a level consistent with the desired level of domestic real interest rates.

Delaying payments on debt service or on goods purchases—that is, increasing arrears—is an important source of finance in some countries. Arrears are implicit credits that have similar macroeconomic consequences to other forms of public borrowing, as well as jeopardizing future financing. A common objective is to reduce arrears either in absolute terms or as a proportion of GDP.

These criteria can be used to judge what level of fiscal deficit is prudent. Higher growth in exports, real demand for money, and overall financial savings means a higher deficit can be financed without violating the objectives of external creditworthiness, low inflation, or reasonable real interest rates. In general, faster economic growth brings bigger deficits within the bounds of prudence, because it usually implies faster growth of exports and demand for money. In a slowly growing economy with low financial savings and stagnant exports, the prudent fiscal deficit is likely to be low.

Sustainability of fiscal deficits

Fiscal deficits have implications for the future as well as for the present. The debts created by borrowing have to be serviced. The public sector must generate the necessary resources through receipts from public investment, through additional taxes

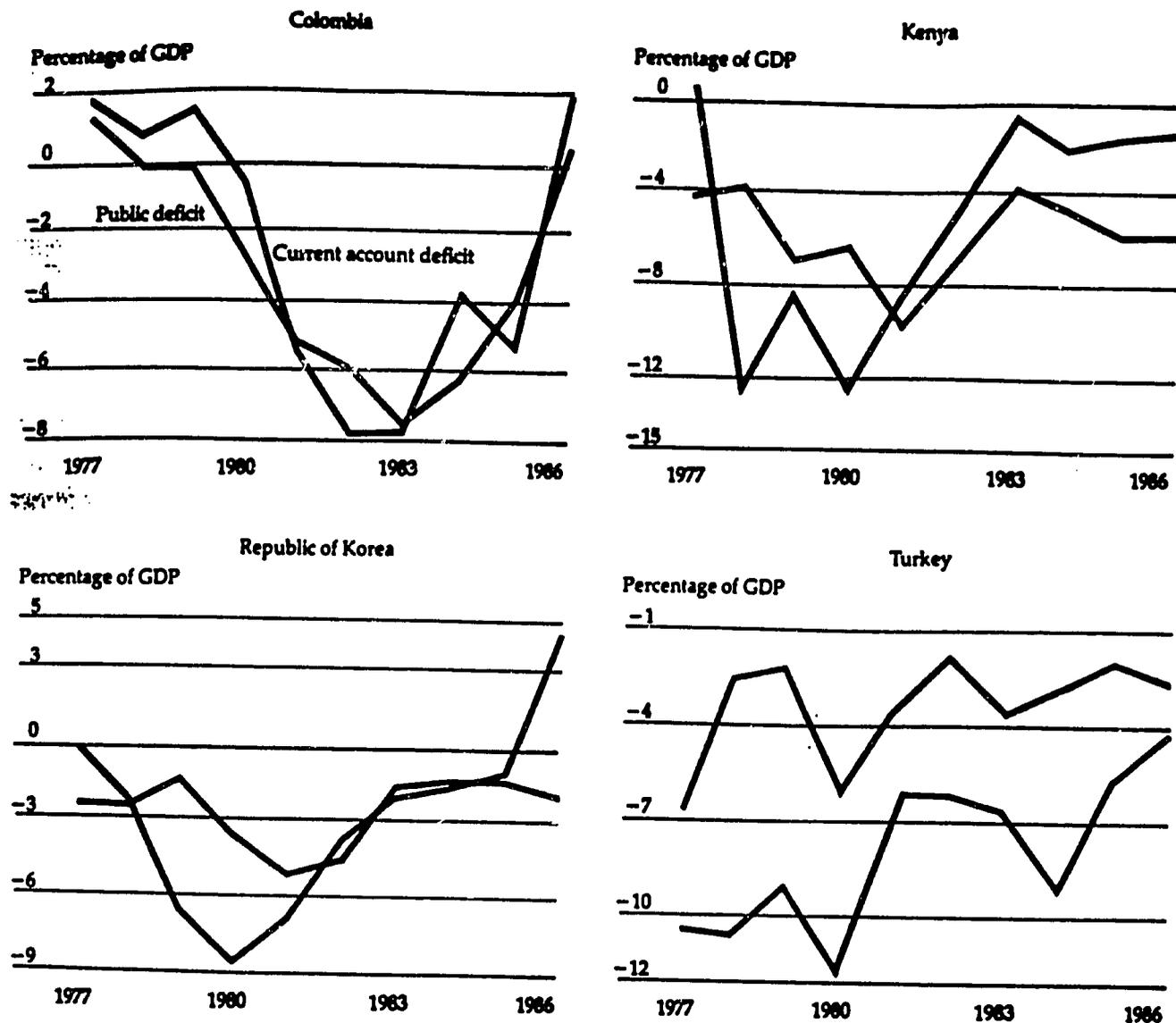
or spending cuts, or through money creation. Although governments can borrow indefinitely, in the long run they must claim enough resources to pay at least part of the interest; otherwise the level of debt will rise without limit as a proportion of GDP. This means that the so-called "primary deficit"—the consolidated public sector deficit excluding interest payments (see Box 3.1)—must eventually run into surplus to compensate for past deficits. The only exception to this requirement is if resources are used so effectively that the growth rate of the economy—and of public revenues—persistently exceeds the real interest rate on public debt.

The sustainability of fiscal policy is not an abstract concern. The private sector takes it into account, for example, when deciding whether to invest. If deficits are perceived to be unsustainable, then the private sector will expect future tax increases or money creation. If it predicts the latter, it will also expect higher inflation and currency devaluation. Savers can avoid this threat of implicit or explicit taxation by taking their capital abroad; this itself accelerates the breakdown of the unsustainable policies. The moment of truth for imprudent fiscal policy often comes with a financial or balance of payments crisis.

Stabilization versus structural adjustment

In analyzing the fiscal crisis in developing countries, a distinction must be made between macroeconomic stabilization and structural adjustment. Stabilization addresses short-term problems that need to be dealt with urgently: inflation, loss of foreign exchange reserves, capital flight, and large current account deficits. Structural adjustment addresses obstacles to longer term growth: distortions in the incentives for production (for example, overvalued real exchange rates); controls on prices, interest rates, and credit; burdensome tariffs and import restrictions; and excessive taxes and subsidies. These tasks must be undertaken together. Careless structural adjustment can make the problem of stabilization more difficult, because the distortions are often a source of revenue to the government. For example, high tariffs provide public revenue as well as protection to domestic industry. Equally, structural reforms are unlikely to command credibility unless stabilization policies are in place. Investors will expect trade liberalization to be short lived if fiscal deficits imply an eventual balance of payments crisis. And fiscal stabilization can hamper structural adjustment. For

Figure 3.1 Public deficits and current account deficits in four countries, 1977 to 1986
(percentage of GDP)



Notes: The public deficit for Turkey includes only central government and state-owned enterprises. The public deficit for Kenya includes only central and local governments. The 1986 public deficit figure for the Republic of Korea is a budget estimate. Other public deficit figures are for the consolidated public sector.

example, cuts in public infrastructure spending to reduce the deficit may cause private investment to fall. Raising tariffs to increase public revenues may distort relative prices.

Stabilization is often associated with a domestic recession characterized by rising unemployment, sharply contracting imports, and falling real wages and living standards. Lower living standards are unavoidable when the previous level has been artificially raised by unsustainable policies. But the re-

cession can be damaging to future growth if it is too deep or too prolonged. The blow to the confidence of domestic investors may inhibit necessary new investment. The decline in the economy can also strain the financial system and impair its ability to finance new growth. Excessive cuts in spending risk a downward spiral of continually falling output. These risks make it vital to team contraction of demand induced by fiscal retrenchment with structural adjustment to increase output.

Some waste of resources can be eliminated with little effect on growth; other forms of fiscal restraint can be damaging. Incentives to expand exports reduce the contraction of imports necessary to restore external balance, and steps to promote savings lessen the fall in investment required to finance the fiscal deficit. Additional external financing can buy time for new supply incentives to take effect.

Stabilization and structural adjustment face different institutional constraints. Stabilization is often postponed, but it can usually be implemented when a crisis forces events. In contrast, structural adjustment seldom carries the same sense of urgency; its results are less obvious and more gradual. It often requires the support of a broader circle of policymakers than stabilization, which is typically undertaken at the behest of the central bank and finance ministry. Structural reforms are difficult, too, because they inflict visible damage on a few and bring less obvious benefits to many. These difficulties reinforce the tendency to pursue short-run stabilization to the exclusion of structural adjustment during crises.

The interdependence of fiscal, monetary, and exchange rate policies

Fiscal policy needs to be judged alongside the other main tools of macroeconomic policy: monetary policy and exchange rate policy. Macroeconomic imbalances are often addressed by tightening monetary policy. However, the governments of developing countries find it more costly to control the money supply than do their counterparts in the industrial countries. To tighten monetary conditions, they are usually forced to impose higher reserve requirements on banks or to induce the banking system to hold more government bonds. In their shallow financial markets this often provokes a bigger rise in interest rates than would be the case in the industrial countries. Private borrowers must therefore reduce their demands for credit more drastically by decreasing capital investment or by going abroad for foreign loans. Higher interest rates on existing private debt are also more likely to cause financial distress for private enterprises and thus to weaken the banking system in developing countries. Interest rate controls are

Table 3.1 Revenues from seignorage on currency in selected countries, average for 1980 to 1985

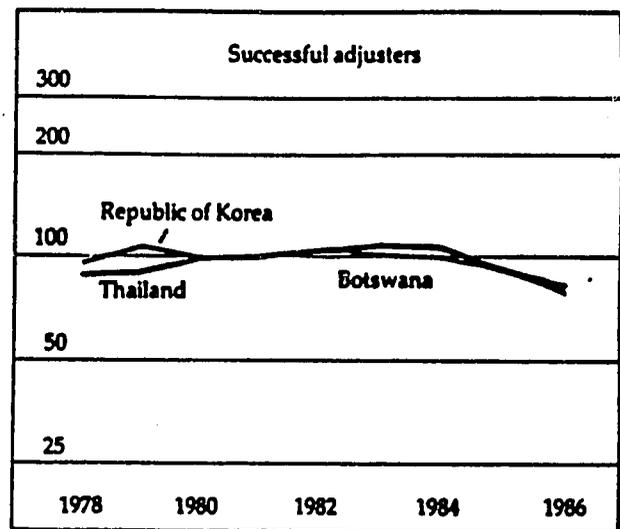
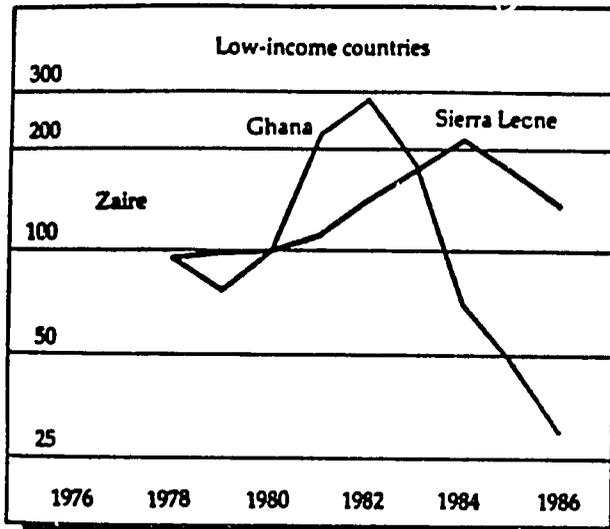
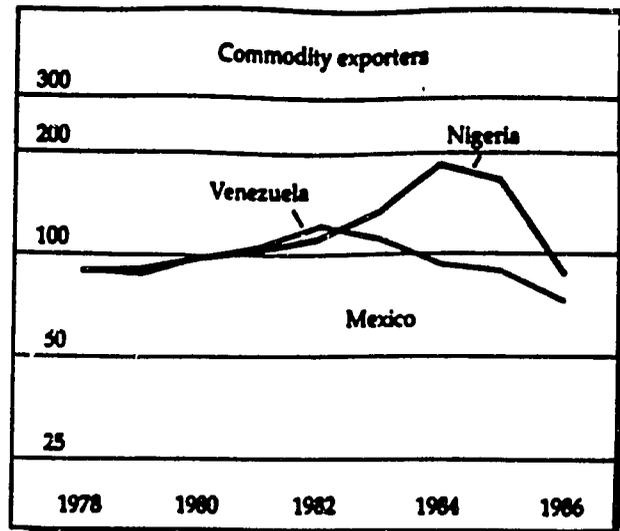
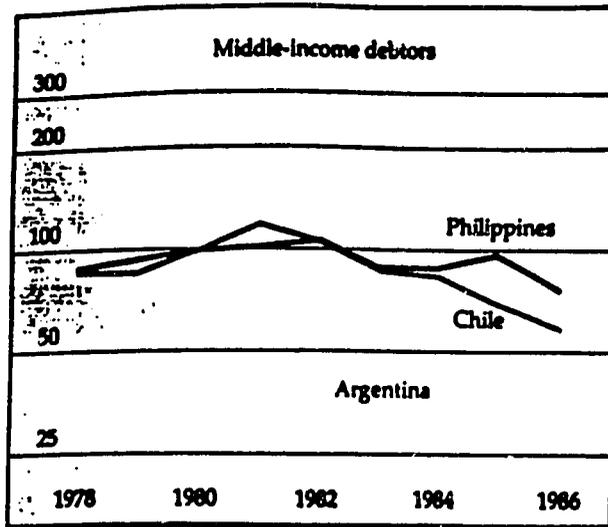
<i>Level of seignorage revenues and country</i>	<i>Seignorage revenues (increase in currency as a percentage of GDP)</i>	<i>Ratio of currency holdings to GDP (percent)</i>	<i>Currency growth (percent per year)</i>	<i>Inflation (percent per year)</i>
<i>High</i>				
Argentina	4.0	3.8	269	274
Bolivia	6.2	6.1	438	506
Ghana	2.2	6.1	45	54
Sierra Leone	2.4	7.7	35	43
<i>Moderate</i>				
Brazil	1.0	1.4	129	147
Israel	1.1	1.3	165	181
Mexico	1.5	3.7	50	58
Peru	1.9	3.1	92	97
Turkey	1.2	3.8	38	46
<i>Low</i>				
Bangladesh	0.6	4.0	16	12
Colombia	0.8	4.7	18	22
Côte d'Ivoire	0.7	9.2	8	7
Dominican Republic	0.7	4.6	16	15
Korea, Republic of	0.5	4.3	13	9
Nigeria	0.8	7.2	13	16
Venezuela	0.4	4.5	8	12

Notes: This table measures only the seignorage corresponding to currency held by the public, since seignorage on banks' holding of currency reserves is difficult to measure for some countries. The first column is calculated as the end-of-year currency outside banks (IFS line 14a) minus the end-of-year value of the previous year, divided by the current year GDP. The second column is the ratio of the average of beginning-of-year and end-of-year currency outside banks to current GDP. The third column is the percentage change in currency outside banks from end-of-year to end-of-year. The final column is the percentage change in the consumer price index (IFS line 64) from December to December. The geometric average of growth rates is used for columns three and four; the arithmetic average of ratios is used for columns 1 and 2.

Source: IMF, *International Financial Statistics*.

54

Figure 3.2 Real effective exchange rate indexes for selected countries



Notes: The vertical axis is in log scale. The real exchange rate is an index of relative domestic and international prices expressed in a common currency. (In technical terms it is defined as the domestic price index times the exchange rate—expressed as units of foreign currency per unit of domestic currency—divided by an international price index in foreign currency.) An increase in this index signifies that the foreign currency equivalent of the domestic price index is increasing faster than the international price index. This is referred to as a real appreciation of the domestic currency, which implies that the country exporters are less competitive in international markets, while foreign producers are more competitive in the domestic market. The real exchange rate index is often expressed in "effective" terms, which take into account the relative importance of inflation and exchange rate movements in each trading partner.

sometimes used to counteract these pressures, but this often leads to credit rationing and capital flight. So, more than in industrial countries, tight money is a poor substitute for fiscal discipline.

Exchange rate policy on its own is also unlikely to be successful at stabilization. Public deficits often result in real exchange rate overvaluation because the additional pressure on domestic demand

drives up wages and prices. Tight monetary policy reinforces this tendency by raising domestic interest rates and attracting capital inflows. Devaluations of the currency without an accompanying fiscal correction will eventually be offset by increases in domestic prices and affect the real exchange rate only temporarily. Equally, when wages and domestic prices do not fall readily in nominal terms, a

95

fiscal contraction without a nominal devaluation is also unlikely to change the real exchange rate.

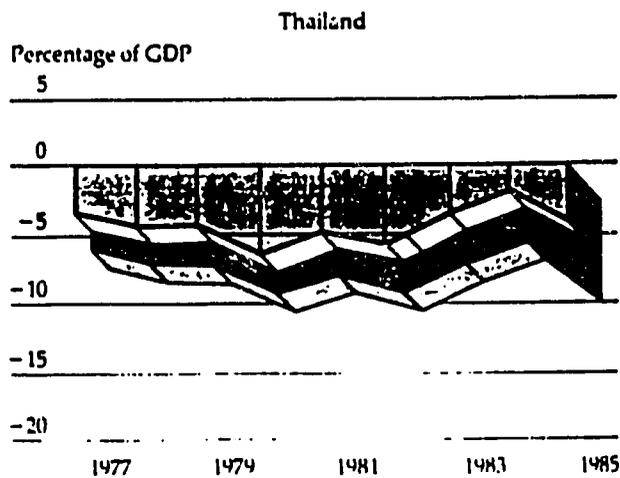
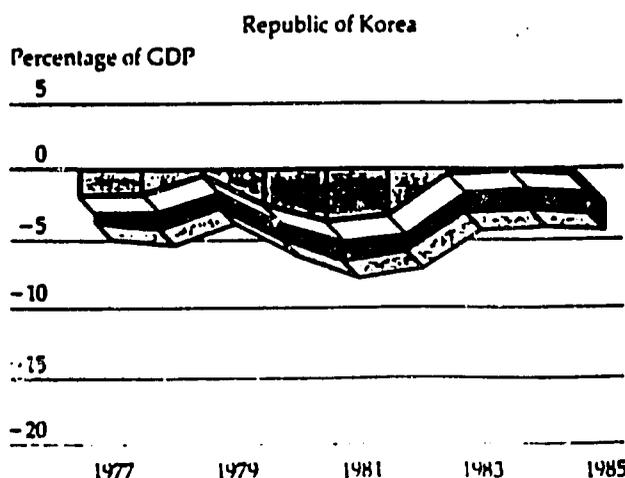
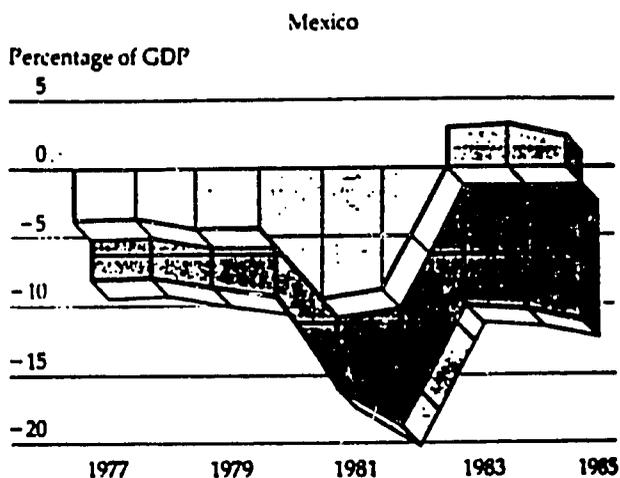
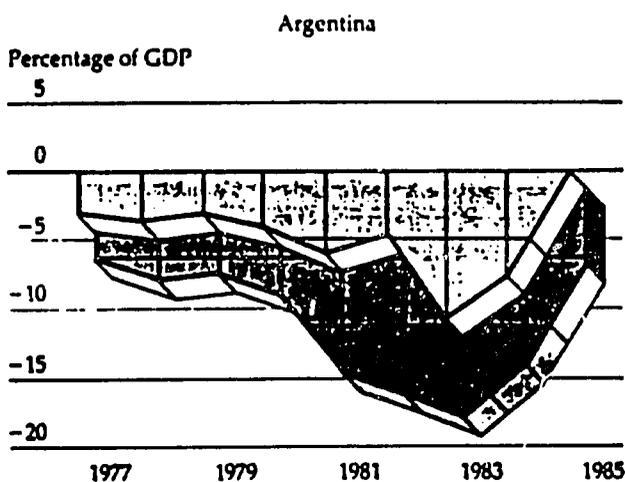
Figure 3.2 shows the pattern of real exchange rate movements for a sample of twelve countries representing middle-income debtors, commodity exporters, low-income countries, and countries that avoided debt-servicing difficulties through successful adjustment. The countries that stayed out of trouble had remarkably stable real exchange rates, thanks partly to stable fiscal policies. The other three groups saw expanding fiscal deficits in the late 1970s and early 1980s, and their real exchange rates appreciated during this period. After 1982 fiscal austerity accompanied by nominal devaluation began in these countries. The result was a sharp depreciation of the real exchange rate.

Nominal devaluations have an immediate effect

on public sector accounts because they revalue foreign currency income and expenditure in domestic currency. Whether the effect on the fiscal deficit is negative or positive depends on whether the public sector's spending on debt service and imports exceeds its income from exports and trade taxes and on how producer prices and public sector wages change. For example, an oil exporter would likely gain additional public revenue from a devaluation, while a debtor without significant public sector exports would more likely find that its extra expenditure was greater than its additional revenue. So the degree of fiscal squeeze needed to achieve a given reduction in the budget deficit following a devaluation varies according to whether the public sector is a net earner of foreign exchange.

Figure 3.3 Overall and primary public balances for four middle-income debtors, 1977 to 1985

□ Primary ■ Overall



6

bia also showed exceptional fiscal restraint by cutting expenditures while revenue was increasing sharply.

Careful fiscal management greatly reduced the macroeconomic side-effects of these countries' commodity booms. Inflation either stayed level or increased only slightly in Botswana, Cameroon, and Indonesia. During the boom the real exchange rate actually depreciated modestly in Cameroon and Botswana, while in Indonesia the appreciation was moderate compared with elsewhere. Exports of other goods were satisfactory in all three cases, and import growth remained within bounds.

Principles for managing commodity export cycles

One commonly stated principle for managing commodity price movements is that the revenue from temporary price increases should be saved, whereas income from permanent increases can be spent. Usually this precept was disregarded, or else price increases were erroneously assumed to be permanent. In one sense, though, the principle misses the point, which is that all commodity prices have been extremely volatile during the past decade. Classifying a particular shift as "permanent" or "temporary" in such an environment is uncertain. Policymakers therefore have to ask which sort of mistake is more costly. The cost of assuming a temporary price increase to be permanent is probably higher than that of assuming a permanent increase to be temporary. As the examples of Mexico, Nigeria, and others illustrate, it is often difficult to rein back spending that increased during a supposedly permanent boom—especially if boom revenue was leveraged through borrowing into even higher spending. Delays in adjustment to the fall in export prices lead to further debt accumulation. When the adjustment finally comes, it is more difficult because countries have to cope not only with lower commodity revenue, but also with increased debt service and reduced flows of new lending. A prudent strategy, therefore, is for the public sector to save a large portion of its commodity revenue.

The use to which these additional savings are put determines how quickly the government can respond to changed circumstances. The main alternatives are increasing the country's net foreign asset position (either through repaying debt or accumulating foreign deposits), reducing public domestic debt, or raising public domestic investment. Besides the drawbacks of increased public spending described above, public investment suf-

fers from the defect that it is difficult to reverse: new investment spending is hard to stop for projects under way, and it is usually difficult and time-consuming to sell physical assets once they have been acquired. All this suggests that any additional public investment financed by commodity revenue should be limited to highly profitable projects.

Although not completely without risk, foreign assets are highly liquid and thus can be sold quickly during bad times. Botswana has protected itself against downturns in the diamond market by increasing its foreign exchange reserves to cover two years' worth of imports. Repayment of debt reduces the public sector's exposure to unstable revenues and avoids the monetary pressures caused by reserve accumulation at the central bank. Cameroon (after 1978) and Colombia (in 1986) used their commodity revenues to repay public external debt. Reducing the government's net debt to the central bank would also reduce monetary expansion by offsetting ("sterilizing") the increase in foreign exchange reserves; Colombia used this method in 1986.

In addition many countries could usefully reconsider the balance between public and private saving during commodity booms. If governments save a high proportion of boom revenues, this can help the country to save enough in good times to provide resources for consumption in bad times. As discussed above, however, governments have often spent too much in booms. It may be better in many cases to allow private producers to retain more of the boom revenue, so that they can themselves save during good times to prepare for bad times. If private saving is thought to be inadequate, it may be due more to controls on financial markets, such as low deposit interest rates, than to any inherent defect in private savings behavior. Wise policy would try to facilitate both public and private saving during booms.

Adjustment in low-income Sub-Saharan Africa

In the 1980s low-income countries have faced economic problems similar to other developing countries. These problems include fiscal and external deficits, excess public indebtedness, overall economic contraction, and inflation. However, the problems in low-income countries have been particularly severe. The external debt problem has become even more serious than in the highly indebted middle-income countries, with little prospect for full debt servicing in the foreseeable

future. In 1986 the ratio of all external debt to GNP in low-income Africa was 88 percent, compared with 61 percent for the seventeen highly indebted middle-income countries.

The special difficulties of low-income economies arise from their limited flexibility, particularly in the financing of public expenditure. Yet the need to build up social and physical infrastructure makes heavy demands on budgets. External financing is mostly limited to official sources, domestic financing is restricted because of thin financial markets, and the tax base is usually narrow. These countries depend heavily on official development assistance: in low-income Sub-Saharan Africa official development assistance amounted to 12.2 percent of GNP in 1986. However, the way the aid flows were managed may have contributed to the severe adjustment problems that became apparent in the 1980s. The inflow of foreign exchange supported an appreciation of real exchange rates, excessive imports by urban consumers, and a resulting decline of export- and import-competing sectors in the late 1970s and early 1980s. The mismanagement of aid may also have contributed to low rates of domestic saving.

The scarcity of public financing has led these countries to rely on some highly distortionary means of financing, including heavy taxes on the main commodity export. These are usually implemented through low producer prices paid by the commodity marketing board or through differential exchange rates that penalize producers. Import tariffs are another important source of revenue. Low-income countries derive 38 percent of government revenues from international trade taxes, compared with 19 percent in middle-income countries. The revenue system of low-income countries is thus very fragile and subject to wide swings as external conditions change. Their high commodity taxes have also encouraged the growth of black markets and smuggling.

Fiscal and external deficits in Africa

Low-income African countries borrowed heavily in the late 1970s and early 1980s to finance consumption and domestic capital formation in the face of declining export prices and volumes. The fall in export revenues was the result both of their own bad policies, such as heavy taxation of export commodities, and of weak growth in export demand from the industrial countries. High fiscal deficits led rapidly to external borrowing because the level of domestic savings is low in most low-income

countries. In 1986 the average rate of gross domestic saving in all low-income countries besides China and India was only 8 percent of GDP, compared with 23 percent in middle-income countries. In Burkina Faso, Lesotho, Mozambique, and Somalia saving was negative in 1986. The corresponding levels of public and private consumption were unsustainable without external financing.

After 1980 official and private creditors and the countries themselves realized that the rate of public borrowing needed to be cut. The debt troubles of the highly indebted middle-income countries also contributed to a drop in lending to low-income countries. Total net lending to Sub-Saharan low-income countries fell from more than \$4 billion in 1980 to less than \$2 billion in 1985 (see Figure 3.7). Repayments of principal on past official credits, as well as a drop in new disbursements, were to blame.

The countries were forced to cut deficits sharply. In Kenya the primary deficit (that is, excluding interest) fell from 7.4 percent of GDP in 1981 to near zero in 1985, while in Malawi it dropped from 11.8 percent of GDP in 1981 to 1.0 percent in 1985. Interest payments increased in Kenya from 2.4 to 4.4 percent of GDP during the same period, however, while in Malawi they rose from 4.6 to 6.3 percent of GDP. This meant that the overall deficit improved about 2 percent of GDP less than the primary balance. As with middle-income debtors, external debt service (including both interest and amortization) was a large burden on the budget and amounted to 34 percent of current public revenue in Kenya and 44 percent in Malawi in 1985. Debt service was also a heavy burden on the balance of payments, although severe import restriction allowed current account deficits to improve in line with improved fiscal balances.

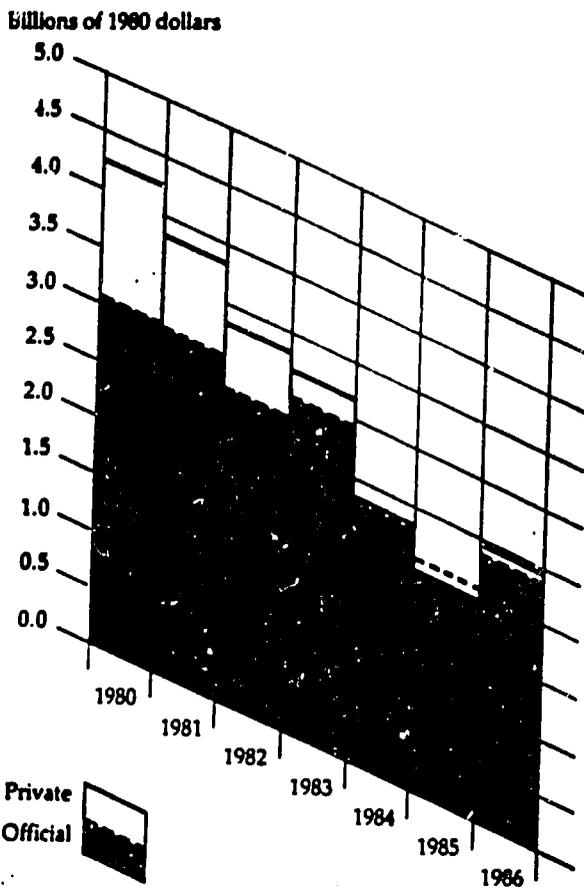
Negative rates of economic growth and more realistic exchange rates have dramatically increased the ratio of outstanding and disbursed debt to GNP in many low-income countries, despite the drop in net flows of new debt. In Malawi the ratio of public debt to GNP increased from 56 percent in 1980 to 71 percent in 1985, while in Kenya it increased from 32 to 51 percent, in Zaire from 43 to 112 percent, and in Zambia from 61 to 133 percent. Unfortunately adjustment to date has been at best a matter of running harder to stay in place.

Exchange rate management in Africa

Overvalued real exchange rates have been particularly common in Sub-Saharan Africa. They are at



Figure 3.7 Net flows of medium- and long-term debt financing to Sub-Saharan Africa, 1980 to 1986



Notes: Net flows are disbursements minus amortization of concessional and nonconcessional lending; figures do not include grants or short-term lending. The deflator used to convert to 1980 dollars is the manufacturing unit value index, which measures the average price of manufacturing exports by the five largest industrial countries. The solid line indicates the level of total net flows, and the dotted line indicates total net official flows. For 1985, net private flows are negative.
Source: World Bank 1987d.

the center of the macroeconomic management problems that many countries in the region have faced. The official exchange rate is used as a fiscal instrument in many low-income African countries, although not in the francophone countries, where the individual authorities do not control the exchange rate. Lacking an adequate tax base to finance desired spending, governments resort to taxing the mineral and agricultural export commodities, which account for a large share of the formal sector. Often this is done by maintaining an official exchange rate below parallel market rates

and requiring commodity exporters to sell foreign exchange at this rate to the central bank. Alternatively the government sets domestic producer prices with reference to the official rather than the parallel rate. The official exchange rate is also often used to subsidize certain sectors through the administrative allocation of foreign exchange to these sectors at the official rate. If the government's purchases of foreign exchange exceed its sales, then the tax implicit in the differential between the official and parallel exchange rates exceeds the subsidy to the private sector. The tax is distortionary because it discourages exports. Attempts to evade the tax lead to the growth of parallel markets in smuggled goods and foreign exchange.

Since 1982 many countries have sharply devalued their official exchange rate (see Figure 3.2). Official and parallel rates have converged, which has reduced the export tax and improved production incentives. However, the devaluations can be destabilizing: where other revenue sources are not found to replace the lost export tax, the result may be bigger fiscal deficits and an inflationary increase in money creation. Fiscal reform therefore needs to happen along with exchange rate reform (see Box 3.5).

The need for fundamental reform

As has happened elsewhere in the developing world, fiscal restraint in low-income countries has often damaged the prospects for long-term growth. Spending cuts have fallen disproportionately on public capital formation, as in the middle-income countries. Social services have been cut from already inadequate levels. A more selective way to reduce expenditure must be found, by eliminating subsidies to better-off consumers in favor of priority areas such as transport maintenance, primary education, and basic health. Chapters 5 and 6 discuss these issues in more detail.

The tension between stabilization and structural adjustment runs in both directions. Stabilization has sometimes made the task of structural reform all the harder—for example, when it has meant cutting productive investment. But structural reform can also set back efforts at stabilization. Low-income countries face this problem in a particularly acute form. They find it hard to reduce distortionary taxes, for instance, since the lost revenue is difficult to replace. Without a doubt these countries need to reduce the massive protection that they grant to inefficient industries, but the revenue role of tariffs cannot be lightly dismissed. No alter-

native revenue source could immediately compensate for the loss of revenue that would result from a sweeping liberalization effort. The implication is that trade liberalization must proceed in stages,

accompanied by matching fiscal reforms. Replacing quotas by tariffs and adopting more uniform tariff structures are two ways to reconcile liberalization and revenue goals in the short term.

Box 3.5 Exchange rate unification and fiscal balance

The effect on the fiscal balance of closing the gap between the official and parallel exchange rates can be seen in the experience of Ghana and Sierra Leone. Before 1983 Ghana had large fiscal deficits financed by printing money, strict foreign exchange rationing, high inflation, and a strong demand for foreign currency as a hedge against inflation. The black market exchange rate was a more accurate measure of the true value of the local currency (the cedi) than the official rate. The purchase and allocation of foreign exchange at the official rate levied an implicit tax on exports and granted an implicit subsidy on imports. The black market premium was generally more than 500 percent and reached more than 2,000 percent in 1982. Production of the key exports, cocoa and gold, fell sharply during 1970-82 in response to the prohibitive rate of implicit export taxation; real per capita incomes fell 30 percent. Because of the fall in exports and the lack of external financing, imports were severely compressed.

In April 1983 the Ghanaian government initiated its Economic Recovery Program. In October 1983 the official exchange rate was increased from 2.75 cedis/dollar to 30 cedis/dollar, at a time when the black market rate was roughly 90 cedis/dollar. The black market received formal recognition: special import licenses were granted to those who wished to bring imports in through the black market, provided the appropriate taxes were paid. Noncocoa exporters were allowed to retain a fraction of their foreign exchange earnings for debt service and approved imports. The Cocoa Board also had a retention account from 1983 to early 1987. In January 1986 the currency was devalued again to 90 cedis/dollar. The market was split into two tiers in September 1986. Only cocoa exports, debt service, and petroleum imports were to go through the official market, while raw materials and inputs were to pass through an auction market for foreign exchange; consumer goods were excluded. In February 1987 the markets were unified at the auction rate. Consumer goods were subsequently integrated into the auction except for a few prohibited items.

The stepwise devaluation of the official exchange rate was accompanied by fiscal reform to reduce the deficit, thus lessening the need for the export tax implied by the previous difference between the official and black market exchange rates. The fiscal deficit was reduced from 2.7 percent of GDP in 1983 to 0.7 percent in 1986. This was accomplished mainly by dramatically increasing tax revenue, from only 5.5 percent of GDP

in 1983 to 13.6 percent in 1986. This allowed the government to decrease its use of the "inflation tax." Wholesale price inflation fell from 81 percent in 1984 to 30 percent in 1986, despite the huge changes in the official exchange rate. Overall the Ghanaian experience is one of successful devaluation accompanied by fiscal reform.

Sierra Leone encountered greater difficulties with exchange rate unification. The local currency (the leone) was floated in June 1986, at a time when the black market rate was five times the official exchange rate. Inflation immediately accelerated from 57 percent for the twelve months preceding the float to 259 percent for the following twelve months. The monetary base increased by 151 percent from June 1986 to June 1987. In reaction, the official exchange rate was artificially fixed one year after the initial float. Since then few transactions have been occurring at the official rate.

The disappointing outcome reflected an underlying fiscal imbalance. During the preceding five years revenue had been greatly eroded; it fell from 16.1 percent of GDP in 1978-79 to 6.0 percent in 1985-86. The sharpest decline was in international trade taxes, reflecting the shrinkage of reported trade flows as goods moved into the parallel market, but domestic tax collections also fell. This chronic inability to collect taxes caused the deficit to increase to 14 percent of GDP in 1985-86. The deficit was financed through a combination of money creation and the implicit tax on exports arising from the difference between the official and black market rates. The effective elimination of the difference led to a drop in the export tax, so the rate of money creation had to rise. Maintaining consumer subsidies on staple foods and petroleum in the face of increased inflation and depreciation increased the deficit further. Thus for fiscal year 1987 the fiscal deficit was about \$6.7 million a month. The average monetary base for the fiscal year was the equivalent of \$44 million, so that inflation of about 15 percent a month was necessary to generate the "inflation tax" to finance the deficit. This was close to the actual inflation rate of about 11 percent a month for this period.

The experience of Sierra Leone illustrates that floating the official exchange rate by itself does not solve a macroeconomic imbalance—indeed, without accompanying fiscal reform it may actually make it worse. The Sierra Leonean float was implemented when the fiscal balance was out of control. Fiscal reform is often a prerequisite to unify dual exchange rates.

In summary, the fiscal problems of the low-income African economies are even more severe than those of the middle-income debtors and commodity exporters. Past fiscal deficits have left a legacy of debt that complicates their present adjustment efforts. Impressive reductions in fiscal deficits have been achieved, but they have by necessity focused on unsustainable short-term measures. The scarcity of public revenue sources is cramping attempts to correct structural distortions, such as large gaps between official and parallel exchange rates, high tariffs, and low producer prices for commodities. Fiscal reform is a way to resolve the dilemma. Broader revenue bases would make it possible for the low-income countries to reduce or eliminate some of their most distortionary taxes. A greater flow of external finance, together with selective debt relief, would help support reform.

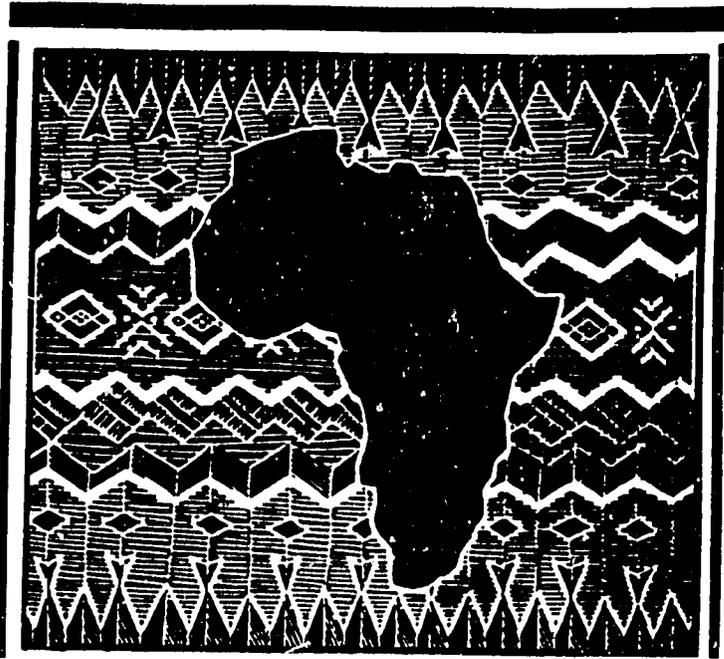
Fiscal policy and the growth imperative

The developing countries face a fiscal dilemma. On the one hand, departures from prudent fiscal policy have helped to create economic crises involving excessive debt and high inflation. Fiscal austerity in these circumstances was unavoidable. On the other hand, it is essential to restore growth, incomes, and employment. Several of the worst affected countries are in depressions as severe as the Great Depression of the 1930s.

One of the most important lessons from this situation is that overspending and unsustainable growth carry a high cost. Countries that followed stable macroeconomic policies were hurt far less by

the turbulence of the 1980s. For example, Thailand surpassed the Philippines, and Colombia outpaced Peru in per capita income in the 1980s, although the pairs were closely matched in the 1970s. The poor also fared much better in the stable economies, although the excessive public spending that helped to destabilize the other economies was sometimes carried out in their name.

The only way to resolve the tension between austerity and growth is to combine fundamental fiscal reform with other measures in trade, industry, agriculture, and finance. The recent progress toward short-term stabilization can now be supplemented with structural adjustment to restart growth. The contribution that sound public finance can make to this task is described in the following chapters. The narrow public revenue base in many developing economies can be expanded through improved tax administration and collection, new broadly based taxes such as the value added tax, and increased reliance on user charges for public services. This would make it possible to rely less on the "inflation tax," excessive trade taxes, and parallel exchange rates, all of which can do great economic harm. Public expenditure can be shifted toward infrastructure and away from subsidies for consumption and ill-chosen capital spending. Reforms in local government and state enterprises can also help to make public spending more effective and revenue less costly to raise. In these ways sound public finance—more perhaps than any other area of policy—offers opportunities to reconcile lower public deficits with long-term economic growth.



**Africa's
Adjustment and Growth
in the 1980s**

The World Bank and the UNDP

EXECUTIVE SUMMARY

Sub-Saharan Africa is often seen with despair as a continent in unrelenting decline. Its agricultural growth has been weak. Its earnings from exports, its terms of trade, and its capacity to import have declined precipitously in the 1980s — pulling down the region's income per capita. Compounding these conditions has been an enormous debt buildup (to more than 350 percent of exports) at a time of severely curtailed capital inflows. Net nonconcessional capital flows to the region shrank from more than US\$8 billion in 1983 to less than US\$1 billion in 1985.

Poor weather, civil strife, and other internal difficulties have also contributed to the region's woes, causing considerable human suffering. Although aggregate GDP growth has recovered on average over the past four years, GDP fell in 1987 and average growth rates remain below those in other developing countries.

A different view

On closer examination, however, the statistics commonly reported mask a more complex, less dismal picture. When recent trends are put in the longer perspective of the past 15 to 20 years — or when Sub-Saharan Africa is disaggregated into important country groups, including those that have, or have not, pursued significant policy reforms — the crisis seems less precipitous, and the road to recovery more obvious and more manageable.

Given the wide range of possible interpretations of Sub-Saharan Africa's recent trends, this report provides a longer historical perspective for viewing recent trends and disaggregates them so as to understand them better. Clearly, the diagnosis and prognosis for Sub-Saharan Africa depend on an accurate reading of how the current crisis arose, how severe it has been, and whether there are any recent signs of recovery.

External conditions

A longer historical perspective shows that the sharp drop since 1980 in Sub-Saharan Africa's export earnings, financial flows, terms of trade, and capacity to import is

more a return to the long-term trend (after a period of unprecedented highs) than a persistent decline. Total export earnings quadrupled from 1973 to 1980, but have fallen by less than half since then.

Moreover, Sub-Saharan Africa has not faced more adverse global conditions than other developing regions. In fact, the region has in many respects been more favored than other parts of the developing world.

Sub-Saharan Africa's overall terms of trade are higher (by perhaps 15 percent) than in the early 1970s; those for other developing countries are also up but by less.

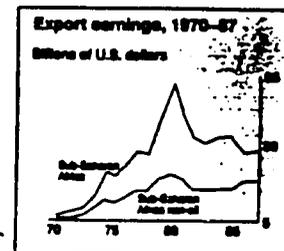
Primary commodity prices, when deflated by the price of manufactured imports, have generally declined in recent years. But the decline for nonoil commodities of Sub-Saharan African exporters has been only half as much since 1975 as that for all exporters of primary commodities. African exporters have been relatively better off than in other developing regions primarily because tropical beverage prices have remained relatively high, while cereal prices (for which Sub-Saharan Africa has few exports) have fallen sharply.

The picture for Sub-Saharan Africa as a whole can be misleading because the fortunes and misfortunes of five oil-exporting countries, which have accounted for nearly 60 percent of Africa's GDP and half its total exports, dominate trends for the region.

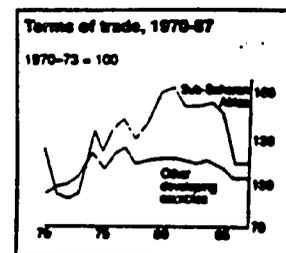
Nearly all the decline in export earnings and the terms of trade for the region since 1980 results from declining oil prices, which hurt the five oil-exporting countries but benefit the other 40 countries that import oil. When these five countries are excluded from aggregate statistics, the sharp rise and fall in export earnings from 1978-83 is muted, and 1987's nominal export earnings are higher than the average for 1978-83.

The terms of trade of nonoil exporters have been fairly level since 1981, but they are about a quarter lower than in the early 1970s. More important, for the IDA-only countries, a group least able to weather the ill effects of declining terms of trade, the terms of trade declined more — by some 40 percent — during the 1970s and have remained flat in the 1980s.

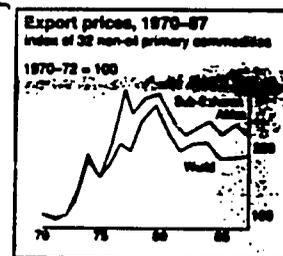
Export earnings fell, but most of the decline came from falling oil prices, which helped oil importers



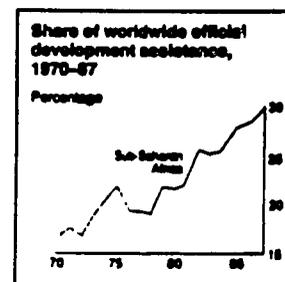
Africa's terms of trade, despite recent declines, are still 15% higher than in the early 1970s...



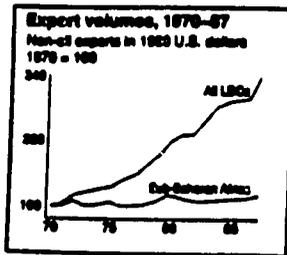
...as export prices in Africa have fallen less than elsewhere



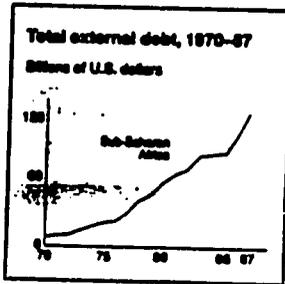
Sub-Saharan Africa's share of global ODA has also doubled



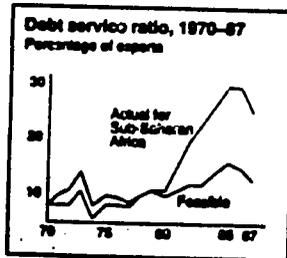
But exports haven't grown



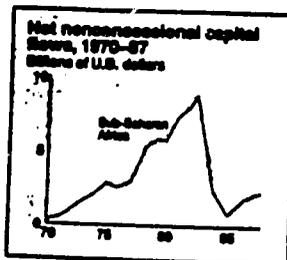
... while debt continues to mount



And Africa's debt service ratio is almost twice what it might be



Net nonconcessional capital dried up between 1981 and 1985, but has begun to flow again



Sub-Saharan Africa has had more favorable access to industrial countries' markets than most other developing regions. For example, Sub-Saharan exports to the European Communities — which account for three-fifths of their exports to industrialized countries — face virtually no tariffs.

Sub-Saharan Africa receives more official foreign assistance and debt relief relative to its GDP and population than any other region. The share of net official development assistance (ODA) disbursements going to Sub-Saharan Africa has nearly doubled in the past 15 years and continues to rise. The region now accounts for 30 percent of global ODA, while its population accounts for only about 12 percent of the total population of developing countries.

One of the main conclusions that can be drawn from this examination of recent trends and comparisons with other developing countries is this: Africa's crisis cannot be satisfactorily explained as the result of an adverse international economic climate, low commodity prices, or dwindling foreign assistance.

Domestic difficulties

Although many external conditions may have been better than commonly believed, evidence suggests that domestic problems and obstacles remain. Sub-Saharan Africa's population growth is the highest of any developing region. Domestic difficulties, including structural rigidities and institutional weaknesses, as well as poor policies have limited the ability of Sub-Saharan Africa to adjust from the exceptionally good years of the late 1970s and early 1980s.

Its real export growth lags behind other developing countries, and it had lost half its 1970 world market share by 1983. Nonoil export volumes have stagnated; the market share of primary commodities has shrunk; manufactured exports have not grown, in contrast to the aggressive performance of developing countries elsewhere.

The loss of competitiveness coincided with the growth of government controls and restrictions. Its real effective exchange rates remain high, with currencies overvalued by perhaps a third when compared with its competitors, limiting Africa's production incentives and competitiveness in the international marketplace. If African coun-

tries had simply maintained their 1970 share of nonoil primary exports from developing countries, their export earnings would have been US\$9-10 billion higher a year 1986-87. This shortfall is similar in magnitude to Sub-Saharan Africa's annual debt service payments, or donor assistance. Africa's export growth had matched that of other LDCs, its debt service ratio would be about half of what it is today.

In addition, structural rigidities in Sub-Saharan economies weaken and retard the response to better policies: infrastructure is sparse or degraded; technological options are limited; exports are highly concentrated in primary commodities; the manufacturing sector is limited in size and scope (manufactures account for only one sixth of exports); and domestic savings and investment rates are low. The institutional capacity to manage reforms and promote economic change is often limited or encumbered.

The windfall resources from the boom of the late 1970s — rather than accelerating the development process — led to unrealistic expectations, overextended borrowing on nonconcessional terms, distorted incentives to producers, and an unmanageable debt burden.

Encouraging signs

There are, however, signs of a turnaround. GDP grew more than 2.3 percent a year average in the three years 1985 through 1987, a clear improvement over the performance of the early 1980s. Furthermore, when the five oil-exporting countries are excluded, GDP grew 2.9 percent a year during the same period. And preliminary data suggest more vigorous growth in 1988.

Statistical anomalies have contributed to the pessimistic picture of Sub-Saharan Africa. The national accounts commonly reported for Sub-Saharan Africa are based on 1980 prices and exchange rates, which reflect both the volume of output and economic policies in that year. On this basis, Nigeria dominates the region, with a share of almost 50 percent. If 1987 exchange rates had been used — following Nigeria's 86 percent currency devaluation — the weight given Nigeria would be less than 20 percent. Rather than show stagnation in Sub-Saharan Africa from 1980-

64

these alternative aggregate statistics would show cumulative GDP growth of about 13 percent.

Agriculture has shown especially strong improvement. The annual rate of growth in agricultural output over the four years 1985-88 was triple that of the average over the previous fifteen — and exceeded population growth for the first extended period since 1970. This recent improvement diverges from a widely held perception that per capita agricultural production is declining in Sub-Saharan Africa, often cited as the clearest evidence of the region's problems.

In part because of the better growth in agriculture, Sub-Saharan Africa's combined share of world exports of 10 major nonoil primary commodities grew 30 percent during 1984-86, reversing the steady decline since 1970.

This encouraging economic performance coincides with bold policy actions by many African governments. They have instituted a wide range of reforms to increase economic efficiency, regain competitiveness in the international marketplace, and improve their fiscal and financial management.

More than half the region's countries have undertaken significant reforms. Devaluations in many countries have brought down their average real effective exchange rates, and the divergence between these rates in Sub-Saharan Africa and in other developing countries is beginning to narrow. Inflation (though still high) has fallen, and real interest rates (though still negative on average) have risen in countries with sustained reform programs. Many governments have improved incentives for farmers by raising producer prices for major

export crops and by liberalizing marketing structures for both food and export crops.

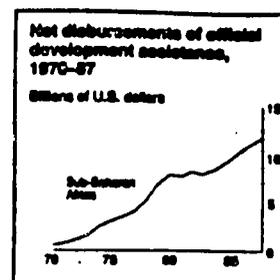
Governments that have sustained strong reform programs have succeeded in lowering the ratio of the fiscal deficit (before external grants) to GDP by a tenth since the early 1980s. But those with weak or no reform programs have allowed spending and deficits to rise. Expansion of the public enterprise sector has slowed considerably since the 1970s, and although the sector is still performing poorly, there are signs of improvement.

Donors have responded with increased aid and debt relief initiatives to alleviate resource constraints on future growth. Multilateral and bilateral aid has shifted to favor countries that have undertaken reforms. Net disbursements of ODA from bilateral and multilateral donors to such countries increased almost 20 percent a year during 1985-87 (even when adjusted for rising import prices). In contrast, countries not pursuing reforms have seen a decline in real net ODA.

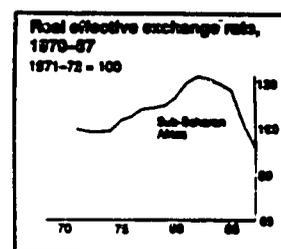
The large variations in recent trends among countries preclude strong conclusions. But when the performance of reforming countries is compared with that of nonreforming countries, there is evidence that the combination of reforms and added assistance has led to higher agricultural growth, faster export growth, stronger GDP growth, and larger investment — this, despite the less favorable terms of trade facing the reforming countries.

The evidence of the past three years leaves room for optimism. These encouraging signs, though still preliminary, augur well for the future.

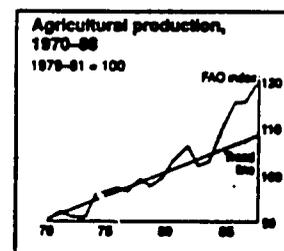
Net ODA disbursements have continued to climb



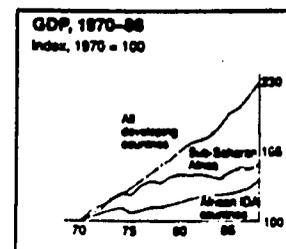
Policy improvements are evident in declining exchange rates



Agriculture is growing faster than population for the first time since 1970



And GDP growth, though still lagging behind that of other developing countries, has started to pick up



65

inflows. Savings rates in these countries nonetheless remain at about half those in the reforming countries.

Agricultural production, exports, and GDP have all improved. The growth of agricultural production more than doubled between 1980-84 and 1985-87 in countries that adopted important reforms. Countries without such reforms have seen their agricultural growth rates stagnate at the low levels that prevailed for both groups of countries in the early 1980s. Compared with countries where government controls food marketing and pricing, food production grew twice as fast in countries that have either recently liberalized food marketing or did not enforce controls: 19 percent between 1980 and 1987 compared with 10 percent.³³ Some of these differences must, however, be ascribed to differing weather patterns, as reforming countries in West Africa have had relatively favorable weather since 1985.

Export performance in reforming countries, which had deteriorated during 1980-84, improved substantially in 1985-87. In reforming countries, average annual export growth rates rose by five to six percentage points from the early 1980s to 1985-87. Aggregate volumes begin to rise when countries that have faced severe shocks — principally the oil exporters — are excluded. In contrast, average rates rose by only about half as much in nonreforming countries. Aggregate export volumes in nonreforming countries continue to decline.

The relative improvement in GDP growth in reforming countries is not evident until account is taken of strong external shocks (both positive and negative) that have affected some countries. Excluding countries recently affected by such shocks, annual GDP growth rates in reforming countries accelerated from just over 1 percent during 1980-84 to almost 4 percent on average in 1986 and 1987. By contrast, the growth

20 Summary of economic performance indicators

(average annual percentage change unless indicated otherwise)

Indicator	Period	All countries		Countries not affected by strong shocks	
		With strong reform programs	With weak or no reform programs	With strong reform programs	With weak or no reform programs
Growth of GDP (constant 1980 prices)	1980-84	1.4	1.5	1.2	0.7
	1985-87	2.8	2.7	3.8	1.5
Agricultural production	1980-84	1.1	1.3	1.4	1.8
	1985-87	2.6	1.5	3.4	2.6
Growth of export volume	1980-84	-1.3 (-11.0)	-3.1 (-0.9)	-0.7 (-4.7)	-5.7 (-2.1)
	1985-87	4.2 (-2.0)	0.2 (-2.5)	4.9 (3.5)	-3.3 (-6.0)
Growth of import volume excluding oil exporters	1985-87	1.7 (-7.7)	-2.7 (-3.0)	6.1 (7.4)	-4.0 (-2.2)
		4.8 (6.8)			
Growth of real domestic investment	1980-84	-8.1	-3.7	-3.5	-7.0
	1985-87	-0.9	-7.0	1.9	-4.8
Gross domestic savings (percentage of GDP)	1982-84	9.9	2.3	7.8	0.9
	1986-87	10.7	6.0	10.7	5.6
Growth of per capita consumption (real)	1980-84	-2.3	-1.1	-2.4	-1.5
	1985-87	-0.4	-0.5	0.7	-0.9

Source: See relevant sections in chapters 2 and 3.

Note: Country coverage varies by indicator depending on available data over the entire period covered. Averages are unweighted except as noted. Growth rates are computed using least squares. Periods are inclusive. Figures in parentheses are weighted averages of country growth rates based on total values summed across countries.

106



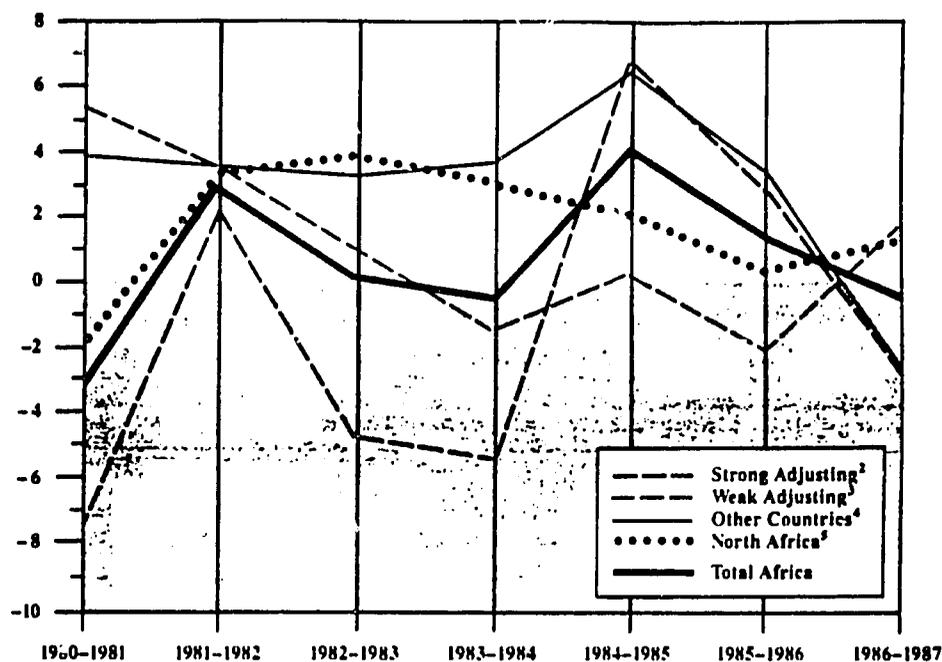
**African Alternative
Framework to Structural
Adjustment Programmes
for Socio-Economic
Recovery and Transformation
(AAF-SAP)**

*With the compliments
of the
Regional Commissions
Liaison Office*

67

64. Figure 3.1, which has been compiled from World Bank data files provides data for the growth of GDP at 1980 constant market prices for the period 1980-1987 for all African countries. Following the World Bank classification, four groups have been considered: (i) countries with strong structural adjustment programmes; (ii) countries with weak structural adjustment programmes; (iii) so-called non-adjusting countries of Sub-Saharan Africa; and, (iv) North Africa. Contrary to the findings of the evaluation of the impact of SAP published in a recent World Bank publication that "The evidence points to better overall economic performance in countries that pursue strong reform programmes than in those that do not ...",¹ gross domestic product growth data show that

Figure 3.1: Growth of Gross Domestic Product in Africa (constant 1980 US dollars, market prices; in percent)



for the first group of countries - those with strong structural adjustment programmes - recorded an overall negative average annual growth rate (about 1.5 per cent) during the period 1980-1987. The performance of this group, however, varied from year to year. At the initiation of adjustment programmes in 1980-1981, these countries registered a negative GDP growth rate of about 8 per cent followed by an improvement in 1981-1982. In 1982-1984, GDP growth declined significantly with some recovery being achieved in the 1984-1986 period, the latter followed again by a significant decline in 1986-1987. The second and third groups of countries - weak adjusting countries and non-adjusting coun-

¹ The World Bank and the UNDP, *Africa's Adjustment and Growth in the 1980s* (IBRD, Washington D.C., 1989); Refer to the Foreword, page (iii) para 6.

² Includes the following countries: Burundi, Central African Republic, Congo, Côte D'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Madagascar, Malawi, Mauritania, Mauritius, Niger, Nigeria, Senegal, United Republic of Tanzania, Togo and Zaire.

³ Includes the following countries: Benin, Burkina Faso, Comoros, Equatorial Guinea, Ethiopia, Liberia, Mali, Sierra Leone, Somalia, Sudan, Zambia and Zimbabwe. Rates exclude Comoros and Equatorial Guinea; 1986 and 1987 excluding Somalia

⁴ Includes the following countries: Angola, Botswana, Cameroon, Cape Verde, Chad, Djibouti, Gabon, Lesotho, Mozambique, Rwanda, Sao Tome and Principe, Sechelles, Swaziland and Uganda. Rates exclude Djibouti; 1986 and 1987 exclude Angola

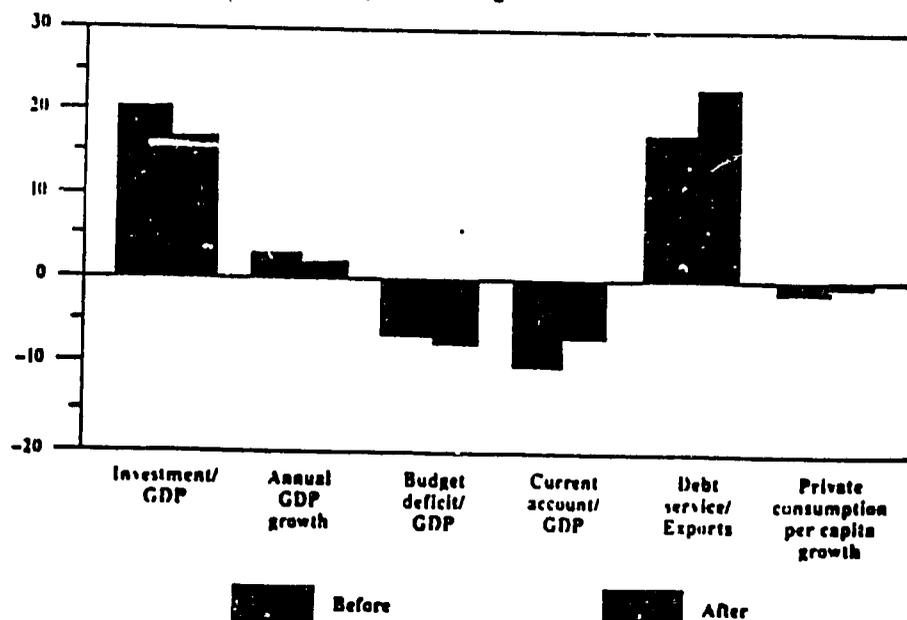
⁵ Includes the following countries: Algeria, Egypt, Libyan Arab Jamahiriya, Morocco and Tunisia.

tries achieved an overall average annual GDP growth rate of 1.2 per cent and 3.1 per cent, respectively, during the period 1980-1987. Although the latter two groups of countries also had varying annual GDP growth rates during the 1980-1982 period, they achieved annual positive growth rates throughout the period, except in 1983-1984 for weak adjusting countries, and 1986-1987 for the "other countries" when negative rates of growth were recorded. For North Africa, the average annual GDP growth rate for the period 1980-1987 was a positive 1.5 per cent with a negative rate of growth being recorded only during 1980-1981. The overall annual average growth rate for Africa as a whole was a relatively low 0.4 per cent, between 1980-1987, largely influenced by the poor performance of countries with strong adjustment programmes.

65. It should be pointed out that in each group of countries there are economies with both negative and positive growth rates during the period. The number of negative growth rates has depended partly on such exogenous factors as: weather, commodity market conditions, inflows of external resources, and the debt situation. Therefore, any attempt to establish a one-to-one relationship between growth trends and adoption or non-adoption of conventional structural adjustment programmes will be unrealistic and not credible, as it will not take into account the above exogenous factors in addition to structural deficiencies.

66. The above analysis is complemented by another evaluation carried out by the World Bank in 1988 which is illustrated in Figure 3.2. According to this, it is indicated that Sub-Saharan countries implementing structural adjustment programmes experi-

Figure 3.2 Indicators of the Sustainability of Adjustment for Sub-Saharan Countries implementing Bank/Fund Adjustment Programmes



Source: World Bank: Washington D.C., Report on Adjustment Lending, 8th August 1988. (Extract from Page 45).

enced after adoption of SAPs: GDP growth decline from 2.7 per cent to 1.8 per cent; a decline in the investment/GDP ratio from 20.6 per cent to 17.1 per cent; a rise in the budget deficit from -6.5 per cent to -7.5 per cent of GDP; and, a rise in the debt service/export earning ratio from 17.5 per cent to 23.4 per cent. The Figure also shows that there has been only a minor improvement in the current account/GDP ratio from -9.4 per cent to -6.5 per cent.

CHAPTER Five:

Policy Directions and Instruments

1. Introduction

93. Having outlined the macro-framework for the alternative adjustment and transformation path in Chapter 4, this Chapter sets out to operationalize this framework by recommending the policy directions, instruments and measures which African countries should adapt to their own peculiar and unique circumstances. As will become clear in the Chapter, the African alternative incorporates a number of policy areas which form part of many of the existing structural adjustment programmes, and on which some broad consensus seems to have emerged however. The most important of these include: (a) improved financial management and efficiency of public enterprises and tighter financial accountability; (b) improved agricultural incentives; (c) export diversification, mainly in processed agricultural products; and, (d) improved external debt management. It also incorporates a number of areas on which consensus has yet to emerge. These include, among others, the issue of complementarity in exchange rate and trade policies, the fallacy of composition in respect of competitive stimulation of the same range of traditional export crops in African countries, and the sustainability of non-autonomous resources to support adjustment in all African countries. The proposed framework, given its holistic approach, naturally addresses all these issues in a coherent and integrated manner rather than merely treating them in isolation or as remedial additions to existing adjustment programmes.

94. In operationalizing the African Alternative Framework to Structural Adjustment Programmes for Socio-Economic Recovery and Transformation (AAF-SAP), it is essential to point out that all countries - developed or developing - find it necessary to adjust from time to time to changing economic parameters and circumstances. What often constitutes the difference is not in regard to the need to adjust but in the capacity to adjust to changing economic circumstances. This, in turn, depends on the leeways and options open to the different countries in terms of the time horizon of adjustment, their structural characteristics and long-term development objectives. It is in the light of these that the modus operandi of the adjustment process are determined. What has become clear from the analysis in the preceding Chapters is indeed not that the symptoms and serious indications of these problems, for example, balance of payments disequilibrium, fiscal imbalance, inflationary pressures and acute shortages of goods are to be wished away or passed off unaddressed. On the contrary, Africa has to adjust. But, in adjusting, it is imperative that it is the transformation of the structures that fundamentally serve to aggravate the African socio-economic situation that constitutes the focus of attention. As such, adjustment and transformation must be conceived and implemented as inextricably linked and intertwined processes such that progress will be made simultaneously on the two fronts.

2. Major Policy Directions in AAF-SAP

95. Given the structural bottlenecks in African economies, adjustment must be seen as part of a continuous process of transformation rather than as a discontinuous exercise on its own. Consequently, the siege-mentality of ad hoc crisis management approach must yield place to the total immersion of adjustment programmes with the long-term needs of transformation since adjustment policies and measures are unlikely to yield any full and enduring benefits outside the context of transformation. It is in this framework that the major policy directions outlined below must be pursued.

96. It should be evident that the policy directions have to be intimately related to the analysis of the African political economy in Chapter 1 and the development objectives in Chapter 2. This is so because, conceptually and operationally, the policy directions provide the broad guidelines for overcoming the structural bottlenecks of the African economies and for the subsequent attainment of the region's development objectives. Also, the policy directions should serve as general bounds that will characterise the specification of, within the context of the proposed macro-economic framework, the models for individual African countries and for the subsequent choice of policy instruments and measures specific to a given country.

97. Within the context of strengthening and diversifying Africa's production capacity and the productivity of investment, which is at the centre of the generation of factor product (module 1) the following are the major policy directions:

- (a) Enhanced production and efficient resource use: This involves mainly the systematic avoidance of constraining productive capacity for the mere purpose of achieving financial balances. In other words, in as much as the resources involved can be allocated and utilised efficiently and productively, the logic of always having to balance the budget at the expense of growth and production must be resisted. Such productive and efficient use of resources would, in itself, involve a policy change to bring about significant shifts towards the production possibility curve and increasing returns to investment.
- (b) Greater and more efficient domestic resource mobilisation: It must be recognized that, at present, there are too many financial leakages - fiscal, monetary, external payments, capital flight, etc. - all of which need to be plugged in order to enhance resource mobilisation for investment and budgetary expansion. This is all the more important in view of the uncertainties surrounding the quantum of external resource flows to Africa, and the increasingly stiff conditionalities attached to such inflows. Given the existing international economic environment, there is little hope of adequate resource inflows being available to all African countries on a sustainable basis for adjustment and transformation. Even if such resources could be attracted, it is almost certain that the terms and conditions on which they would be made available would be such as to offer mere temporary relief to the African countries and serve more to aggravate and deepen their structural problems and deficiencies.
- (c) Improving human resources capacity: One important aspect of this policy direction is that reductions in budget deficits must not be accomplished at the expense of expenditures on the social sector, i.e., education, health,

and other social infrastructure, including the maintenance of law and order, which are prerequisites of an enabling environment. Recognition of the paucity of human capital as a limiting factor on the enabling environment for transformation in Africa and of the relative neglect of this sector during the 1980s dictate that efforts must be made to ensure that an annual average of at least 30 per cent of total government outlays is devoted to the social sector and that, in any case, the annual rate of growth of social investment is significantly higher than the population growth rate.

- (d) **Strengthening Scientific and Technological Base:** The medium- and long-term perspectives of structural transformation require an adequate scientific and technological base essential for transforming national raw materials in the form of agricultural products, minerals, forestry and aquatic resources into consumable goods and services both for local and export markets. The strategy for achieving these objectives and the main issues involved are: (i) having a Chapter in national socio-economic plans on science and technology policies which reflect the role, development and application of science and technology essential for meeting the socio-economic needs of the people; (ii) enhancement of endogenous capacity to deal with the development and application of science and technology by strengthening the scientific and technological infrastructures, by establishing a technologically-focused educational system, by improving the quality of manpower training, by linking production with indigenous research efforts, and by having appropriate personnel and mechanisms for commercializing the results of research undertaken in universities and research institutes; (iii) finding alternatives to the export of raw materials by the development of new products and processes, and ensuring the competitiveness of African products in view of the advent of new and emerging science and technology which has a direct impact on African products and raw materials and the bio-engineered products that are supplanting Africa's basic products on the world market and affecting adversely their competitive base; and (iv) the development of an endogenous capacity of a harmonized sub-regional and regional policy that will enable the implementation of joint multinational projects and the optimization of available scarce resources.
- (e) **Vertical and Horizontal Diversification:** The first crucial dimension of diversification is that of producing essential goods and services to meet the needs of the majority of the population in all sectors. The second dimension of diversification relates to the need to lessen mono-culture export dependence and its associated instability in terms of earnings. This would necessitate export re-orientation, involving the widening of the existing narrow range of exports and export markets to include an increasing share of processed commodities and manufactured goods, and refocussing on African markets.

98. It should be stressed that the pattern and level of factor income allocation (module 2) is very important in the process of adjustment with transformation as it greatly influences the dynamics and patterns of production, the effective size of

domestic markets as well as the alleviation of mass poverty. In this regard the following policy directions are basic:

- (a) **Establishing a pragmatic balance between the public and private sectors:** In determining such balance, the main criteria should be the availability of local entrepreneurial capability and the optimum social and economic rates of return on investment. It should, however, be noted that there are areas such as the building of the physical, human and institutional infrastructure, environmental protection and conservation as well as the provision of essential services in which the public sector has a role to play, especially given the present level of development in African countries. But where the State has over-extended itself, particularly in non-social service and non-strategic sectors, selective privatization should be considered.
- (b) **Creating an enabling environment for sustainable development:** This policy direction includes a number of important factors among which are broad participation in decision-making, consensus building, maintenance of equity and justice, elimination of civil strife and instability, facilitation of access to opportunities for all, and creating a favourable investment climate. In line with the policy direction in paragraph 97 (a) above, the enabling environment should incorporate the issue of encouraging entrepreneurship and the effective contribution of the private sector and grassroot initiatives to the development process through consistent policies and appropriate incentives.
- (c) **Shifting of resources:** This policy direction should aim at minimising non-productive expenditures and excessive military spending. In Africa, where needs are greatest, social priorities have increasingly taken a second place to defence spending. The significance of budgetary disparities between public welfare and defence is illustrated by estimates which show that, in the mid-1980s, developing Africa spent less public resources on education than on the military, in contrast to Latin America where expenditure on education is double that of defence. The military-social imbalance is further reflected in the fact that, in Africa, annual public expenditures on health have, on average, accounted for less than a third of military outlays. It is not difficult to imagine what it would mean to social welfare in Africa, with all its positive multiplier effects, if a saving can be achieved in defence spending and in non-productive expenditures. It is of course understood that for African countries facing unabated external aggression and destabilisation, this policy direction may be difficult to pursue until the external destabilising forces are removed.
- (d) **Improvements in the pattern of income distribution among different socio-economic categories of households:** This constitutes an important element of adjustment with transformation as it has direct impact on the size of domestic markets for domestic products and the alleviation of mass poverty. It should be reiterated that to pursue this policy direction also entails ensuring that, in the generation of output, the poor and the disadvantaged will have increased access to the means of production, especially land.

99. The pattern of expenditure of income for the satisfaction of the required needs (module 3) is an essential component in the adjustment with transformation process.

Therefore, the following policy directions are basic:

- (a) **Food self-sufficiency:** In this regard, policy emphasis will have to be put on achieving a proper balance between the food subsector and the production of agricultural export commodities. This will have to necessarily reverse the present trends of adopting policies that tend, especially in terms of price incentives, to create a bias against the food subsector and to favour the production of export commodities.
- (b) **Lessening import dependence:** In order to ensure a sustained and sustainable satisfaction of the critical needs of the population, it is necessary to move away from the present situation whereby most of the essential needs, intermediate inputs and capital goods in African countries are generally satisfied from imports.
- (c) **Re-alignment of consumption patterns with production patterns:** This will call for a change in consumption habits so that the people will start to consume more of what is domestically produced, especially in the areas of food, clothing, housing and other essential necessities. It is important also that the opportunities for exchange and trade in basic food staples and in other essential goods be widened both at national and sub-regional levels, with a view to enhancing national and sub-regional collective self-reliance.
- (d) **Managing debt and debt-servicing:** In order to release the scarce and badly needed foreign exchange resources, it is necessary to establish strong debt management systems. This would involve, *inter alia*, a continuous assessment of payment capacity in the short- and long-term. It would also have to entail the rationalisation of debt accumulation by concentrating future external loan resources on productive projects that have quick and high returns with substantial foreign exchange component.

3. Policy Instruments and Measures for Adjustment with Transformation

100. The policy directions outlined above will necessitate the use of a number of policy instruments and measures for achieving the goals of adjustment with transformation. They also call for the modification or avoidance of certain policy instruments and measures.

101. The policy instruments and measures that must be modified under AAF-SAP are in Table 5.1. They are inappropriate for the process of adjustment in African countries given the structural rigidities and the desired goals of transformation and sustained development of the African economies already outlined in Chapters 1 and 2. They include: (a) practices that, *de facto*, lead to excessive dependence on the market mechanism; total price and import liberalisation; (b) doctrinaire privatisation; (c) inflation-adjusted interest rates; (d) across-the-board credit squeeze; (e) total elimination of subsidies; (f) generalized devaluation; (g) indiscriminate promotion of traditional exports; and, (h) deflationary budgetary measures, especially drastic reductions in public spending. It will be seen from Table 5.1 that these policy instruments and measures will have negative impact on adjustment with transformation. Although they might provide temporary relief in respect of internal and external

financial balances, they are more likely to aggravate the crisis in the long-run, particularly if non-autonomous resource flows to the countries concerned were to dry up. These policy instruments, together, would lead to the inappropriate sequencing illustrated by figure 4.1 in Chapter 4.

Table 5.1: Summary of Policy Instruments and Measures to be modified under AAF-SAP	
Description of Policy Instrument and Measures	Effects for adjustment with transformation
1. Drastic budgetary reductions, especially with respect to expenditures and subsidies on social services and essential goods.	Undermines the human conditions, the enabling environment and the future potential for development; necessitates massive retrenchment in the public sector.
2. Indiscriminate promotion of traditional exports through price incentives offered only to the "tradeables".	Undermines food production and self-sufficiency, and can lead to undesirable environmental degradation; could result in over-supply and fall in prices (fallacy of composition).
3. Across-the-board credit squeeze.	Leads to overall contraction of the economy; declines in capacity utilisation and closure of enterprises; and an accentuated shortage of critical goods and services.
4. Generalised devaluation through open foreign exchange markets, currency auctions and large and frequent currency depreciations.	Leads to socially unsupportable increases in prices of critical goods and services; raises the domestic cost of imported inputs and undermines capacity utilisation; triggers general inflation; diverts scarce foreign exchange to speculative activities and exacerbates capital flight; worsens income distribution patterns; undermines growth and can result in structural entrenchment of traditional exports through price incentives for such commodities or "tradeables".
5. Unsustainably high real interest rates (inflation-adjusted nominal rates of interest).	Shifts the economy towards speculative and trading activities by becoming a disincentive to productive investment; fuels inflation.

Description of Policy Instrument and Measures	Effects for adjustment with transformation
6. Total import liberalisation..	Leads to greater and more entrenched external dependence; intensifies foreign exchange constraints; jeopardises national priorities such as food self-sufficiency; erodes capacity of infant industries and thereby slows industrialisation.
7. Excessive dependence on market forces for getting the "prices right" in structurally distorted and imperfect market situations.	Worsens inflation through sharp rises in production costs and mark-ups; causes deviations from desirable production and consumption patterns and priorities, and may derail entire process of transformation.
8. Doctrinaire Privatisation.	Undermines growth and transformation; jeopardises social welfare and the human conditions.

102. In line with the proposed framework, the desirable policy instruments and measures have been categorized into three groups; each group comprising of a set of policy instruments and measures consistent with the range of policy directions outlined in paragraphs 97 to 99. These three groups are: (a) strengthening and diversifying production capacity; (b) improving the level of income and the pattern of its allocation; and, (c) expenditure of income for satisfaction of critical needs. In addition there are institutional support measures required to ensure the efficient operationalization of AAF-SAP.

Table 5.2: Summary of Proposed Policy Instruments and Measures under AAF-SAP	
Description of Policy Instrument and Measures	Effects for adjustment with transformation
A. Strengthening and Diversifying Production Capacity	
A.1 Land reforms for better access and entitlement to land for productive use; enhancement of the role of women as agents of change and the modernization of the food production sector.	increased production and opportunities for gainful employment; poverty alleviation and more equitable income distribution.

Description of Policy Instrument and Measures	Effects for adjustment with transformation
<p>A.2 Devoting at least 20-25 per cent of the total of public investment to agriculture.</p>	<p>improved rural infrastructure and agricultural institutions; increased agricultural productivity; expansion of rural employment.</p>
<p>A.3 Allocation of an increasing share of foreign exchange for imports of vital inputs for agriculture and manufacturing sectors; expansion of agricultural and industrial employment; increased domestic output of essential commodities and avoidance of import strangulation; and increased interlinkages between agriculture and industry;</p>	<p>satisfaction of critical needs.</p>
<p>A.4 Sectoral allocation of credit using credit guidelines that would favour the food subsector and the manufacture of essential goods.</p>	<p>increased production of food and essential manufactured goods; increased gainful employment.</p>
<p>A.5 Adoption of investment codes and procedures tailored to the promotion and development of small-scale industries.</p>	<p>better enabling environment with greater involvement of local entrepreneurs.</p>
<p>A.6 Use of selective nominal interest rates in such a way that interest rates on loans for speculative activities would be greater than the rates on loans for productive activities, and resulting weighted real interest rates for savings would be positive.</p>	<p>increased mobilisation of domestic savings; reduction of speculative activities; shifting resources to productive activities.</p>
<p>A.7 Creation and strengthening of rural financial institutions.</p>	<p>increased mobilisation of rural savings and improved financial intermediation.</p>
<p>A.8 Rehabilitation and rationalisation of installed productive and infrastructural capacities; and setting up of an effective national maintenance system.</p>	<p>fuller capacity utilisation; economic growth; savings in foreign exchange.</p>

Description of Policy Instrument and Measures	Effects for adjustment with transformation
<p>A.9 Utilizing the existence of <u>de facto</u> multiple exchange rates systems in a rationalized manner and/or creating and streamlining such a system for purposes of resource transfers, resource mobilisation and reversal of capital flight and ensuring availability of essential imports.</p> <p>A.10 Creation of a special fund for loans at subsidized interest rates to certain groups of economic operators.</p>	<p>encouragement of capital inflows, especially by nationals working abroad, and discouragement of capital flight; improvement in balance of payments; satisfaction of critical needs.</p> <p>encouragement of greater productive activity. Description of Policy Instruments and Measures Effects for adjustment with Transformation.</p>
<h3>B. Improving the Level of Income and the Pattern of its Distribution</h3>	
<p>B.1 Enlarging the tax base, improving efficiency and probity of the tax collection machinery.</p>	<p>increased government revenue.</p>
<p>B.2 Reduction of government expenditure on defence as much as possible, and on non-productive public sector activities.</p>	<p>release of resources for investment; improvement in resource allocation; improvement in balance of payments.</p>
<p>B.3 Removal of subventions to parastatals other than those in the social sector and nationally strategic basic industries.</p>	<p>release of resources for productive investments; better fiscal balance.</p>
<p>B.4 Use of limited, realistic and decreasing deficit financing for productive and infrastructural investments that have little import content.</p>	<p>sustaining growth through support to relevant production units.</p>
<p>B.5 Guaranteed minimum price for food crops managed through strategic food reserves.</p>	<p>food production on a sustained basis; assured income to farmers; increased access to food for majority of the population; control of inflation.</p>

Description of Policy Instrument and Measures	Effects for adjustment with transformation
C. Pattern of Expenditure for the Satisfaction of Needs	
<p>C.1 Expenditure-switching (without necessarily increasing total government spending) to raise government outlays on the social sectors, particularly those aspects of education, health and the integration of women in the development process that are likely to increase productivity, such that an average of 30 per cent of total annual government outlays is devoted to the social sectors; and, thereafter to maintain a growth rate in public outlays on these sectors at above the population growth rate.</p>	<p>satisfaction of critical social needs; investment in human capital; raising living standards of majority of the population.</p>
<p>C.2 Selective policies through subsidies, pricing policies etc., to increase the supply of essential commodities required for maintaining a socially-stable atmosphere for development.</p>	<p>increased affordability of essential goods and services as well as critical intermediate inputs; increased production of industrial raw materials; control of inflation.</p>
<p>C.3 Selective use of trade policy, including banning of certain specified luxuries; high tax rates on conspicuous consumption and competitive factor inputs that have domestic substitutes; and mass education towards consumption of domestic goods.</p>	<p>changes in consumption patterns; enlargement of markets for domestic goods; changes in production patterns; internalisation of production of factor inputs; improvements in balance of payments.</p>
<p>C.4 Strengthening intra-African monetary and financial cooperation as well as payments and clearing arrangements.</p>	<p>increased self-reliance and capacities to finance adjustment with transformation.</p>
<p>C.5 Limitation of debt service ratios to levels consistent with sustaining and accelerating growth and development.</p>	<p>freeing of resources for productive activities to sustain adjustment with transformation; improvement of balance of payments position.</p>
<p>C.6 Specific export incentives for processed exports and carefully-selected primary commodities.</p>	<p>increased diversification; reduced vulnerability to fluctuations in commodity prices; export growth and increased export earnings.</p>

Description of Policy Instrument and Measures	Effects for adjustment with transformation
<p>C.7 Differential export subsidies; removal of trade barriers; and encouraging barter trade to boost intra-African trade.</p> <p>C.8 Bilateral and multilateral agreements on primary commodities.</p>	<p>reduced external dependence and better product mixes and integration in Africa.</p> <p>improved and more stable balance of payments.</p>
<h3>D. Institutional Support for Adjustment with Transformation</h3>	
<p>D.1 Creation of adequately funded "supervised food production credit systems" in rural areas with easy access by farmers in terms of limited collaterals etc.</p>	<p>sustained increase in food production and adoption of technologies to reduce vulnerability to weather through increased investments in areas like small irrigation schemes.</p>
<p>D.2 Strengthening agricultural research focussed on production; creation of extension services and systems for the diffusion, application and operationalisation of research.</p>	<p>will accelerate process of achieving a green revolution in Africa especially in the five food crops that are basic to food self-sufficiency in the region. (maize, sorghum, millet, rice and tubers) as well as accelerate the building up of a viable industrial base.</p>
<p>D.3 Creation of rural institutions to support cottage industries and small scale industries with emphasis on indigenous technology, domestic finance, rural infrastructure and women participation.</p>	<p>promotion of integrated rural development; enhancement of the attractiveness of rural areas; promotion of rural technological development; employment generation.</p>
<p>D.4 Legislation of a clear framework of ownership and participation of the different socio-economic groups such as rural cooperatives, artisans, traders etc.</p>	<p>will enable popular participation in production, marketing and development in general; and the strengthening of the informal sector and its ultimate integration into the mainstream of development.</p>
<p>D.5 Establishment of community development institutions especially indigenous NGOs and self-help programmes.</p>	<p>will enable use of direct community labour on a voluntary basis for the provision of rural infrastructure such as feeder and access roads, health centres and dispensaries, school buildings and small irrigation schemes.</p>

Description of Policy Instrument and Measures	Effects for adjustment with transformation
D.6 Greater mass participation in decision-making and implementation of programmes.	greater confidence of the people in their own societies and government; greater commitment to and sacrifices for development; more efficient of highly motivated human resources.

103. Notwithstanding the diversity of the policy instruments and measures in Table 5.2, there will be need for flexibility in the articulation, design and choice of national policy packages, taking into account the circumstances in individual African countries and how they evolve over time. Policy packages may also differ from one period to another even in the same country, in respect of the policy instruments and measures employed and how they are combined. However, whatever policy instruments and measures are chosen by a country, it will be necessary to ensure that there are policy instruments and measures selected from each of the four categories outlined above.

104. In order to keep the policy instruments and measures in Table 5.2 in proper perspective, they should be read and viewed in the context of the sequencing of the process of adjustment with transformation illustrated in figure 4.2 of Chapter 4 whereby the economy, through appropriate changes in policy directions, and through the adoption of appropriate policy packages deriving from the proposed framework, achieves adjustment and transformation simultaneously.

105. While the policy instruments in Table 5.2 necessarily derive from the structure of the proposed framework, and its corresponding policy directions, it is essential to bear in mind the specific rationale for the choice of the different policy instruments or measures. This is briefly attempted below in terms of the anticipated or associated effect(s) of some of the policy instruments and measures on the goals of adjustment with transformation.

106. In respect with strengthening and diversifying Africa's productive capacity, emphasis has to be on accelerated rates of capital formation, adequate subsidies for fertilizers and other farm inputs for food production, and greater budgetary and foreign exchange allocations to the food and agricultural sectors as well as to industries producing basic essential goods. To reorientate production activities towards those producing basic essential goods as well as critical capital and industrial inputs, preferences will have to be given to the food sub-sector and to some manufacturing sub-sectors in terms of access to credit and the cost of credit. The banking system may be required to lend larger proportions of its resources to these "preferred" activity areas and to charge lower interest rates on such loans compared to the rates on loans to other activities. The adoption of appropriate investment codes and procedures tailored to the needs of small-scale investors and industries will encourage the creation of a better enabling environment for greater participation of local entrepreneurs in the development process. Land reform is also a very important and necessary instrument to ensure gainful employment to the vast majority of the population. As major agricultural producers, especially of food, women must receive particular attention. Their role can be enhanced through, *inter alia*, increased access to land, credit, farm inputs and more modern technology.

107. If greater domestic resource mobilisation is to take place and the forces of growth and development internalized in Africa, it follows that there must not be excessive financial liberalization which aim at driving up real interest rates to levels that become counter-productive and inimical to the small modern sector and are, in any case, of little or no relevance to savings decisions in vast segments of the economy, especially the rural areas and the informal sectors. Rather, more domestic resources would have to be mobilized largely through the encouragement of thrift and financial deepening and the use of nominal interest rates which are attractive enough to encourage savings. To promote the mobilisation of savings in the rural areas and enhance the intermediating role of financial institutions in the savings-investment process in the economy, rural money and credit structures need to be established and/or strengthened. By adopting multiple exchange rates for resource transfers, it should be possible to encourage greater home remittance by nationals working abroad and at the same time discourage capital flight. By strengthening intra-African monetary and fiscal co-operation as well as payments and clearing arrangements, it will be possible to reduce Africa's external financial dependence and increase the capacity of its countries to finance adjustment with transformation without the constraints of foreign exchange.

108. In respect of increased efficiency in the allocation and judicious use of resources, there will be need for expenditure-switching in the form of curtailment of government expenditures on defence and non-productive activities, removal of subventions to parastatals other than those in the social sector or nationally-strategic basic industries, and the limitation of debt service ratios to proportions that would not be detrimental to productive activities so as to ensure economic growth. To promote a more efficient allocation of available loanable funds, higher lending rates must be prescribed for loans for speculative purposes and general trading than for productive activities. The programmes of adjustment with transformation should be such as to reduce inflationary pressures which give rise to a number of social and economic distortions such as diverting activities away from productive investment to speculation and financial manipulation; worsening income distribution patterns; capital flight and reduced savings. Taking into account the structural origin of inflationary pressures in African countries, the relevant policy measures should center principally on production expansion. In addition, budgetary restraint especially with respect to reductions in government spending on non-productive and marginally productive activities should form part of the strategy of controlling inflation.

109. In the satisfaction of individual and national needs, it is necessary to embark on selective trade policies, involving elements of import controls and import management, particularly the prohibition of non-essential imports, tariff protection and quota restrictions to support changes in consumption patterns; encourage the production and use of local inputs; and promote viable infant industries. Thus industrialization, which has to be fostered vigorously if the internalization of the forces of production and the creation of greater internal dynamics are to be achieved, will have to proceed under an umbrella of some import protection if it is to succeed.

110. The whole issue of export promotion and revitalisation of the traditional export sector has to be approached in a selective manner, and not just through generalized devaluation. There is need for African countries to take steps to diversify away from the existing mono-culture of exports both in order to increase their range of options and reduce reliance on commodities which have very limited growth potential. In spite of the immediate gains from maximising returns from a static comparative advantage, the requirements of adjustment with transformation are such that governments should build into their programmes incentives which create a longer-term, dynamic comparative advantage based on new production structures and processing.

Export incentives need to be deliberately selective, recognizing the differentials in opportunities as between sectors and products for breaking into export markets and for expanding existing market shares. The appropriate levels of price incentives that need to be put in place will vary also from commodity to commodity, depending on world prices, import content, marketing margins, prices in neighbouring countries, prices of competing commodities, required contributions to fiscal revenue, etc. Further, scarce foreign exchange resources available for spending on the export sector need also to be assigned to those commodities able to generate the largest net foreign exchange returns. Such pricing and resource allocation decisions cannot be left entirely to the market in the African countries given the severity of market imperfections on the continent. It calls for some selected interventions by the State.

111. Efficient utilization of available resources in Africa will also be enhanced to the extent that countries in the region effectively integrate their production structures and markets. This means that African governments will have to begin, through regional and subregional rationalization, to plan to remove some of the costly duplications of industrial production capacities which have arisen in the post-independence period, and to establish new industries designed to raise the level of trade within Africa and between Africa and the rest of the world. There must, therefore, be bilateral and multilateral agreements among African countries on industrial rationalisation. Such a plan of rationalisation and co-ordination, if extended to the production of African primary export commodities such as coffee, cocoa and copper, will enable the producing countries in the region to avoid the problem of the "fallacy of composition", whereby production of the same range of export products is stimulated in a number of countries within and outside Africa through repeated increases in price incentives only to find that the net result is a reduction in the world price of the commodities in question, which thus frustrates the effort to raise export earnings. It may be useful to throw further light on the issue of complementarity of exchange rate and trade policy as essential policy instruments and measures for adjustment with transformation. Exchange rate policy has implications for the economy beyond its narrow and immediate impact on export and imports, and so does trade policy. Corresponding with the need for multiple exchange rates in Africa, therefore, is the need for import management policies, including varying elements of import controls, import duties and export subsidies in place of an outright reliance on trade liberalization. Indeed, exchange rate management in Africa must be supported and supplemented by a purposive import and export policy in order to bring about the required adjustments in existing foreign-oriented consumption and production patterns.

112. Some of the arguments against the use of selective trade policies and multiple exchange rates, involving the separation of foreign exchange markets into tiers either through exchange controls or a distinction between free and officially supported foreign exchange markets, relate to the difficulties of administration, the costs of operation as well as the possibilities of abuses and evasion. It must be admitted that a significant precondition for the successful application of multiple exchange rates and selective trade policies, is the existence of serious and good government, and the capacity to manage and enforce controls. What is often forgotten, however, is that multiple exchange rates do already exist in many African countries, in some cases receiving the reluctant endorsement of the IMF/World Bank under Window I and Window II. Given the emergence of parallel foreign exchange markets in most African countries, there is hardly any African country today which does not have a de facto dual exchange rate. Perhaps what is significant about the use of multiple or dual exchange rates in African countries as part of the policy package for adjustment with transformation is taking official cognizance of a de facto situation, and galvanizing policies towards deriving the maximum benefits from the use of the policy instruments in a purposive and streamlined manner.

113. Another significant question relates to the use of selective interest rates. Although there is little doubt that it is desirable to achieve real positive interest rates so as to encourage savings, it is at the same time necessary to take into account the fact that very high nominal interest rates have adverse impact on the economy as a whole. As such it is important to carefully consider the following issues.

- (a) whether the savings effect of interest rates is large enough in the economy as a whole;
- (b) whether the market, through interest rate adjustments, could actually take advantage of potential savings such as in the rural areas;
- (c) whether nominal interest rates will not cause a high contraction of the economy and lead to inflation through working capital cost-push;
- (d) whether nominal interest rates will not result in a collapse of credit demand, especially if the economy is already in a recession.

114. Consideration of these issues in the African context would tend to suggest that very high nominal interest rates that are pushed up to ensure a real positive rate of interest could result in the stifling of investment, and in the reallocation of resources away from production activities, with relatively low rates of return, to speculative activities with quick and high rates of returns. It is such a consideration that has led to the proposal that different interest rates should be adopted on loans for speculative activities and for production activities. The choice of these different rates should be such as to ensure that the weighted average of the two borrowing rates (i.e. on speculative loans and loans for real production) would result in a real positive rate which would be applicable for savings.

4. The Dialectics of Adjustment with Transformation

115. It is perhaps worth repeating that the policy packages that individual countries will adopt under AAF-SAP in respect of the on-going crisis on the continent will vary from country to country. Given the policy directions discussed above and the instruments and measures summarised in Table 5.2, it is left to each country, taking into account the peculiar circumstances of its development process, to design its own policy package within this overall thrust and frame, and to articulate the appropriate mix of complementary policy measures and instruments for achieving the goal of adjustment with transformation. It will, however, always be necessary to ensure the consistency of the political framework with the macro-framework and the policy directions, instruments and measures.

116. It is clear that the proposed policy measures and instruments under AAF-SAP should contribute to the simultaneous attainment of adjustment and transformation. For example, the combined use of selective trade and credit policies will interactively lead to releasing some of the pressure on the balance of payments by increasing exports, boosting food production and reducing imports. The judicious use of multiple exchange rates, in addition to stimulating production, should stem speculative capital

flight and encourage the repatriation of capital and income transfers of incomes earned abroad. This should help to ease the crunch on the balance of payments position. Further, some foreign exchange resources will be released for investment purposes through the limitation of debt service ratios to manageable levels. At the same time, putting emphasis on supply rather than demand through the use of selective credit and interest rates policies to encourage savings and productive investments, while discouraging non-productive transactions, will facilitate greater domestic resource mobilization, enable African economies to acquire the necessary capacities to better cope with external and internal shocks, reduce structurally-induced inflation and ensure growth.

117. It should also be clear from the proposed policy directions and instruments and measures that national packages and programmes of adjustment with transformation will have to be much less dogmatic and much more pragmatic than orthodox programmes have been on the question of the role and size of the public sector. A judicious mix between expanded private initiatives and efficient government intervention is needed to create an environment that would enable both the private and public sectors to thrive and contribute effectively to the growth and development process. Government interventions in Africa have so far become discredited, not because there is an effective alternative in the form of efficient market mechanism but because of inefficient management, poor results and misallocation of resources. There is little doubt, therefore, that efforts must be made to improve the efficiency of the public sector and to ensure that government interventions are properly targetted and government-determined priorities are effectively pursued. However, in the contemporary African situation, calling for wholesale replacement of the government with markets which hardly function is unjustifiable, since it is only as and when the necessary productive capacity is built and put in place that market forces would become competitive and progressively play an increasing role as an engine of growth and development. This means, firstly, that a pragmatic balance will need to be established between public intervention and private initiatives, with the emphasis being put on the creation of an enabling environment that is conducive to the effective functioning and contributions of both sectors to development, and, secondly, that government would need to yield to the private sector only progressively.

118. To administer the proposals of AAF-SAP will require the re-orientation and strengthening of the institutional framework at all levels, and the strengthening of existing administrative structures especially with respect to enhancing government ability to administer programmes efficiently. It also calls for greater accountability and dedicated and patriotic management on the part of the public sector. At the institutional level, there is need for excessively centralised bureaucracies to yield to local decentralisation, grass-roots initiatives and community self-management. The potential and capacity of the individual and the private sector in general to participate in development must also be fully exploited. The increased role of the people in adjustment with transformation should facilitate the functioning of a system of checks and balances and safe-guard against bureaucratic excesses.

119. The proposed policy directions and instruments in AAF-SAP will also require the harmonisation of the design of national programmes of adjustment so as to avoid policy conflicts and costly duplication among countries. Bilateral and multi-lateral agreements must be entered into by African countries to specifically ensure such harmonisation. Such agreements must cover the areas of regional food security and food self-sufficiency; environmental protection; rationalization of industrial production, taking into account the requirements of dynamic comparative advantages; encouragement of the production of intermediate and capital goods on sub-regional and regional basis and increasing the level of intra-African trade by adopting financial

arrangements that will reduce dependence on foreign exchange and facilitate intra-African trade and the explicit encouragement of commodity barter trade. One issue which needs to be further clarified is the relationship between AAF-SAP and the national development plan or programme. Conventional SAPs have almost invariably been conceived and implemented outside the frame development plans in the African countries. The inevitable result has been that development plans have been put on hold, and short-term crisis management has become the poor substitute. Since AAF-SAP is essentially a framework of adjustment with transformation, it must, ipso facto, be consistent with national development planning and programmes, and indeed forms part of their core.

120. Finally, it is vital not only that the African countries adapt and use AAF-SAP in designing their adjustment programmes, but that Africa's bilateral and multilateral donors also create the conditions that are necessary for the successful implementation of such programmes. Given the holistic nature of the proposed alternative framework in terms of simultaneous focus on adjustment and transformation, it is clear that Africa's main requirements for external financing will be for larger autonomous inflows from bilateral and multilateral partners. However, in the present circumstances of a transition for conventional SAPs to adjustment with transformation, the multilateral development and financial institutions will need to show increased flexibility both about policy perceptions and the need for non-autonomous resource flows to support the new generation of adjustment programmes in Africa. The prospects for implementing the alternative approach would be greatly compromised if African countries fail on their part to rise to the challenge of increased domestic resource mobilisation that would be required, and if Africa's development partners persist in predicating their assistance and support upon the strict conditionalities of adherence to the orthodox structural adjustment programmes rather than on the proposals contained in AAF-SAP. Even if AAF-SAP might involve higher levels of external non-autonomous resource inflows in the short-run, its essentially transformational nature is such that the need for balance of payments support and such other inflows would progressively become less as progress is made towards structural change and sustained development. It is therefore hoped that a broad consensus will be built around the proposals of the African Alternative Framework to Structural Adjustment Programmes to make them a successful reality.

CHAPTER Six:

Implementation Strategies and Monitoring

1. Introduction

121. To implement the alternative framework for adjustment and transformation (AAF-SAP) outlined in Chapter 4 and whose policy directions and instruments were spelt out in Chapter 5, a principal shift has to be made from current approaches. It is essential that, henceforth, country programmes for the alternative adjustment with transformation process in Africa should be and remain the primary responsibility of African governments and people within the context of a new partnership. It is the responsibility of the international community to support such programmes. This is a fundamental departure from the current practice in which external development agencies play a principal role in the formulation, design, implementation and monitoring of adjustment programmes in member states. The gradual erosion of sovereignty implied in the growing role of officials of international financial and development institutions and donor agencies in policy design, implementation and monitoring without any accountability to the people of Africa will be reversed by the adoption of the implementation and monitoring strategy outlined in this chapter.

122. The process of formulation of these programmes should avoid the mistake of excluding the people from full participation in the formulation, implementation and monitoring of adjustment programmes. As the well-being of the people is principally at stake through the implementation of these programmes, it is necessary that consultative machineries be established to develop the consensus that is so essential for the successful implementation of national programmes for adjustment with transformation.

2. Implementation Strategies at the National Level

123. The implementation of policy packages and instruments outlined in Chapter 5 must be based on a genuine and active partnership between the government and the people through their various political, social and economic organizations at national, local and grassroots levels. This requires a reorganisation and/or realignment of the decision-making process for the design and implementation of adjustment with transformation programmes to ensure maximum co-operation between public and private sector agencies, and between the government and the governed, as well as to mobilise popular support.

124. The key role of the government, in this respect, will embrace the creation of an enabling environment and institution building for effective implementation and vigorous support for grassroots initiatives. On the other hand, democratisation and popular participation will encourage the people to increase their development effort and to accept whatever sacrifices that may be implied by the programmes, thereby

consolidating and deepening the process for national self-reliance. There are several key elements of this implementation strategy which must be taken into consideration.

125. Design of national programmes for adjustment with transformation: The process of formulating adjustment and transformation programmes must integrate policy formulation with policy implementation and evaluation. It should, therefore, be based on the following procedures and considerations:

- (i) democratisation of the decision-making process at national, local and grassroots levels so as to generate the necessary consensus and peoples' support;
- (ii) regular and effective inter-ministerial consultations to ensure that all ministries responsible for the productive and social sectors, and all executive agencies and public sector enterprises are fully involved and take responsibility for the final programmes adopted;
- (iii) full involvement of the central planning machinery both in the design and implementation of adjustment with transformation programmes so as to take into account short- and long-term development objectives;
- (iv) consultations between the public sector and the various sections of the private sector so that all social groups play their part in the mobilisation and utilisation of national resources for development; and,
- (v) grassroots consultations through local authorities, private associations, including indigenous NGOs and grassroot-level communities.

126. Popularisation of the programmes: There is a strong need for evolving procedures for the dissemination of information to the general public on the implications and challenges of adjustment with transformation programmes as well as on their impact on the economy and the people. All available modes of mass media should be utilized. As far as possible, the public education exercise should rely more on the general public and organised interest groups, rather than government agencies, so as to enhance the popular participation aspects and the support of the programmes by the people.

3. Inter-Country Co-operation in the Implementation of Programmes of Adjustment with Transformation

127. Co-operation between and among African countries in harmonising their approaches to the alternative adjustment with transformation programmes is essential in complementing the efforts of African countries towards the attainment of collective self-reliance. In this regard, the ECA secretariat, including the subregional MULPOCs have an important role to play.

128. African countries, especially those belonging to the same economic grouping or subregion, should make all efforts to avoid duplication of production units beyond the capacity of the potential market. They must also pool their resources with a view to optimizing output. Similarly, the required needs to be satisfied should be harmonized. For example, any attempt in a given country at changing consumption

patterns or at internalizing production factor inputs may be nullified by the persistence of undesirable consumption patterns in neighbouring countries.

129. The selection and application of policy instruments and measures is, perhaps, the most important area requiring harmonization of programmes of adjustment with transformation among African countries. For example, more often than not, lack of co-ordination in exchange rate, pricing or interest rate policies has resulted in the undermining of some of the on-going structural adjustment programmes. Since the alternative framework covers both the short-, medium- and long-term, it is important to ensure that policy instruments and measures adopted by individual African countries are well co-ordinated among them so that they can achieve the desired effects.

130. Finally, African countries must determine the appropriate mechanisms for ensuring the overall co-ordination of national programmes of adjustment with transformation. In this regard, some of the existing mechanisms such as joint inter-country commissions or subregional economic groupings will have to play an important role.

4. Financing of AAF-SAP Implementation

131. There is need to mobilize fully both internal and external resources required for AAF-SAP implementation of programmes designed under the new framework. Precise estimates of the quantity of resources needed to finance these programmes have to be worked out at individual country level. It is necessary, first, to design national programmes on the basis of AAF-SAP prescriptions which would then be followed by determination of resource needs. Some of the policies and measures already identified (see Table 5.2) are directed towards the mobilization of the domestic and external resources that would enable African countries to finance their programmes for adjustment with transformation. These include:

- (a) improved international commodity trade environment;
- (b) appropriate policies and measures for mobilization of domestic resources;
- (c) more efficient utilization of the limited domestic resources especially the direction of resources to economic and social sectors which are accorded high priority such as agriculture and education;
- (d) reduction of outlays on external debt servicing;
- (e) additional resources being generated from the growth of African economies;
- (f) increased external resource flows from bilateral, multilateral and private sector sources;
- (g) promotion of transfers by nationals living abroad; and,
- (h) the prevention of financial leakages through capital flight, over-invoicing of imports and under-declaration of export earnings.

132. A vigorous implementation of many of these measures should lead to greater mobilization of resources under AAF-SAP than under the current SAPs.

133. Export earnings constitute a major source of autonomous resources for financing adjustment with transformation. It is important, therefore, for solutions to

be found for commodity problems and for issues that have been under international discussion for over two decades including the establishment of a generalized programme for stabilization of export earnings, acceleration of the establishment of the Common Fund, and removal of barriers to African exports of processed and non-traditional exports to be resolved. An improved international trade environment could help avert the kind of situation in which Africa lost almost US\$19 billion in 1986 through a sharp fall in export prices. The commodity wholesale price index for Africa at 1980 prices declined to 54.2 in 1988.

134. External debt relief provides another important area for generation of resources for financing AAF-SAP implementation. By limiting the debt service ratio to manageable proportions, larger amounts of resources would be released for the adjustment process. In 1988 Africa's debt servicing obligations amounted to US\$ 29 billion. It would make a great deal of difference to African economies if a substantial part of these transfers were to be available for financing AAF-SAP. Furthermore, Africa has become a net exporter of capital even to the IMF. It has been estimated that Africa, in net terms, transferred approximately US\$1 billion to the IMF in 1986 and 1987 which is almost 1.4 per cent of the annual exports of goods and non-factor services of the region. If this trend were to be reversed, additional resources would become available to Africa for the adjustment process.

135. Autonomous external resource inflows, both public and private, have been declining in real terms throughout the 1980s. More resources would become available for the adjustment process if this trend were to be reversed.

136. Finally, given the transformational nature of the adjustment programmes under AAF-SAP, it is evident that non-autonomous inflows to African countries in support of AAF-SAP would have a bigger impact, and indeed constitute a more productive and optimal approach to assisting Africa.

5. Monitoring

137. The major objective of the monitoring process for adjustment with transformation programmes is the assessment of the extent to which objectives and targets are being achieved. There is need, therefore, for each African State to establish monitoring systems that are appropriate to its programmes.

138. In general, however, monitoring systems should be designed to cater for the assessment and evaluation of progress being made in achieving the main objectives, policies and targets of the programmes. In this regard, while macro-economic performance indicators, focusing on economic growth, aggregate demand components, population and related data, will still be required, there is a strong need to go beyond these indicators to the assessment of the programmes impact on the quality of life of the people and the extent of progress in meeting their basic needs as well as in relation to the process of transforming the production structures and consumption patterns. The monitoring systems should also provide for measurement of the extent to which people are being involved in the development and decision-making processes.

139. It will be essential to organise national, subregional and regional data systems which facilitate the assessment and monitoring of the impact of adjustment with transformation programmes, so as to provide early warning against any deviations from objectives and set goals.

**STRUCTURAL ADJUSTMENT AND
ITS CRITICS**

by

Elliot Berg

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Elliot Berg Associates
907 Duke St.
Alexandria, VA 22314
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II. STRUCTURAL ADJUSTMENT AS EXTERNALLY IMPOSED

The market-oriented economic reforms which are so central a part of most adjustment programs are widely viewed as being imposed by outsiders, particularly by the IMF and World Bank, but also by some bilateral donors, such as the U.S. and France, which have "adjustment" or "policy-based" lending programs of their own. Two corollaries follow: that in adjusting countries there is little real conviction that these reforms are right; and that without outside pressures they would not be adopted.

This is only partly right. It is true that the IMF and World Bank have played major roles in defining economic reform programs as part of their policy-based lending programs. Some bilateral donors have also attached conditions to their policy-based loans. It is also true that in most of the Third World, especially in large portions of Latin American and Africa, the political and intellectual classes are generally skeptical about the effectiveness and desirability of liberalization-based development strategies.

However, most of the measures associated with stabilization/adjustment programs would have been widely adopted anyway during the 1980s, even without outside pressures via policy-based loans. This is so for a number of reasons.

- o Some of the measures are quasi-automatic responses to economic distortions. The current account deficits of the

92

balance of payments are "automatically" reduced by import reductions due to the drying up of trade credits as foreign arrears mount. Real wages in public sectors tend to fall when revenues rise more slowly than prices. Food prices tend to rise faster than wages as heavily taxed or otherwise disfavored farmers shift to more profitable activities or sell in parallel markets.

Other adjustment measures are required if large-scale economic disorder is to be avoided; they are imposed by political authorities anxious to prevent such disorders. Budget deficits and money expansion that generate high rates of inflation are, after all, shunned by most political authorities--at least in Africa and Asia. Export promotion is a natural response to persistent foreign exchange scarcities, as are adjustments in exchange rates. Hiring for already overmanned public sectors becomes too costly in terms of real wage levels.

The measures associated with "orthodox" stabilization programs are thus, for the most part, not imposed by external agencies, but arise out of the imperatives of domestic economic stability. Any political elite with a moderate sense of responsibility for the economic welfare of their society will be forced to pursue "orthodox" policies in the face of severe economic distortions.

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It is the same for the "adjustment" measures that favor export orientation, liberalized and competitive markets, restructuring of private sectors and resort to private actors: the objective circumstances of the 1980s explain their widespread introduction more than external imposition.

The shocks of the mid 1970s and 1980s made clear in many countries that many of the policies of the previous twenty years had to be changed. The emphasis on import-substituting industrialization had led many developing countries to industrial stagnation; they found themselves saddled with highly protected, inefficient, import-dependent industrial structures, often subsidized and rarely capable of competing in export markets.

The vast growth in the role of government in the 1960s and 1970s had also led to impasse. Government budgets had come to take 25-35 percent of GDP; the mushrooming of state enterprises had led most often not to profitable operation and high public savings and investment rates, but to dependence on subsidies and budget drains. The regulatory systems that were supposed to protect the vulnerable, in fact most often benefited the rich and powerful more than the poor, induced corruption and parallel markets, and often stifled enterprise.

In the quarter century after 1950, writers about economic development had been eloquent in their description of private market failures; they invariably jumped to the conclusion that where the private sector was deficient, the state should step in. Experience revealed, however, that public sector failures can be at least as constraining as those in private

114

markets. Some reassessment of the role of the state naturally followed, with a new realism about public sector capacity to take on developmental tasks.

For many countries, declines in rate of increase of government revenues, unfavorable external circumstances and a growing debt burden, stagnant agricultural production and slow output growth in general--all these internal and external factors forced a search for new sources of economic dynamism and faster growth. More positive policies toward the private sector followed naturally. Just as the need to restore internal balance imposes austerity on governments with or without the international financial institutions, so too the need for external balance forces attention towards export growth and towards measures that raise competitiveness. Deregulation of controlled markets, a search for encouragement of private agents, and the restructuring of state sectors are "natural" choices. The hand of the IMF or the World Bank may be seen in some particulars, and in the determination of how fast policy changes are introduced. But the main impulse is endogenous; it comes from recognition of past policy failures and the need for new sources of growth.

III. THE ANALYTIC CRITIQUE

From the earliest days of theorizing about economic development, the intellectual community has been generally unimpressed with the development potential of free market policies in poor countries. We need only recall that

95

even so liberal-minded a writer as Ragnar Nurske, one of the early pioneers in development economics, believed that export-led growth was not feasible, and perhaps not even desirable for developing countries. Development economics textbooks before 1980 said lots about the role of the state and little about private markets.

The skepticism has both analytic and historic aspects. The analytic critique argues that many of the diagnoses and prescriptions in the reform agenda of the 1980s are unsound. The historical critique stresses the point that many of the now-developed countries pursued policies condemned by the World Bank and the IMF and that some of the examples cited as evidence of the soundness of free market growth (e.g. South Korea) are nothing of the kind.

One old and broad argument against market-oriented policies is that markets simply don't work the way the text books say. An early expression of this attack on orthodoxy was Dudley Seers' famous article of the early 1950s--"The Limitations of the Special Case," in which Seers argued that infrastructure, information, entrepreneurs, political stability and other factors assumed to exist in industrial economies were absent in most developing economies. More recently, this view has resurfaced in the United Nations Economic Commission for Africa paper, African Alternatives to Structural Adjustment Programs (AA-SAP): A Framework for Transformation and Recovery (1989, pp. 3.3-3.6). It is worth citing this document at length.

9/6

According to the authors of this paper, most of the underlying assumptions and the presumed universality of orthodox economic theory are largely inappropriate for poor countries.

Underlying the current adjustment programmes is the well-known argument, based on classical economic theory, that output, employment, and prices (including wages, interest rates, and the exchange rates) are best determined by the free play of market forces, and that prices are the most effective instruments for the efficient allocation of resources. The argument is, of course, based on the assumption that economic structures are time invariant and sufficiently flexible so the demand and supply changes respond promptly to market signals.

While the African experience does not completely negate these principles, it illustrates, perhaps in a most profound manner, the difficulties that would be encountered if the underlying assumptions are far from reality, and if economic aggregates are not very responsive to market forces. In the African situation the simple truth is that many countries have moved toward free markets without being in a position to take full advantage of available market opportunities because of low capacity to adjust their production structures. The consequences of these structural rigidities are evident in many areas, but most notably the limited capacities of African farmers to respond to price incentives without assured supplies of relevant production inputs and in the failure of domestic production to respond to new opportunities in export and domestic markets, following a currency devaluation, because of a myriad of technical and supply difficulties; and, in the slow response of savings to high interest rates. These rigidities imply that the main burden of adjustment has been borne by drastic reductions in domestic expenditures with serious economic and social consequences that have tended in many cases to retard rather than promote the process of structural transformation.

According to the authors of the ECA paper (and others with a similar vision) the orthodox prescriptions are wrong: raising interest rates only "encourages speculation" and discourages productive investment; devaluation fails to stimulate tradeables production because of "technological

97

rigidities"; if grain markets are liberalized, the gains from higher prices go mainly to middlemen because markets are not competitive.

The orthodox prescriptions for agricultural development are especially harshly judged in the ECA paper, which reflects the views of "structuralist" critics who have become more vocal in recent years. Orthodox "adjusters" emphasize better prices for farmers as part of overall improvement of incentive structures. But this, say the structuralists, puts the cart before the horse. What holds back agricultural growth is not so much inadequate prices but the absence of new technology and other nonprice factors such as the absence of good roads, poor extension systems, limited fertilizer availability, poorly functioning systems of rural credit, etc. This, they argue, is the message of the vast majority of econometric studies of aggregate supply elasticities in agriculture, which show them to be low--rarely higher than .2 or .3, even in the long run.

Moreover, in developing countries more than in rich countries, rural markets are said to be inadequately competitive, power relationships are highly unequal, and, even in the most underdeveloped agricultural systems, many rural households are net buyers of food. All of this is said to limit the utility of price policy interventions.

Liberalization of foreign trade regimes, another pillar of World Bank/IMF-sponsored structural adjustment programs, is similarly viewed as a flawed option. Genuine liberalization of imports might devastate much of local industry in most of the Third World, especially in the least developed

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countries. And, more important, export-led growth is not viable for most countries. Protectionism and fierce competition by more advanced producers and import-replacing technological change make export-led growth problematic as the foundation of a development strategy. This is especially so for primary products. Price prospects for raw materials are equally poor. Low price and income elasticities make output expansion self-defeating, except for minor producers. If all the poor countries that produce beverages or fibers or oilseeds were to expand output, resulting falls in prices might mean lower export earnings rather than higher. There's no way, the critics say, that expansion of primary product exports can generate an acceptable rate of growth of output in exporting countries.

Privatization is attacked as another erroneous element in standard adjustment packages. Economic theory, according to many critics, does not say anything persuasive about ownership, only about competition. What matters, according to this view and according to most recent analysts, is competition and not ownership structures. In practice, moreover, the privatization process has revealed many flaws and dangers, notably the frequent granting of financial privileges (high protection, direct subsidies, special contracts with government, etc.) to encourage private takeovers of state enterprises. And, in the least developed countries, indigenous private sectors are too thin to buy and run state enterprises. Where foreigners are allowed to buy, fears of recolonialization are kindled.

Finally, the critics say that much of the enthusiasm for market-oriented adjustment strategies is based on a misreading of history. The great

99

success stories in East Asia (notably South Korea and Japan) never entailed dismantling the state, nor early exposure to external competition. The state was an active and important partner of the private sector in those cases. The same is true in most of Latin America, including such growth powerhouses as Brazil. Aren't the Bank and Fund recommending, for today's "adjusting" countries, policies that were not pursued in successful economies elsewhere?

Even when thus presented in capsule form, the far-ranging nature of intellectual or analytic attacks on orthodox adjustment policies is obvious. To fully assess these arguments would require more time than we have here. I will concentrate on some of the main issues.

First a few general points:

- o No single set of specific adjustment policies is implied in a market-oriented strategy. The size of the country, its administrative capacity, its political and economic structure and other factors will determine what is an appropriate mix of public and private activity, of outward and inward-lookingness, of reliance on markets and controls. Much of what is right for South Korea will not suit Guinea. A market-oriented strategy, in other words, can encompass widely varying policy mixes.

- o We are dealing always with imperfect alternatives--with flawed models, not ideal types. The implications of a weak,

small private sector has to be weighed against the existence of a heavily bureaucratized, ill-paid public sector. The obstacles to export expansion have to be considered in the light of the costs of a stagnant, inward-looking industrial sector, a handicapped agriculture, and the limited alternative uses of climate, land, and labor.

- o The existence of "structural" deficiencies should lead to efforts to remove them, not to continuation of failed policies of the past. If markets function poorly, their operations should be improved; they should be made more transparent and competitive, for example, not returned to control by state monopolies/monopsonies. Moreover, the validity of any strategy depends on how effectively it erodes structural constraints to development. Encouragement of private provision of "public" services, for example, is the most obvious way to stimulate the growth of an entrepreneurial class. Entrepreneurship is rarely hatched inside public sector organizations.

Second, in agriculture, policy does matter. This means not only price policy, but also policies toward rural institutions and the level and quality of public spending in agriculture. Certainly it would be better if higher prices were accompanied by good credit systems, research and extension, etc. But in fact, in much of the world, especially in countries with lagging agricultural systems, it is not feasible. New technology is often sparse, as

in Africa. Credit and extension systems are usually paralyzed and input-supply arrangements crippled. Price policy may be the only feasible instrument available to spur agricultural growth.

Despite the pessimism about supply response, there do exist examples of how price and institutional changes (liberalized marketing systems, freedom of organization of production) can have large impacts on output and induce structural changes in agriculture. The most spectacular example is, of course, China after 1977. Agricultural production rose by more in the period 1978-1985 than it had in the previous thirty years. And this was achieved principally through better policies and freer, more market-oriented rural institutions. No new technology was at hand, and input use (land, labor, tractors) actually fell except for some additional fertilizer.

Less well known and dramatic are recent changes in Madagascar. A rice market liberalization program there has induced substantial change. Higher rice prices led farmers to improve their irrigation facilities, buy more inputs (tractors and fertilizers), reallocate land (with smallholders renting to larger, more efficient growers), drain old, neglected fields, and make new plantings of upland rice.

Many other examples of agricultural responsiveness to policy reforms could be cited, from Mauritania, Somalia, and Ghana to Bangladesh, among others. There is a paradox here. Pessimism predominates in the econometric studies of supply elasticities. But anecdotal and case study

evidence shows much more responsiveness to the policy environment.

Third, the attack on trade regime liberalization is exaggerated and fails to define viable alternatives. Almost nowhere do adjustment programs entail massive removal of tariff or other forms of protection. What Bank/Fund-sponsored programs generally seek is lower and more even levels of protection. In reality, very few countries are ready to dismantle tariff and other barriers, or to completely liberalize import regimes, and they are not asked to do so.

Also, while export pessimism has deep roots, the growth in developing country exports in the last forty years has exceeded all expectations. Even in the unfavorable period of 1975-1979, twenty-four developing countries managed to increase their exports of manufactures by more than 15 percent a year. It is true that the prospects for primary-product-led export growth are not good. But meat, citrus, fish, some fibers, and rubber are among commodities with higher income elasticity of demand or with environmental advantages that make their prospects brighter. And in any case, what are the alternatives for primary exporters? If individual countries or subregions do not continue to fight for export markets by increasing production and productivity they will lose market share to competitors. This happened between 1960 and 1980 to many African exporters who suffered dramatic losses in market shares in beverages, fibers and minerals.

In terms of viable alternatives, the "inward-looking" alternatives to an export-based growth strategy are hardly appealing--slower output growth;

102

lower income; greater constraints on imports; a reduction in the "training effect" that comes from competition in export markets; less exposure to new ideas and opportunities and hence reduced potentials for discovery of new economic options.

Where regional economic integration presents promise, it should be more actively pursued; unification of small national markets into larger regional ones is in fact a potential source of new growth. Opportunities undoubtedly exist also in new, more carefully studied, import substitution. But none of this need be incompatible with better performance in export production and marketing, which under any likely scenario is sure to be--at least for a generation--the principal engine of development in most of the poorest countries.

A fourth point is that the role of the state will remain extremely large and of critical developmental importance in all developing countries. But the state can't do everything and shouldn't try. This is common sense, not ideology. As ex-President Machel of Mozambique once said: "Marxism-Leninism doesn't mean that the state should sell tomatoes and matches." Concentration on strategically important activities will allow the public sector to work more efficiently. As for the mix of instruments, using the market has well-known economic advantages. Under an auction system, for example, the rents from foreign exchange scarcity go to the budget and not to private importers. Auctions also economize on human capital and are easier to run than administered allocations. Finally, the widespread weaknesses of personnel practices, of accounting and auditing capacity, of financial

104

management and budgetary practices, combined with low wages and freezes on employment, suggest that for many governments the administrative efficiency of public sectors is not likely to increase in the medium term. This gives greater urgency to the use of more economical policy instruments, and to the transfer to private agents of nonstrategic functions, and perhaps even some strategic ones.

Finally, privatization of state assets, the main target of anti-free-market critics, does indeed have its limits. The gains from the sale of state assets are not likely to be large, unless accompanied by other changes--for example the creation of a more competitive market structure. Moreover, many obstacles have become evident, and these suggest that asset sales will have a relatively limited scope, especially in the poorest countries. Privatization approaches can be improved by greater transparency in negotiation, and by greater willingness to allow nonviable enterprises to die. Most important, privatization is likely to have greater impact in areas other than privatization of property, notably privatization of management via leasing of state assets, arranging various types of management contracts, and, above all, bringing in private service providers by deregulation (allowing free entry) and by utilization of the many techniques available to privatize service delivery--contracting out, franchises, voucher systems, etc. These are feasible and still neglected ways to mobilize private energies and resources, and to nurture entrepreneurship at the same time.

IV. HAVE ADJUSTMENT PROGRAMS FAILED?

Adjustment programs were certainly oversold. The initial notion was that structural changes could be brought about in five years; this was the original World Bank vision when the first structural adjustment loans were introduced. Everyone now recognizes that this was wildly optimistic.

Good answers to the question of whether "adjustment" has failed or not are, in any case, extremely elusive. If the main criterion is growth in per capita income, then two fundamental truths make evaluation difficult. First, good policies are only one factor in explaining growth; the best policy reforms may not help much in the short and medium term if export markets collapse or if drought hits. Second, evaluation must take into account the "counterfactual" or "without-adjustment" scenario, which is difficult to do.

Other, somewhat less fundamental factors impede evaluation of success or failure in policy reform. There are many countries at issue, within each of which the speed and nature of reform varies. Countries that are star performers in one year fall off track two years later. The intensity of reforms varies; in one country, trade liberalization may involve a minor overall tariff reduction with small effects, while in another there may be a truly significant opening up to external competition. More important, reforms are only partially implemented in most instances. A decree may announce full liberalization of grain marketing, but multiple market restrictions may remain--movement controls, licensing requirements, etc. A tariff reduction

106

may be frustrated by informal increases in administrative controls of imports. A devaluation may occur, but fear of capital flight and other factors may lead to persistence of export-constraining administrative requirements on exporters. Another consideration is that where severe distortions prevailed before "adjustment," most of the economy may already have adjusted informally, via ubiquitous parallel markets; the effects of a formal reform program will thus be much diluted.

In many cases, finally, it is too soon to judge. In sub-Saharan Africa, for example, it was not until 1985 or so that effective reform programs predominated; in 1984, for example, real effective exchange rates had appreciated in more African countries than they had depreciated, and real producer prices showed little improvement over 1980. Effective reform in much of the region got under way only in 1985--too recently for serious evaluation of impacts.

The difficulties of evaluation have not prevented heated controversy on the question, however. In recent reports of UNICEF, the Economic Commission for Africa (see above) and other agencies, "structural adjustment," defined as economic stabilization measures plus market-oriented policy reforms, is severely criticized for its sparse results in terms of growth, as well as its heavy cost in terms of impact on the poor.

Africa has more formal adjustment programs than any other region--about thirty--and the debate has been especially vigorous there. The Economic Commission for Africa, in its draft report African Alternatives to Structural

Adjustment Programmes (March 1989) says; ". . . poverty in Africa has worsened in the 1980s. The average annual growth rate of per capita income in 1980-1985 was either stagnant or negative in most of the countries implementing adjustment and stabilization programs. In a few cases where improved per capita income was recorded, it was largely at the expense of higher external debt and the deterioration of social services. By 1988, average real incomes in Africa, south of the Sahara, are . . . no more than 80 percent of their levels in the 1970s."

The ECA paper cites in support of its analysis the findings of a major World Bank study (Report on Structural Adjustment Lending, August 1988), in which the sub-Saharan countries studied in that report experienced a fall in GDP growth to 1.8 percent after adoption of adjustment programs, compared to 2.8 percent growth prior to adoption. Also, investment ratios fell and budget deficits rose after implementation of adjustment programs.

The World Bank study, however, while noting slow growth in African countries, concluded that the adjustment programs worldwide seem to have had positive impacts in terms of growth. The thirty countries with adjustment programs did better than those without adjustment loans. The Bank study found also that middle-income adjusters did better than low-income, and twelve "adjustment-lending-intensive" countries did best of all. They note, however, that all countries did relatively poorly in the 1980s, that sustainability was not assured, that sub-Saharan African experienced especially slow growth, that social costs were high, and that the commitment of most governments is uncertain.

A new World Bank report, Adjustment and Growth in Africa in the 1980s (1989), has come out with a more positive assessment. It says that there are signs since the mid-1980s of faster growth, and that this is evidence that adjustment programs are working. Economic performance in nineteen African countries with "strong reform programs" is better than in other countries of the region. These conclusions have been strongly attacked by the ECA, among others. The ECA, defining country classifications differently, concludes that African "adjusting" countries have done worse than any other group of countries in terms of GDP growth and some other indicators.

In my view, these approaches to assessment of the "success" of structural adjustment inevitably yield contestable and fragile results. Problems of choice of time period, country classification, and "weighting" are monumental. The World Bank study, Structural Adjustment Lending, for example, defined "adjusting" groups to include any country that has received an adjustment loan by 1984. The Bank's report Adjustment and Growth in Africa in the 1980s defined reforming countries as those with an acceptable program in place in 1986-1987. So the Adjustment Lending report includes Sierra Leone, Sudan, Zambia, and Zimbabwe among the "adjusters," and excludes from this category, eight African countries that had programs in 1986-1987 but not by 1984: Burundi, Central African Republic, Gambia, Guinea, Madagascar, Mauritania, Niger, and Zaire. It's no wonder that conclusions about outcomes differ.

109

No firm answers, then, can be given about the economic "success" or "failure" of the overall adjustment effort of the 1980s. It may be that the question is wrong. We should be interested less in output and longer-term effects and more in processes and in proximate or intermediate effects. Has the process of defining adjustment programs increased insight into the obstacles to growth, and generated new ideas about overcoming them? Have the agreed programs been implemented, and if not, why? Have local officials and others learned something from the experience? Are policymaking processes and institutions stronger? Have institutional reforms put core economic agencies on a track that promises continued strengthening? Have any minds been changed about what is good and what is bad policy?

V. IMPACT ON THE POOR

This has become the most discussed aspect of the adjustment problem and among the most controversial. Two positions have been staked out. The first, championed by UNICEF, is that the "costs" of structural adjustment programs have fallen most heavily on the lower ends of the income and asset distribution. The removal of protective subsidies (on food, for example) and cuts in social sector spending hurt the poor, while middle class groups (higher civil servants and businessmen, for example) are little touched.

The second position, set out mainly in various World Bank documents, is that many of the "standard" structural adjustment policies in

fact help the poor. Liberalization of agricultural markets, reform of agricultural parastatals, devaluation, and export promotion schemes all tend to help rural people, who form the bulk of the poor in most developing countries. Subsidy reduction may hurt the poor, but since a bigger share of many subsidies is absorbed by better-off people than by the poor (housing, fuel, electricity, water subsidies, for example), the removal of subsidies or better targeting tend to make income distributions more equitable. And, of course, faster economic growth, which is supposed to result from policy reform, is the best way to reduce absolute poverty.

Better information will not resolve these differences, especially since the "with vs. without" conundrum remains. But it would help, since in fact little is known about the preadjustment condition of the poor or about what has actually happened during the 1980s. To know the equity impact of food price rises, for example, we have to know more about who in rural areas are net buyers and net sellers. Cutting of aggregate health and education expenditures is not so revealing as is detailed knowledge about the structure of cuts and spending: whether primary schooling is cut, or scholarships for university students, for example.

Better assessment of impacts on the poor will thus have to await fuller information. Given the large volume of resources now being devoted to this matter, better information should not be long in coming.

One final observation is worth noting. Most people can agree that it is better to have adjustment policies that spare the most vulnerable social

101

groups, all other things equal. That is, if there is no trade-off between the efficiency of adjustment policies and protection of the poor, the poor should be protected. But if there is a domestic political consensus to this effect, then the poor should receive this policy treatment, adjustment or no adjustment. If there is no domestic political consensus about it, then the donor community, which may have different concerns on this issue than local governments, may have to impose its view via new types of conditionality. Thorny issues of sovereignty and donor intrusiveness are raised.

Moreover, if there are trade-offs between an avoidance of "excessive social costs" and efficient adjustment policies, as is likely, broad issues of social policy are evoked. These include, from the donor perspective, the nature and objectives of policy-based lending, and in particular the relationship between lending for direct alleviation of poverty and growth/efficiency-focussed aid.

VI. CONCLUSIONS

Cynics suggest that policy-based lending and the structural adjustment which is its main objective are fads of the 1980s--the most recent in a long line of faddist notions that have characterized thinking about economic development, from technical assistance in the 1940s to capital investment in the 1950s and 1960s, to human needs in the 1970s. That is not my view. Policy reforms that involve moving economies toward free markets,

world prices and private activity reflect the lessons of experience since 1950. Never again can intellectuals, civil servants or political authorities adopt the asymmetrical approaches of the past, whereby governments were assumed capable of taking on economic functions that were inadequately performed by private actors. Everybody knows enough about public sector failures and deficiencies to ask the question: can the state perform better than private markets, even flawed private markets? Everybody also knows that new sources of growth are needed and that better mobilization of private resources and energies are therefore indispensable.

For reasons indicated earlier, no firm judgment is possible about the impacts of adjustment programs on economic growth. One consequence, however, is evident--as the World Bank Study, Adjustment Lending, indicates, countries that adopt adjustment programs receive more external support than countries that do not. Most observers would regard this as a positive indicator, though increased indebtedness and intensified external dependence are also implied.

Those who have crafted the adjustment program have produced, on many occasions, brilliant policy innovations as well as ill-conceived proposals. There has probably been more pointed discussion of policy issues in developing countries in the past decade than ever before, and the policy realism of thinking and writing about economic development has greatly increased.

113

Weaknesses in the process have impeded progress, and persist. The Bank and Fund continue to play too dominant a role in devising programs and pushing their implementation. Conditionality is excessive, frequently unnecessary, unmonitorable, and conducive to game playing and shoving of problems under rugs instead of genuine, joint problem solving. Creating a greater sense of "ownership" in the ideas of market-oriented reform, and addressing more appropriately the dilemmas of conditionality, are tasks of the 1990s.

Finally, it would be extremely helpful if those who deal in the language of economic development could find a way to ease the term "structural adjustment" out of common usage. It's a misleading term because it implies a one-time set of changes with a one-time result ("adjustment"). In fact, what is at issue is general economic policy. True "adjustment" is in fact an ongoing process of framing good policies, which means deepened knowledge, more rational decisionmaking procedures and strengthened policymaking institutions. In this sense, poor countries, like rich ones, are never beyond adjustment.

Revised March 1989

**AGRICULTURAL SECTOR ADJUSTMENT LENDING
AND AGRICULTURAL POLICY**

by

Odin Knudsen and John Nash

This paper reflects only the views of the authors, and should be used and cited accordingly. The findings, interpretations, and conclusions are the authors' own. They should not be attributed to the World Bank, its Board of Directors, its Management, or any of its member countries. We wish to thank Bela Balassa, Ajay Chhibber, Francis Colaco, Jean Jacques Dethier, and Jaime de Melo for very thoughtful comments on earlier drafts. Remaining errors are our responsibility.

115

I. BACKGROUND: THE NEED FOR AND EMERGENCE OF AGRICULTURAL ADJUSTMENT LENDING

Both in terms of employment and value added, agriculture is one of the most important sectors in most developing economies, especially the poorest.¹ In the early to mid twentieth century, governmental policy toward this sector was frequently characterized by benign neglect. In this atmosphere, complemented by overall macroeconomic stability, agriculture led many countries into relative prosperity, based on natural comparative advantage and export-led growth.

In more recent decades, and increasingly since the 1950's, official attitudes shifted, as many governments embraced the paradigm of state-planned development based on growth of the industrial sector. This strategy was carried out through an inward orientation and an infusion of resources into industry by explicit taxation of the agricultural sector, pricing policies that depressed food and agricultural commodity prices to keep wages low, over-valued exchange rates and commercial policy that discriminated against exports, parastatal agencies to carry out the government's policies in all sectors, and heavy borrowing from abroad.² The inflow of foreign capital, especially when it was invested in the industrial sector, further overvalued the real exchange rate and shifted the internal terms of trade against agriculture.

1/ In 1984, agriculture accounted for 36 percent of GDP in low-income economies and 22 percent in the lower middle-income economies. (World Development Report, 1986.) In Sub-Saharan Africa, agriculture is even more important, accounting for almost 60 percent of GDP and close to 90 percent of employment in some countries.

2/ Loans for industrial projects rose to almost 20 percent of the World Bank's portfolio in the mid-1970's (from about 15 percent two decades earlier), before falling to 8 percent in 1980 and 6 percent in 1985.

In the late 1970's and early 1980's, as the shortcomings of this strategy became increasingly apparent, many developing countries found themselves with large foreign debts to service, little potential for significant growth based on industrial sectors that had failed to develop as planned, and agricultural sectors in deterioration from years of hostile policies. In low-income Sub-Saharan Africa, for example, the agricultural growth rate fell from 2.6 percent per annum in the period 1965-73 to 1.4 percent in 1973-84 (World Development Report, 1986). While some shift away from primary production is a normal part of development, and the decline in world commodity prices played a role as well, much of the sector's poor performance was due to the policy environment.

From the perspective of the Bank's lending strategy, the implication of this experience was that project lending in a distorted policy environment not only failed to promote agricultural growth, but actually discouraged it by providing foreign exchange, thereby perpetuating overvaluation and other policies inimical to development of agriculture. A strategy was needed to meet the dual objectives of supporting economic reforms on the macro and sectoral levels while assisting countries in meeting their urgent need for foreign currency to service the debt and maintain necessary levels of imports. The mechanisms that were developed at the World Bank were the Structural Adjustment Loan and Structural Adjustment Credit (hereafter, collectively called SAL's), and after 1983 the Sector Adjustment Loans (SECAL's). Most of the early SAL's contained conditionality intended to redress the historical policy bias against agriculture. Some of the conditions were directly related to agricultural policy, while others were aimed at improving the economic environment for agriculture indirectly by, for example, reducing protection of the

industrial sector or depreciating the real exchange rate. Agricultural SECALs were generally preceded by macroeconomic stabilization measures, and did not themselves contain extensive conditionality outside of the agricultural sector, per se. There have been exceptions. The Colombia Trade and Agricultural Policy Loan, for example, made provision for a detailed review of macroeconomic policies prior to second tranche release.

The theory underlying the policy-based lending was that there were advantages in "packaging" policy conditionality with a large fast-disbursing loan. First, in many cases, the reforms sought through adjustment lending were politically unpopular with some factions of the governments involved. Packaging the conditions together with a loan substantially larger than the typical project loan would strengthen the position of the reform-minded factions, increasing the likelihood of successful and sustainable implementation. Second, many reforms would have been difficult to make in an atmosphere of balance-of-payments crisis, so the fast-disbursing nature of the loans supported the reforms by ameliorating the crisis. And third, the credibility of the reforms may have been improved by being "underwritten" by a large loan from an external source coupled with formal commitment by the governments.

This paper in section II presents an overview of the type of conditionality related to agriculture in SAL's and agricultural SECAL's. Section III draws on lessons from economic research and experience in agricultural reform to infer what kinds of policy changes are likely to be most successful in meeting the goals of reform. These are compared to the design of loans as discussed in section II, and lessons are derived for the Bank's future lending in the sector.

1/5

II. Policy Reforms in Agricultural Adjustment Loans

Conceptually, the objective of agricultural adjustment lending is to enhance growth by changing the incentive structure (price and non-price) for agriculture vis-a-vis other sectors and within agriculture in ways that will promote the efficient use of resources. Operationally, this objective is defined by the policy conditionality in the loans. The following section gives an overview of the agricultural conditionality in the Bank's lending program. The discussion is based on Tables 1 and 2 and the results of an analysis of a sample of adjustment loans carried out by the Industry Development Division.³

^{3/} Table 1 summarizes the results of a study of 79 SAL's and SECAL's containing some agricultural conditionality in fiscal years 1980-87. Table 2 (based on Table A1) is from a study of 21 agricultural SECAL's, including virtually all agricultural SECAL's through fiscal year 1987, plus the Mexico AGSAL.

**Table 1: Agricultural Policy Conditionality in 79
SAL's and SECAL's, FY 1988-1987**

(Number of loans with % of total loans in parentheses)

Policy Area	Africa (23) ¹	Asia (5) ¹	Emena (3) ¹	LAC (12) ¹	Total (43)
Ag. Pricing (Input & Output) ²	20 (80%)	3 (27%)	3 (33%)	9 (39%)	45 (57%)
Trade	16 (44%)	6 (66%)	5 (56%)	23 (100%)	49 (62%)
Institutional Reform	29 (81%)	5 (45%)	7 (78%)	15 (65%)	56 (71%)
Credit and Banking ³	11 (31%)	3 (27%)	1 (11%)	9 (39%)	24 (30%)
Public Investment Budget	21 (58%)	1 (9%)	5 (56%)	10 (43%)	37 (47%)
Macroeconomic	20 (56%)	2 (18%)	6 (67%)	10 (43%)	38 (48%)
Environment	3 (8%)	1 (9%)	1 (11%)	2 (9%)	7 (9%)
Total Loans Evaluated	36	11	9	23	79

Source: Ridley and Roberts

^{1/} Number in parenthesis is number of countries whose loans were evaluated.

^{2/} Includes interest rate subsidy issues.

^{3/} Excludes interest rate subsidy issues.

Table 2: Conditionality in 21 AGSAL's, FY 1980-1988¹

		Reforms Pre- ceding Loan ²	Conditions in Loan
I.	PRODUCT PRICE	17	15
	A. Decontrol Cons. Price	2	4
	B. Decontrol Prod. Price	3	1
	C. Change Official Cons. Price	5	1
	D. Change Official Prod. Price	7	5
	E. Reduce Subsidies/Margin	2	2
	F. Liberalizing for Trade	9	8
	G. Studies	3	7
II.	INPUT PRICE	14	15
	A. Decontrol or set at World level	1	1
	B. Raise Official Price	10	12
	C. Lower Official Price	0	0
	D. Liberalize Trade	4	3
	E. Studies	1	3
III.	PRIVATIZATION	10	9
	A. Product Distribution	7	5
	B. Input Distribution	3	3
	C. Studies	0	1
IV.	INSTITUTIONAL REFORM	10	17
	A. Deregulation	0	3
	B. Other	9	14
	C. Studies	1	6
V.	ENVIRONMENT	0	2
VI.	PUBLIC INVESTMENT	4	10
VII.	POVERTY	2	2
VIII.	MACROECONOMIC	12	3
	A. Exchange Rate	12	1
	B. Deficit	4	1
	C. Other	2	3

^{1/} Source: Table A1.

^{2/} As cited in President's Report for each loan.

Agricultural conditions as a whole accounted for about 10% of all conditions in the sample of loans, or 9% of all legal requirements.⁴ This varied little for all regions except LAC, where the corresponding figures were 5% and 6%. The importance of these conditions was about proportionate, with about 11% being judged "critical" to their respective loan's success.

(A) Pricing

Since prices are the primary determinant of the incentive structure for agriculture, an almost universal concern of adjustment loans has been to "get the prices right." Around 60% of all adjustment loans, and almost all (with one exception) agricultural sector operations have included agricultural pricing conditionality. These conditions have been especially common in Africa, where 80 percent of SAL's and SECAL's have contained such conditionality. Input and output pricing conditions have been about equally common. They have been among the more important types of conditions, with almost one third of the conditions judged "critical" to their loan's success.

Successful implementation has occurred for about 68% of agricultural pricing conditions, somewhat below the average for all conditions of 73%. Implementation has been especially poor in LAC, with only 44% successful. This may be related to the unstable macroeconomic environment in which price reforms must take place in Latin America.

^{4/} All of these figures probably understate the true contribution of agricultural conditionality, since agricultural SECAL's are under-represented in the sample.

122

(1) Producer Prices

Adjustment loans have taken a number of different approaches to producer price adjustment conditionality. In general, these conditions have been intended to raise producer prices.⁵ A large number of loans have required studies of output pricing, and a few of input pricing issues. Some loans have required that prices paid to producers be set at specific levels agreed with the Bank. The Mexico AGSAL included a particularly interesting variant of this by explicitly linking official domestic prices for some crops to international prices via a price band. The use of this mechanism for all official prices, along with measures to minimize industrial protection, would not only assure that the prices for agriculture as a whole are approximately correct, but that relative prices within the sector are also appropriate. Other loans have required that the mechanisms or formulas used to establish prices be altered. By making the improved pricing strategy somewhat more institutionalized, this kind of conditionality may be more likely to lead to sustained reform in future years than are conditions that merely set prices. This type of conditionality has been used for example in the Morocco AGSAL, Jamaica SAL III, and a number of other loans.

^{5/} A few, such as the Colombia Trade and Agricultural Policy Loan and the Morocco AGSAL II, have put a ceiling on producer prices or required that they be reduced. For some other countries, such as Uganda, Ghana, Burkina, Cotes d'Ivoire, Ecuador, and the Philippines, the pricing conditions in the loans were concerned with improving relative prices so as to diversify the sector.

12

The pervasive nature of government control in agricultural markets --and the reluctance to relinquish that control--is reflected in the fact that very few loans (only 4 of 21 SECAL's) have included the actual abdication of official price-setting authority (i.e., decontrol) and withdrawal of government from any market. The Madagascar AGSAL required the government to refrain from setting an official price for rice and procuring domestically. Even in this case, the government would operate a buffer stock using imported rice to prevent price from rising above a trigger level, which was, however, set high enough to assure that it would not often trigger stock releases. The Ecuador AGSAL required the government to get out of procuring commodities in order to set minimum prices.

(2) Consumer Prices

Very few loans have dealt with price controls for agricultural commodities on the consumer level. The exceptions to this have been the Ecuador AGSAL and some African SAL's, which have included consumer price decontrol. Some others (e.g., the Mexico AGSAL) have required that global subsidies administered via low consumer prices be reduced or not be expanded. Together with higher procurement prices, this implies higher consumer prices.

(3) Input Prices

Many agricultural adjustment loans (15 of 21 SECAL's) have included conditions related to pricing of inputs. Apart from those that only required studies, virtually all of these loans required increased prices (or reduced subsidies) for the three most important inputs--fertilizer,

water, and credit. A few (e.g., the Kenya AGSAL) related to certified seeds, though these have been mostly non-price institutional conditions. None of the loans required decontrol of prices or disengagement of the state from these input markets, even though sector analysis identified state involvement as a problem.

(4) Trade

An area closely related to pricing issues is trade liberalization, since trade controls of some kind must be used to reinforce policies that cause domestic prices to diverge from their international levels. A number of loans (8 of 21 SECAL's and 49 of 79 SAL's and SECAL's) have required some trade liberalization steps. Of the 8 SECAL's requiring liberalization, all but 2 were linked to pricing reforms. Frequently, these removed restrictions (or reduced taxes) on exports of agricultural products or imports of inputs, or both (as in the Uruguay AGSAL), since these measures are commonly used to create an anti-agricultural bias in the trade regime. Some loans, however, in the interest of reducing all barriers to trade, also included reductions in barriers to imports of agricultural products (e.g., the Mexico and Ecuador AGSAL's). Taken alone, these steps would exacerbate the bias against the sector by removing trade protection for agriculture while leaving industrial protection in place. However, as part of a comprehensive trade reform effort (as in Ecuador and Mexico), including reduction of trade barriers in the industrial sector and devaluation of overvalued exchange rates, they can be effective in opening the economy to expanded trade opportunities. Conditions to liberalize trade in inputs have been rare (only 3 of 21 SECAL's).

123

(B) Institutional Reform

(1) Privatization

Most analyses of agricultural sector policies have placed the operation of government-owned companies (parastatals) high on the list of problems. The problems have been of two types. First, the legal monopoly power frequently enjoyed by these companies removes them from the disciplinary effects of competition, leading to inefficient operation and large fiscal losses. Second, these companies operate--as intended--as tools of the state to carry out pricing and regulatory policies that have been instrumental in depressing the sector.

Adjustment lending has frequently been preceded or accompanied by conditions aimed at resolution of the first problem, but has almost completely ignored the second. Seven SECAL's have required that the private sector be allowed to compete with the parastatal(s) active in a particular market or that some parastatals be divested (i.e., sold to the private sector) or closed. Four of these were in product markets; three in input markets. The AGSAL's for Mexico and Morocco, as well as the Trade and Agricultural Policy Loan for Colombia, included such conditions for parastatals involved in product marketing, while the Tanzania Multi-sector Rehabilitation Loan required the opening of an input market. Others, especially SAL's in Africa, have required various reforms aimed at making the parastatals operate more efficiently. For example, 12 out of a sample of 29 loans required some divestiture, with all but 2 of the 12 in Africa. For the seven loans in the sample for which implementation data was available, the implementation was generally successful.

Virtually no loans, however, have required that parastatals be abolished or their role altered so as to withdraw them from direct

126

participation in the market. In some countries, especially in Africa, private sector institutions are weak, at least in part because their development has been suppressed by competition with parastatals. This makes it difficult to completely withdraw parastatals from the market precipitously. With few exceptions, however, it does not appear that this was even considered an explicit long-term objective, with concrete steps taken. Two exceptions were the Ecuador AGSAL, which required complete withdrawal of the crop marketing parastatal from procurement, and the Panama SAL II, which required that the role of the agricultural marketing parastatal be limited to providing market information and managing warehouses.

(2) Deregulation

A few loans (3 of 21 SECAL's) have contained conditions to remove regulatory constraints on markets. The Tanzania Multisector Rehabilitation Loan, for example, required the abolition of permit requirements for internal movements of grains. The Morocco AGSAL II required the complete dismantling of an elaborate system for regulating upstream flour marketing, including a licensing system that limited market access and a system of fixed allowances for distribution margins.

(C) Macroeconomic

Macroeconomic policies have historically been as important or more important than "agricultural" policies in depressing the sector. Exchange rate policy is the macroeconomic policy most directly relevant to agricultural development. It is not surprising, therefore, that most agricultural adjustment programs have been preceded or accompanied by

exchange rate reform of some kind (President's Reports of 12 SECAL's cite progress on the macroeconomic front preceding the loan). The most common requirement has been for more rapid devaluations. Some have also been preceded by other measures to correct anti-agricultural biases in the trade regime. With the main exception of the Colombia Trade and Agriculture Policy Loan, this has usually been done through SAL's or trade policy loans, rather than directly through SECAL's.

(D) Environment

Environmental issues have only rarely been addressed in adjustment lending, in spite of the major impact agricultural policies have on the environment. A few loans have required regulation of pesticide use, one (Jamaica SAL I) required development of erosion control measures, and one (Jamaica SAL II) required sale or lease of government-owned land to improve land use.

(E) Poverty Alleviation

Incorporation of programs to alleviate poverty in adjustment loans has been rare, but may be becoming more common. Between FY's 1980-87, only one loan (the Ghana Export Rehabilitation in FY84) included such a program. In FY88, however, two (the Mexico AGSAL and the Morocco AGSAL II) included this feature. The Colombia Trade and Agricultural Policy Loan addressed poverty alleviation concerns by targeting counterpart funds for investment in regions where incomes would fall during adjustment. Agreement on the targeting was reached informally with the government.

128

III. The Design of Agricultural Reform

The Bank's experience in promoting agricultural reform is relatively limited as enough time has not passed to really make a long-term assessment of what works and what does not. (Currently, only one agricultural sector adjustment operation has a completion report.) However, the literature on agricultural development and the limited experience in policy reform points to some design issues. In this section, selected lessons from the on-going experience are reported and some broad guidelines are derived.⁶

A. The Role of Price and Non-Price Factors in Agricultural Growth: Implications for Structural Adjustment

As noted earlier, one of the virtually universal objectives of agricultural sector conditionality in Bank lending is to move crop and input prices toward their international levels. While this is clearly a worthwhile objective, it cannot be expected, even if successful, to lead to major gains in sectoral or national growth in the short run. We will argue here that these necessary price reforms must be accompanied by complementary non-price policy measures to create sufficient conditions for enhanced growth, and that even then, the growth rate will only respond in the medium to long term.

^{6/} We concentrate in this paper on the more important broad issues. Design questions, for example with respect to tranching and conditionality, are discussed in the Annual Agricultural Report from AGR.

1. Price reforms enhance efficiency, but not growth rates in the short run

Because the supply response is high for individual crops, "getting the prices right" causes a rapid adjustment of relative production between crops in favor of those that can be produced most efficiently, as land is shifted from one crop to the other. Long-run supply responses of individual crops are greater still, with estimates for developing countries 10 times or more the short-run magnitudes. (WDR 1986, Askari and Cummings and Scandizzo and Bruce). These production shifts between crops provide gains in terms of allocative efficiency, increasing in a step fashion the economic value of production.⁷

Correction of relative prices alone, however, will not lead to major increases in growth of the sector, for several reasons. First, aggregate supply response in agriculture as a whole is much lower than the response of individual crops, even in the longer run, since a major factor of production--land--is in relatively inelastic supply in many countries (Binswanger, et. al.). Even in Argentina, which until recently has had a fairly elastic supply of land and well-developed infrastructure, the

^{7/} The China agricultural reform is an interesting example. While output of several crops increased at unprecedented rates (grains at 5 percent, cotton at 17 percent) from 1979 to 1983, output slowed considerably after 1984 (1.1 percent and 1.2 percent, respectively) as the effect of the initial price and institutional shocks dissipated. Even the growth between 1980 and 1983 was largely attributable to non-price factors such as institutional reform. An econometric study found that 60 percent of the expansion was due to institutional reform, 25 percent from input use and technology changes, and only 15 percent from price changes (Lin).

aggregate supply elasticity in the short run has been estimated to be between .21 and .33; for the long run, it may be close to .8. For countries where infrastructure is less developed, the aggregate supply elasticity is generally much lower: for India between .2 and .3 both in the short and long run, for Kenya about .1 in the short run and .16 in the long run (Chhibber).

Second, the price adjustment is often comparatively small. In a study of 19 developing countries, it was found that on average domestic prices for export crops were only 11 percent below their international equivalents in 1975-84. This study also found that, for crops where domestic supplies were in part imported, domestic prices were actually higher than their international counterparts by about 19 percent (Krueger, et. al.)⁸ Finally, aggregate response to price changes is limited by the extent to which producers market their crops or use purchased inputs. These changes have virtually no impact on the sizeable subsistence production sub-sectors.

In one class of cases, reduction of price distortions may contribute directly to increasing sectoral growth. If this leads to a shift into production of outputs with high income elasticities, such as livestock or fresh fruits and vegetables, growth may improve. (The switch to fruits and vegetables contributed to the growth of Chilean agriculture, for example).

^{8/} Indirect taxation through overvalued exchange rates and other measures, on the the other hand, was quite substantial, overwhelming even positive price differences between domestic and international prices. These distortions, however, are not ameliorated by reducing the differences between domestic and border prices.

However, with the exception of livestock in some countries (e.g., Argentina and Uruguay), these products are not heavily taxed by direct pricing. (Lowering of a price of a commodity that competes for land with these higher valued crops may help but the gross substitution is usually low).

2. Non-price factors are important and complementary to price reforms.

Studies of the factors that influence agricultural growth find that non-price factors (public goods such as roads and irrigation and research and extension) are more important in explaining agricultural growth than prices. (For a survey of these studies, see Lele and Mellor). Chhibber, for example, found that on average a one percent increase in irrigation infrastructure increased supply output by one percent in countries with inadequate infrastructure and agricultural services. But rather than asking whether price or non-price factors are more important, a more useful approach views them as complementary. Investment in irrigation or drainage essentially expands the "fixed" factor of production, land, and increases the options available to farmers with respect to the crops they can produce. Transportation infrastructure likewise allows farmers to produce outputs, for example, perishables, that they could not produce otherwise. In this way, these non-price factors lower the cost of adjusting to changes in relative prices and thereby increase responsiveness.

In another, longer run sense, price and non-price factors are complementary. Recent research has emphasized the importance of relative prices in guiding the direction of technological change in agriculture (Hayami and Ruttan; Mundlak). Where one input is relatively expensive, technical change will proceed so as to economize on its use. Beyond this, decisions on both public and private investment in physical infrastructure,

132

human capital and research and extension, as well as adoption of new varieties or techniques by farmers, are all guided by relative prices. Where prices faced by public and private decision-makers are close to their opportunity costs, investment and technical change will be more efficient, leading to higher rates of growth. This is particularly true with regard to intersectoral pricing. A study that modelled technical change (as embodied in capital formation) induced by changes in intersectoral prices estimated a higher aggregate long-run supply elasticity than other studies (Cavallo and Mundlak).

Of course, since public goods such as roads, irrigation systems, and research and extensions services take many years to construct and yield returns, it can be expected that their effectiveness in raising growth will also be measurable only in the long-term. Because structural and macroeconomic adjustment in an economy often requires austerity in public expenditures for agriculture as well as other sectors, it would not be unexpected to find that agricultural growth even slowed under adjustment, despite the raising of agricultural prices. Because the effect of adjustment are realized in the longer-term and, when accompanied by austerity, may actually result in some decline in agricultural growth, the sustainability of the reforms may come into question as the government and farmers lose heart with the process.

3. Experience on the effects of agricultural adjustment shows mixed results in the short run; adjustment is a long term process.

The evidence on the relation between adjustment operations and agricultural growth reflects this ambiguity in results. The countries that

were recipients of adjustment loans (not necessarily agricultural) increased their average annual agricultural production growth rate from 1.6 percent (before the loan) to 2.8 percent (the three years following) to 3.2 percent (for all years following the loan, until 1987). Agricultural growth increased relative to the industrial production growth rate, which remained constant before and after the loans. Agricultural growth also increased more in recipient countries than in the comparable countries in each group. This average performance, however, masks substantial variation. Of the 29 recipient countries, 13 showed lower agricultural growth rates between the loan year and 1987 than for the three years before the loan. Of those, 4 (Nigeria, Jamaica, Brazil, and Yugoslavia) showed increased industrial growth rates while agricultural growth rates were declining (See Balassa, 1988c).

But what about the evidence of the effect of agricultural reform on long-term growth? The Bank's experience with agricultural reforms is relatively recent so it is difficult to derive conclusions about their long-term effects. Certainly the sequencing and pace of reforms is important. Although the Bank was only indirectly involved in its early evolution, Chile's experience presents some evidence on the effects and pace on long-term reform. Beginning in 1974, Chile initiated a long-term program of general economic and agricultural reforms that now appears to have been successful (Knudsen and Yotopoulos). Previous to the military takeover in 1973, the government administered the agricultural sector through direct ownership of important production, distribution and financial enterprises. It also carried out a multitude of controls and subsidies including price controls, quantitative restrictions, negative interest rates, and tariff preferences.

Starting in late 1973, the government quickly introduced changes based upon the principles of a free-market. The government deregulated prices; divested itself of the ownership of marketing and distribution enterprises, state land and agro-industrial processing; reduced technical assistance and public expenditures; and attempted to bring order to the budget, exchange rates and banking. These actions all taken together, and within a short period, represented a deep change in the agricultural sector which would take time to work itself out. In the interim, they led to pronounced instability in the sector. This was exacerbated by international disturbances, including economic and price instability abroad. Land ownership became exceedingly fluid (with many of the recipients under agrarian reform losing their lands), agriculture became decapitalized, agricultural debt accumulated, a large number of loans became non-performing, and overall crop hectarage of the 14 traditional crops declined from 1.2 to .87 million hectares by 1983. While fruit hectarage increased from 65 to 97 thousand, helping to maintain employment in rural areas could not offset the decline in traditional crops.

Beginning in 1983, the government retrenched by instituting variable tariffs (to stabilize agricultural prices) and government procurement of some commodities. Certainly, the retrenchment was not a complete backsliding. Instead, the government attempted to minimize its role in the sector through relying on indirect measures such as tariffs and procurement instituted through a cooperative financed by the Central Bank. With the instituting of these measures and continuing macroeconomic stability, the agricultural sector rebounded and stabilized. Fifteen years after the commencement of the agricultural reforms, the sector is booming, with rapid

137

growth (7.1 percent per year from 1984-1986) of both traditional crops for domestic consumption and fruits for exports.

Chile's experience emphasizes that agricultural reform takes years, that too much change too quickly can lead to instability, and that retrenchments may be necessary. Furthermore, despite believing profoundly in the importance of laissez faire, the government found it necessary to afford agriculture special consideration through price stabilization and protection for wheat, oilseeds, sugar and milk, markets that it viewed as artificially depressed and unstable due to policies of developed countries.

4. Lessons

From the Chilean experience and from the determinants of agricultural growth in general, it appears that agricultural reform should be considered as long-term, with its effectiveness in the short-term perhaps minimal or even destabilizing. This means that before embarking on the first sector adjustment operation, the Bank and the government should agree on a series of adjustment type operations over at least a five-year period. (Ideally it should be longer but governments can rarely commit beyond their own administration). Some of these operations could include hybrid loans, where fast-disbursing funds are committed along with slower-disbursing project or program funds. Also, since it is a long-term process, the first operation should not be too ambitious or politically painful, so long as there is a very clear commitment to the longer-term objective and precedents are set in various areas, so that no important area is later ruled out-of-bounds for the reform process. Ideally this commitment should include a pronouncement by the government on its commitment to a long-term program (along with its basic elements).

Effectiveness in each of the loans should be evaluated by whether policies were adjusted and not by whether agricultural growth and trade balances immediately improved. Provision should also be made for some retrenchment, when unforeseen events develop or reforms are found not to work. Once the program is well advanced (perhaps five to ten years after the beginning of reforms), then a more valid assessment of its effectiveness can be made.

Another lesson that emerges from the experience of long-term agricultural growth is that public and private investment must be maintained. Under fiscal austerity, public investment programs have suffered in general, and particularly in agriculture. Since public employment is dependent more on current expenditure budgets, fiscal cuts have concentrated on investment. For example, in Mexico where fiscal constraints are particularly severe, public investments for agriculture have fallen from US \$1,824 million in 1982 to less than US \$500 million in 1987. Yet, the potential for switching some current expenditures to investment, while still reducing overall expenditure is tremendous. Credit subsidies alone accounted for fractions of total government spending in agriculture (including investment) ranging from 4% to 99% in a sample of six Latin American countries in 1970 and 1980 (Elias). Yet, in most countries under adjustment, while salaries and input subsidies have declined, the released funds have not been used to augment investment budgets. In Morocco, for example, agriculture's share of public investments fell from 15 percent in 1984 to 7 percent in 1986 despite substantial fiscal savings from drastic reductions in input subsidies. Instead net investment in agriculture has probably been negative with depreciation in agricultural and rural infrastructure outweighing the small amounts of investment that have continued.

Rarely have sector loans addressed both the quality and specific level of funding of the portfolio. Although about 50 percent of sector loans have some conditions related to a satisfactory investment budget, these conditions have frequently been enforced through pressure to stop "white elephant" projects, rather than through a thorough review of the portfolio or ensuring that the government has a sound institutional process to review project selection. Loans also have not addressed the level of funding. The Mexico AGSAL is an exception where conditions were placed on the minimum level of funding for agriculture investments. Conditions on current expenditure reduction and switching should be more prominent in these loans, with "savings" from reduction in input subsidies and expenditures at least partially converted to investments. Similarly, both to guide decisions on provision and use of government-provided goods and services and to safeguard investment budgets, expenditures of government (both current and capital) should be increasingly financed by farmers through user fees and cost recovery. Design of administrative structures to permit this cost recovery should be part of Bank financing. By exerting stronger pressure to reduce current spending and recover costs, the Bank could ensure the survival of investment budgets without running afoul of over-riding macroeconomic objectives on deficit reduction.

B. Price Stabilization, Food Policy, and Agricultural Reform

Price stabilization and food subsidy programs are almost universal in developing countries. International prices of food staples are volatile and this volatility is magnified in domestic markets by erratic devaluations typical of countries with macroeconomic imbalances. The causality relation between price instability and macroeconomic instability

120

also runs the other way in some cases, with export price fluctuations threatening to destabilize macroeconomies. Furthermore, food constitutes a large fraction of the total expenditure of the population, especially the poor. In this section, we argue that, because of the priority placed on stabilizing food prices and protecting food consumption (especially of the poor), sustainable reform of the inefficient mechanisms aimed at these objectives must in most cases be achieved by substituting less intrusive and more efficient mechanisms, rather than by abandoning the objectives. We then consider the form of some substitute mechanisms.

1. Concern with price stabilization is virtually universal

One almost universal intervention in agricultural markets is the government's attempt to stabilize prices of important agricultural crops. The mechanisms used vary widely and often result in direct taxation of producers over a long period. Table A2 gives a summary of some schemes for a sample of developing countries. They range from schemes that address a specific commodity directly by either domestic procurement or importation to financial schemes such as buffer funds financed through variable taxes. What is particularly evident is that a variety of governments with different political views on the public sector's role have intervened to stabilize prices.

Some of policymakers' concerns about price instability are based upon micro-economic repercussions, such as the effect on production because of uncertainty and risk induced by price movements. The welfare of urban consumers is also a prime concern of governments, but here the concern goes deeper to not only stabilizing consumer prices but also subsidizing consumption either through price controls or through general subsidies.

129

These concerns are reinforced by related political considerations--such as the possibility of political unrest that could arise from suddenly higher prices for basic foods or unemployment in other traded sectors.

Exchange rate instability accentuates the desire to stabilize commodity prices. When the government devalues the currency (in real terms) as part of an overall adjustment program, it will almost always want to tax at least partially the "windfall gains" to producers and holders of commodity stocks and not permit a full transmission of the effects of price rises to consumers. Since the price adjustments resulting from devaluations are often large (80 percent or more in the case of Venezuela), the effect on consumers, especially the poor, could be substantial. The use of export taxes to partially offset exchange movement is well-documented for Uruguay (Jarvis and Medero) and Argentina (Sturzenegger).

Stabilization of commodity prices in some cases may also be perceived as contributing to macroeconomic objectives. Large movements in the export earnings of commodities that are a large part of aggregate foreign exchange earnings can destabilize the macroeconomy through effects on the money supply or "dutch disease" effects. (See, for example, Pinto). While the government can institute countervailing fiscal and monetary programs, this is not always possible because of general macroeconomic instability. Export taxes can exert a stabilizing impact on macroeconomic variables if they are not used to increase spending, but rather to reduce domestic credit creation (relative to its path without the extra taxes). If used in this way, the taxes automatically sterilize part of the change in the flow of foreign exchange. A narrow agricultural perspective would judge a step increase in export taxes as detrimental--while from a broader economy wide view these taxes might be considered beneficial. In countries

140

such as Argentina and Uruguay where the principal agricultural exports are also basic staples, the desire to stabilize will be even greater because of their effect on consumers.

Governmental perceptions of beneficial effects notwithstanding, an extensive economic literature has developed debating whether a theoretically well-designed price stabilization scheme would increase or decrease welfare of producers and consumers, with no clear conclusions. What is very clear, however, are the enormous costs imposed by the mechanisms governments used in practice. Price support levels, reinforced by trade controls, often not only insulate producers from short-term fluctuations in world prices, but completely divorce domestic prices from the long-term trends of border prices. Parastatals pre-empt private sector participation in procurement, storage, transport, processing and sale of basic foods, while purchases are subsidized by fiscal transfers or low prices to producers. These mechanisms generate huge financial losses, as well as costs in economic efficiency (Knudsen and Nash 1989a and 1989b).

Experience with sector operations has demonstrated that for political and (in some cases, weak) economic reasons, most governments will not completely abandon the objectives of stabilizing prices and subsidizing consumption. Furthermore, if a parastatal is the mechanism to implement this goal, the government most likely will not be willing to privatize or abolish this parastatal until a viable alternative to the price stabilization role of the enterprise is found. The Ecuador AGSAL required the end of government procurement without explicitly specifying a viable alternative; this attempt at removing government intervention in the market later proved to be an unsuccessful.

Likewise, sector loans that attempt to eliminate consumer price controls or general subsidies on foods important to the poor and even middle-class without the development of an alternative are likely to fail. Recent operations have increasingly recognized this. The Mexico AGSAL in binding the maximum level of global subsidies also required a minimum level of funding for direct targeted subsidies so that the impact of lowering of subsidies could be buffered. The team preparing the Venezuelan SAL is very conscious of this tradeoff and is actively focusing on the development of indirect and direct food subsidy schemes that target the poor.

3. Lessons

In agricultural sector lending, the desire of governments to stabilize prices or macroeconomic variables should be recognized and more efficient means sought to achieve these objectives. In general, the government's intervention should be limited to a minimum number of commodities and should not include direct handling of the commodity. Ideally, the intervention should be transparent and based upon pricing rules known by all, with prices flexibly linked to international prices. However, if the exchange rate is unstable, then the price stabilization scheme will tend to be ad hoc until the macro situation is under control. (This underscores the importance of coordinating sectoral and macro policy). Where the government's concerns are to stabilize prices to avoid macroeconomic fluctuations, alternative means to ad hoc export taxes deserve consideration, such as the revenue stabilization fund as used in

142

Chile for copper or the buffer funds used in Papua New Guinea for agricultural exports.⁹

With respect to consumers, the elimination of consumer price controls and general subsidies on important foods (by linking consumer and producer prices) should remain a priority, but must be accompanied by establishment of a targeted food system for the poor. A cost effective alternative approach to food subsidies is for the government to distribute food stamps to the poor. But this is not a system that can be developed overnight. Much administrative work must go into the program to minimize abuses and check the costs of the system. The food stamp system in Mexico took over a year to design and begin implementation-- even then serious errors were made.

A number of considerations are important in designing alternative systems. First, it should be recognized that leakages are inevitable and may be politically important as they broaden the support for the alternative system of subsidization and hence contribute to its sustainability. In Mexico, food stamps were provided to unions as part of the bargain in removing global food subsidies. Second, both to limit the program's costs and to avoid creating strong incentives for rural-urban migration, it is important that the subsidy not be open-ended. If the price of the food stamps are fixed in nominal terms, that is, not linked to the price of the food product, program costs can quickly balloon in a period of rapid inflation. This occurred in Mexico where stamps redeemable

^{9/} These funds not only partially neutralize the macroeconomic consequences of export earnings instability, but do so in a way that does not in the long run tax the agricultural products. See Knudsen and Nash (1989a).

143

for a given physical quantity of food had a fixed price with no connection to the food's price. A reasonable approach to setting the initial parameters of the system is to estimate the impact of actual price rises from the adjustment program on the income of the target population, and then try to ensure that the program transfers approximately equivalent resources to this population. The Mexican AGSAL estimated that food price adjustments reduced the purchasing power of the poorest 20% by about US \$225 million, and included conditionality that targeted food programs to redress this reduction. Obviously levels of funding for direct subsidies must be balanced by macroeconomic and fiscal considerations.

C. Trade Liberalization and Agricultural Reform

While liberalization of agricultural trade is a worthwhile goal, it is not advisable without a general trade liberalization program for other commodities, including adjustment of the exchange rate to realistic levels. By far, the most significant discrimination against agriculture has been through protection of industry and overvaluation of the exchange rate.¹⁰ If industry is not being liberalized at the same time, agricultural liberalization would simply exacerbate these biases. Furthermore, one of the strongest incentives to farmers to produce more may well be the availability of a greater variety of industrial products at lower cost, in part brought about through more free imports and greater competition.

^{10/} In a study of 16 countries, it was found the "disprotection" of agriculture from overvaluation and industrial policy was 25-29%, generally overwhelming even those cases where domestic prices to producers were subsidized (Krueger, et. al.).

144

The agricultural trade regime however cannot be treated independently of the objectives in agricultural pricing. If quantitative restrictions are to be removed for a particular commodity where minimum price or other price stabilization targets are in effect, then the replacing regime must be able to fulfill the stabilization objective (or the government must be convinced to abandon the objective). While a variable tariff may be able to achieve on paper the same degree of protection, in practice it may not. Nominal exchange rate movements may overwhelm even a variable tariff. While in theory a variable tariff can be adjusted to account for exchange rate fluctuations in maintaining a nominal domestic price, it may be administratively difficult to make this adjustment, especially when parallel exchange rate markets and capital controls exist. Furthermore, the stated or invoice price by which the tariff is calculated may be false or may not take into account other favorable terms such as credit concessions. Also, when capital controls are in effect, it may pay to import agricultural goods at a loss because it permits false invoicing and provides a mechanism to move capital abroad.

If the government has a minimum price scheme under which it is committed to purchase all available supplies at a fixed price, the budgetary repercussions of under-cutting the trade protection for the government may be significant, as it finds itself paying the support price for domestic production displaced by a flood of imports. As a consequence, attempts to convert quantitative restrictions to tariffs for commodities where price stabilization and support are government objectives may find government agreement extremely difficult or, if successful, reversed when price or exchange rate movements are adverse to the government's price stabilization efforts. Under these circumstances, the need for direct

145

government procurement (in addition to trade controls) may be questioned, but as long as the program is in place, complete abolition of quantitative restrictions may be difficult. Furthermore, if variable tariffs are put in place, the government should not try to enforce rigidly a minimum price when an unstable exchange rate exists. Price movements (although buffered) below this price are inevitable as exchange rate movements undercut prices.

In the longer term, means need to be found to achieve the objectives without the need for direct procurement or trade controls. The Madagascar AGSAL began a staged process to build up a private sector that would handle the procurement and storage of rice on the premise that a well-functioning storage market will optimally stabilize prices. As a first step, the government got out of the domestic procurement business, but operated a buffer stock of imported rice with a pricing mechanism that would avoid large price increases from speculation, but still allow a profit to private traders and storers. This worked well in establishing the private sector in these activities. The next step is intended to be withdrawal of the government from its role in running the buffer stock, with all storage done by the private sector. This paradigm of phased withdrawal, with substitution of a viable alternative to intervention, deserves consideration as a model for other operations.

With import barriers providing indirectly a disincentive to export, some governments have attempted to institute measures to promote exports, almost always including, and sometimes emphasizing, agricultural and agro-industrial exports. Direct export promotion measures (excluding indirect measures, such as devaluation) have included reduced export taxes, tax or duty drawback schemes, special credit lines, insurance or other special subsidies for exporters, creation of duty-free zones, or institutionalizing

government agencies to promote exports in other ways. While it is arguable that these incentives may in some sense offset other anti-export biases (e.g., overvaluation), in practice, the determination is seldom made whether these measures are not enough or perhaps too much to off-set these other biases. The appearance, and probably the reality in some cases, is that the government is promoting exports as an end in itself, rather than just correcting anti-export distortions. Subsidizing exports may turn out to be as costly and inefficient as overzealous protection of agricultural commodities on the import side. A study of export promotion through subsidized credit and insurance found the schemes to be ineffective in achieving their goals and socially costly (Fitzgerald and Monson).

Cross-country evidence from Africa seems to indicate that the best policies for promoting agricultural exports may simply be to follow realistic exchange rate policies and reduce governmental interference in the markets. Balassa compared the export performance of 19 sub-Saharan African countries in the 1974-78 periods. He found that on average, those following basically market-oriented policies gained 15% in export market share, while those following interventionist policies lost 24%, with intermediate countries losing 10%. It may be advisable to restrict export promotion measures to the elimination of anti-export distortions or restrictions rather than establishing direct export incentives. The former reforms at a minimum would promote efficiency in internal resource use, whether they actually increase exports or not.

This discussion suggests the following guidelines with respect to trade adjustments in agriculture. First, reducing agricultural protection should be conducted either after or at the minimum, in conjunction with a program of industrial trade liberalization. Second, the form and extent of

trade liberalization must take into account the stability of the exchange rate and the structure of trade in the individual commodity. If a support price with government procurement is in effect, and subsidies through credit, transport or invoicing are prominent in trade transactions, then quantitative restrictions may need to continue, at least while procurement is proceeding. (This does not imply, of course, that it is desirable to have governments procure or that it is necessary for governments to import commodities for which quantitative restrictions are in effect). Furthermore, the close linkage between agricultural trade and pricing policy requires that they be treated together--that is, reform in trade and pricing should proceed in coordination. This is a primary reason for dealing with these issues in an agricultural adjustment operation where attention can be focussed on the inter-relations rather than in a general structural or trade adjustment operation. In the longer run, especially when the macroeconomic situation is stabilized, means can be sought to phase out quantitative restrictions altogether and replace them with a variable tariff. Finally, export promotion measures should directly address the causes of distortion--overvalued exchange rates, taxes and trade prohibitions--rather than focus on additional government measures and export subsidies whose ultimate effects are difficult to predict and control.¹¹

^{11/} This does not mean that no direct measures for export promotion are needed. Activities such as trade conventions, reports from overseas commercial agricultural attaches, market studies are well within government sponsorship.

198

D. The Deepening of Reforms

The original strategy for policy-based lending was that basic economic reforms would be made under the auspices of a SAL or some broad-based SECAL. These reforms--macroeconomic and sectoral--would "stabilize" the economy, creating an appropriate environment so that further sectoral reforms could improve the structure of the economy. This second stage of reforms was envisioned to comprise measures that would "deepen" and "broaden" those carried out in the first stage. This deepening should entail a process of institutionalizing reforms and making them more permanent. Mexico's commitments upon accession to the GATT, for example, institutionalized or deepened its trade reform process. The deepening of reforms is essential to a program's success, as the private sectors must view the reforms as permanent in order to encourage the investment decisions that are crucial for making the required changes in the economic structure. The critical role of credibility of reforms in inducing investment during the adjustment process has recently been stressed by Rodrik.

Measured according to this definition, most adjustments undertaken either previous to or as conditions of SECALs have not acted to deepen reform in some key areas. With respect to product pricing, for example, the pattern consistently followed has been to try to raise the levels of controlled consumer prices and/or official producer prices. These measures are useful as far as they go, but usually they leave the institutional apparatus that determines official prices completely intact, unchanged, and subject to essentially the same political forces (e.g., pressure from urban consumers) that caused them to be set at low levels to begin with. This is especially troublesome, since as inflation erodes the increases, it will be

109

necessary to continually fight the political battles to ensure they are maintained in real terms.

In a few cases, the mechanisms used to set official prices (as opposed to just the specific levels) have been altered, e.g., by creating some kind of link with world price levels, which creates a certain insulation from political pressure. But in almost no case (only 4 out of 21 SECAL's examined) has the real structural problem been addressed by eliminating trade controls and price controls on the consumer level. Given the ease with which superficial price changes can be reversed (e.g., by passively allowing erosion by inflation), the private sector will be extremely reluctant to base long-term investments decisions on these reforms. Given the crucial and complementary role of relative price changes and investment (Section IIIA), failure to view price reforms as permanent will severely diminish effectiveness of the adjustments in eliciting an aggregate supply response.

On the input side, the situation is similar. Reforms in fertilizer pricing have always consisted of raising the official price to reduce the heavy subsidies required by the fertilizer sector, which is frequently a government monopoly. The adjustment process has rarely attempted to take fertilizer prices out of the political arena by removing the government from the business of manufacturing and distributing fertilizer. Since the reforms have not been deepened, it is questionable whether the pressure to allow prices to lag behind inflation can be resisted once the government's pressing budgetary problems are ameliorated.

Even with respect to "privatization", most reforms have been quite superficial. Many loans have required that the legal monopoly status of certain parastatals be eliminated, allowing private competition in these

130

markets. Only one, however, has required that the government withdraw from a market. In light of the threat of unfair competition from a government parastatal with unlimited resources and the power of government at its disposal, it is not surprising that the private sector is sometimes reluctant to enter these markets. (This was, for example, a problem in Mexico, when the private sector did not respond quickly when a parastatal's monopoly in grain imports was abolished).

Another sense in which reforms have not been deepened or institutionalized is that the legal regulatory framework has barely been touched. Regulation of economic activities along dimensions other than pricing is extensive in developing countries, and may extend to the establishment of new firms as well as to the operation of extant ones (Balassa, 1988a). Requirements for filing extensive paperwork to set up or expand a business, to hire or lay off workers, or to change the operation of a firm not only impede change, but especially discriminates against small and medium-sized firms that cannot spread the cost of compliance over a large output. These problems are usually not critical to the agricultural sector directly, but are of special concern to agroindustries, many of which should expand in response to changes in the trade regime or other adjustments. Burdensome regulatory environments can thwart the aims of trade liberalization in another way as well, if safety or health regulations are used in a protectionist way. In spite of the clear importance of regulatory issues for institutionalizing the adjustment process, only 3 of 21 SECALs acted to alleviate regulatory burdens, and none cited movement on such issues previous to the loans.

Overall, agricultural structural adjustment lending has instituted reforms in some key areas that have been largely superficial. It is not

difficult to understand why this pattern has emerged. Deepening of reforms requires a very detailed and complete information base on the legal framework in each country. This is an especially serious problem in tackling regulatory issues, where the legal framework may be extensive and intricate. In addition, governments are much less willing to make changes that are not easily reversed. Nonetheless, at this point in the adjustment process, the Bank should put more emphasis on the legal framework, and governments, if they are truly committed to the process, should be more willing to relinquish controls in ways that are not readily reversed. Privatization of state enterprises, while not a guarantee against reversal, certainly raises its costs. Finally, there does exist an international forum for making trade reform binding--the GATT. Under GATT accords, reversal of trade reductions in tariffs or other restrictions (except for limited reasons) could invite retaliation from other member countries and further raise the costs of reversal.

Dismantling of parastatals and privatization of commercial activities associated with previous policy should be part of the reform program. Pricing and trade reforms should only be viewed as transitory unless they are deepened through institutional changes. However, because of the political difficulty of some of these institutional reforms, the Bank should be prepared to accept that reforms may be gradual. But, a sine qua non of initial lending should be the government's willingness to establish its commitment to significant long-term movement in this area by policy declarations and precedent-setting dismantling or sales of at least some public enterprises.

12

One issue related to sustainable reforms that was brought out in the Bank review of structural adjustment is whether sector adjustment lending can proceed before macroeconomic stabilization. While in practice one can find circumstances where progress on agricultural reform may be possible in an unstable macro situation, it is rare, especially when pricing and trade policy are being dealt with. This is not just because under inflation or unstable exchange rates it is difficult to have relative prices and trade adjust quickly in response to uncertain signals, but also because the political will for change deteriorates. The Argentina and Ecuador AGSALs largely failed, not necessarily because the designs were faulty or overly ambitious, but that the macroeconomic situation was so unstable that the political will was eroded. In democracies, political strength is often the outcome of a sound economy and not just good intentions. When the macroeconomy crumbles, so does the political ability and will to implement change, especially in sensitive areas such as in agriculture and food policy.

The Future

In this paper, our analysis has been primarily backward-looking, dealing with the bank's experience to date. What does the future hold? Have the Bank and its borrowers learned the lessons of the early 1980s in adjustment lending?

Unfortunately, the answer is mixed. A certain fatigue is evident. As shown in Table 3, for the 1988-92 period, agricultural SECALs are not planned for many countries that previously received such loans. This is the case for 12 countries--Burkina Faso, Colombia, Central African Republic, Ecuador, Madagascar, Morocco, Nigeria, Sierra Leone, Sudan,

Uruguay, Yugoslavia, and Zambia. Only four loans made in 1986 or 1987 are currently expected to be followed up during the next five-year period. Even in these cases the lags are often long, three to four years. While the lack of the Bank's participation does not mean that reform will not proceed, it does imply that the Bank's input may well be limited. Furthermore, it raises doubts on whether previous reforms will stick and whether reforms will be deepened.¹²

On the other hand, the Bank in recent loans has begun to address some problems in innovative ways that may generate momentum for the reform process to proceed. One area where this has occurred is price stabilization in the context of agricultural trade liberalization. The Morocco AGSAL II has assisted in building a variable tariff system to replace trade controls. The Mexico AGSAL has a study initiated on the feasibility of implementing a similar system. The Madagascar Loan is systematically exploring buffer stocks to stabilize prices. However, as yet we still know very little on the practical difficulties with implementing variable tariffs or buffer funds. Variable tariff schemes are relatively new for developing countries, with Chile's price band being the longest running system. Buffer funds have operated in Papua New Guinea for agricultural exports and in Chile for copper. In-depth evaluations of these systems have not been conducted.

The situation is similar with food subsidy programs. While recent loans (Morocco and Mexico for example) have recognized the need for buffering price adjustments with targeted subsidies, the Bank is just

^{12/} We are indebted to a memorandum from Anandarup Ray to Randolph Harris dated March 8, 1989 for making this point.

134

beginning to build among operational staff the specialized knowledge to deal with food programs.

The Bank and developing countries are beginning to learn from the difficult process of agricultural reform. It is a relatively new process that has yet to reach a self-sustainable stage. The Bank's continuing participation is necessary. Hopefully, the difficulty of the task and the failures that have already been experienced will not discourage either governments or the Bank in its efforts to provide a policy environment conducive to a more viable agricultural sector. With the Uruguay Round of Multilateral Trade Negotiations in its last phases, hopefully these reform efforts in developing countries will be complemented by global reform so that markets more than governments will guide agricultural development in the 1990s.

155

Table 3¹

	1980 - 1987			1988 - 1992		
	SALs	Non-Agric. SECALs	Agric. SECALs	SALs	Non-Agric. SECALs	Agric. SECALs
Argentina	-	87	86	-	88(2)	90
Algeria	-	-	-	90 ₂ /	92	92
Brazil	-	83	83,86	-	91,92	-
Burkina Faso	-	-	85	-	-	-
Burundi	96	-	-	88,90,92	-	89,90(2)
Central Af. Rep.	86	-	87	88,90	-	-
Chile	85,86,87	-	-	-	-	-
China	-	-	-	-	-	88,90,92
Colombia	-	85,87	86	-	89	-
Comoros	-	-	-	89 ₂ /, 90 ₂ /	-	91
Ecuador	-	87	85	-	89,91	-
Ghana	87	83,84,85,86(2)	-	89,90,91	88,89(2)	-
Guinea Bissau	87	84	-	89,91	-	90
Yaiti	-	-	-	-	-	90
Honduras	-	-	-	88,89	89(2),91	91
Hungary	-	86	-	89	88	90
India	-	-	-	-	90,91(3)	90
Indonesia	-	87	-	89 ₂ /	88,90	90
Jamaica	82,83,84	81,83,87(2)	-	-	89,91	89
Kenya	80,82	-	86	-	88,89,91	90
Korea	81,83	85	-	-	92	-
Madagascar	-	85,87	86	90,92	88	-
Malaysia	-	-	-	-	90	91
Malawi	81,83,85	-	83	91	88	89
Mali	-	-	-	90	88,89,92	90
Mauritania	87	85(2)	-	89 ₂ /,90	-	89
Mexico	-	83,86,87	-	-	88,89(4),91(2)	88,90
Morocco	-	84,85,86,87	85,87	88,90	90	-
Nigeria	-	86	83	-	88,89,90,91	-
Pakistan	-	80,85,86	-	-	89(2),90(2),92	88,91
Philippines	80,83	87	84	88 ₂ /	89	90
Senegal	80,86,87	-	-	89,90 ₂ /	89,90(2)	90
Sierra Leone	-	-	84	-	-	-
Somalia	-	-	86	-	-	89
Sri Lanka	-	-	-	-	90,91	90
Sudan	-	80	83	89 ₂ /,90 ₂ /	-	-
Tanzania	-	81,86	-	-	88	89,91
Thailand	82,83	-	-	-	-	-
Tunisia	-	87	86	88	89(2)	89
Turkey	80,81,92,83,84	86,87	85	-	88,90	91
Uganda	82 ₂ / 84 ₂ / 87 ₂ /	-	83	89 ₂ /,91	91(2)	89
Uruguay	87	-	84	89	-	-
Yugoslavia	83	-	84	89,90 ₂ /,92	91	-
Zambia	-	84,85,86	85	90 ₂ /	-	-

g/ Program loan

Source: A. Ray Memorandum, March 8, 1989

951

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157

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152

TABLE A2 Mechanisms used for price stabilization

Country	Marketing Board or Parastatal			Buffer Fund	Buffer Stock	Export Taxes or Quotas	Import Quotas	Import Taxes
	Monop.	Non monop.	Delivery Quotas					
<u>Argentina</u>								
Wheat		x				x		
Meat		x				x		
Other crops						x		
<u>Brazil</u>								
Wheat	x							
Other crops					x		x	x
Export crops		x				x	x	
<u>Chile</u>								
Wheat								
Oil seeds								x
Sugar		x						x
<u>Cote d'Ivoire</u>								
Cocoa	x							
Coffee	x			x				
Palm oil	x			x				
Cotton	x							
Rice		x		x				
<u>Egypt</u>								
Cotton	x							
Sugar	x							
Rice								
Sesame			x					
Groundnuts			x					
Wheat			x					
Maize								
<u>Ecuador</u>								
Maize							x	
Rice		x					x	
Wheat		x					x	
Coffee		x					x	
Cocoa						x		
Sugar		x				x		
<u>Ghana</u>								
Cocoa	x							
Palm oil	x					x		
Maize	x							
Rice	x						x	

Source: Knudsen and Nash, 1988b, derived from information furnished by Ron Duggan

160

TABLE A2 Mechanisms used for price stabilization (Continued)

Country	Marketing Board or Parastatal			Buffer Fund	Buffer Stock	Export Taxes or Quotas	Import Quotas	Import Taxes
	Monop.	Non monop.	Delivery Quota					
India								
Wheat	x							
Rice	x				x		x	
Milk	x				x		x	
Mexico								
Maize		x						
Other grains		x			x		x	
Meat							x	
Malaysia								
Rubber						x		
Oil palm						x		
Rice	x	x				x		
Morocco								
Soft wheat (parastatal is major procurer -- 50%)		x					x	
Hard wheat, sugarcane, sugar beets, barley (parastatal is minor procurer -- 10%)		x					x	
Pakistan								
Before 1977: sugar, rice, cotton, wheat, veg. oil, "many others"	x							
After 1977: oilseeds		x						
wheat	x							
sugar	x							
rice	x	x	x					x
cotton	x							
Papua New Guinea								
Coffee, cocoa, copra, palm oil				x				

161

TABLE A2 Mechanisms used for price stabilization (Continued)

Country	Marketing Board or Parastatal			Buffer Fund	Buffer Stock	Export Taxes or Quotas	Import Quotas	Import Taxes
	Monop.	Non monop.	Delivery Quota					
<u>Philippines</u>								
Sugar (Export)	Until 1986					From 1978		
Coconut	Until 1986					From 1978		
Rice, wheat	"	"	"					
Soybeans								
Corn, foodgrains	"	"						
<u>Sri Lanka</u>								
Coconut, rubber								
Tea						"		
<u>Thailand</u>								
After 1986, all controls lifted								
Rice		"	"			"		
Sugar						"		
Maize						"		
Rubber						"		
<u>Turkey</u>								
Tobacco, cereals (wheat, barley)								
Cotton	"	"						
Sugar beets	"							
<u>Zambia</u>								
Maize, sunflower, soy, rice, wheat, cotton, tobacco groundnuts	"							

162



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Trade policy and industrialization

Which trade strategies have enabled countries to attain high growth and to develop their industrial potential? This chapter attempts to answer the question in two ways. First it examines the thinking that lies behind different strategies, the circumstances under which governments have adopted them, and the economic performance of countries that have pursued them. Then it discusses the economic costs and benefits of alternative trade strategies and suggests some reasons why economic performance has varied so widely under the different strategies.

Economic growth is fundamental to economic development. Without generating greater output and income, a country cannot make a sustained attack on poverty, unemployment, and other social and economic problems. In the first decades following World War II, economists viewed industrialization as an essential stage in reaching the goal of rapid economic growth. But industrialization cannot be a policy objective in its own right. This chapter suggests that the real question is not how fast an economy can industrialize, but how to structure the industrial sector so that it supports sustained economic growth.

Alternative trade strategies

Economists and policymakers in the developing countries have long agreed on the role of government in providing infrastructure, promoting market efficiency, and maintaining stable macroeconomic policies. But they have disagreed on policies toward trade and industry. The form of government intervention in this area is the distinguishing feature of alternative development strategies.

For analytical convenience, trade strategies can

be broadly divided into two groups, outward oriented and inward oriented. An outward-oriented strategy is one in which trade and industrial policies do not discriminate between production for the domestic market and exports, nor between purchases of domestic goods and foreign goods (see Box 5.1). Because it does not discourage international trade, this nondiscriminatory strategy is often (somewhat inaptly) referred to as an export promotion strategy. By contrast, an inward-oriented strategy is one in which trade and industrial incentives are biased in favor of production for the domestic over the export market. This approach is well known as the import substitution strategy.

Protection switches demand to products produced domestically. Exporting is then discouraged by both the increased cost of imported inputs and the increased cost of domestic inputs relative to the price received by exporters. This rise in the relative cost of domestic inputs may occur through domestic inflation or an appreciation of the exchange rate following the imposition of barriers to imports. In effect, protection puts a tax on exports (see Box 5.2).

This implicit tax is sometimes offset with export subsidies. As far as the trade account is concerned, a 10 percent tariff on all imports together with a 10 percent subsidy on all exports would be equivalent to a 10 percent depreciated exchange rate with no tariff and no export subsidy. Such a policy does not discriminate between exports and imports, so that it too is an outward-oriented strategy. But combining export subsidies and import tariffs involves administrative cost; in practice, the policy is rarely, if ever, designed to simulate liberal trade.

Box 5.1 Measuring neutrality in trade regimes: nominal and effective rates of protection

The concept of neutrality in trade regimes is straightforward: it means that the aggregate effect of all trade and industrial policies is to offer equal incentives to the production of all tradables. Measuring departures from neutrality, or bias, is not so simple, however. It involves several different indicators.

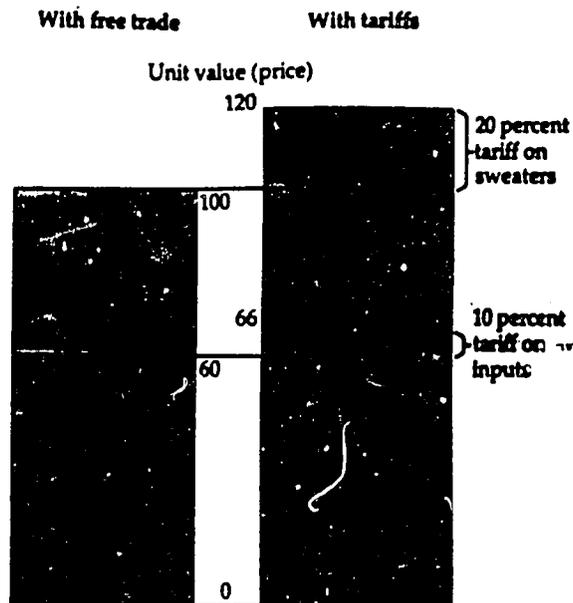
One way of measuring bias starts with the *nominal* rate of protection. For any good, this is the difference between the domestic price and the world price, expressed as a percentage of the world price. The overall bias of a trade regime can then be estimated as the ratio of (a) the average nominal rate of protection for importables to (b) the average nominal rate of protection for exportables. If this ratio is greater than one—that is, if importables have a higher nominal rate of protection than exportables—it reveals a bias in favor of import substitution. A ratio of one implies neutrality. (Exactly the same result can be obtained by using the ratio of the effective exchange rate for importables to the effective exchange rate for exportables. The effective exchange rate for importables must take account of any import duties, import premiums resulting from quantitative restrictions, and other incentives. Similarly, the effective exchange rate for exportables must take account of any export subsidies, tax credits, and other export incentives.)

Nominal rates of protection, however, often fail to measure the degree of protection actually received by domestic producers. This is because protection depends not only on the nominal protection given for the product itself, but also on any taxes or subsidies that there may be on inputs. For this reason, a different measure is more widely used to evaluate the orientation of trade regimes.

The *effective* rate of protection is designed to capture the protection accorded to value added in production, rather than to the finished product. It is defined as the difference between value added (per unit of output) in domestic prices and value added in world prices, expressed as a percentage of the latter. The effective rate of protection for importables is therefore equal to $\frac{v' - v}{v} \times 100$, where v' represents value added at domestic prices, and v represents value added at world prices. The result can be positive or negative, depending upon whether v' is greater or less than v . In an extreme case v itself could be negative. This represents the case in which domestic production is so inefficient that it is actually destroying value.

As an example, consider the effects of tariffs on the sweater industry. Suppose a sweater sells for \$100 in the absence of import restrictions and that the material inputs—wool and buttons—cost \$60 in world prices. The value added at world prices is therefore \$40. If a tariff of 20 percent is levied on sweaters, raising their imported price to \$120, and inputs remain duty free, the value added in domestic prices is \$60. The effective rate of protection is the difference between the value added in domestic prices (\$60) and the value added in world prices (\$40), as a proportion of the value added in world prices. In other words, the effective rate of protection is 50 percent, as opposed to the 20 percent

Box figure 5.1 Calculating the effective rate of protection



Note: In this example, where the nominal rate of protection is 20 percent on sweaters and 10 percent on inputs, the effective rate of protection is:

$$\frac{v' - v}{v} = \frac{54 - 40}{40} = 35 \text{ percent.}$$

nominal rate of protection. But if this tariff on sweater production is combined with a tariff of 10 percent on inputs, the domestic cost of inputs rises to \$66, which decreases the effective rate of protection to 35 percent (see Box figure 5.1).

The effective rate of protection for export production can be obtained in the same way; now v includes subsidies to exports. As before, the ratio of (a) the average effective rate of protection for importables to (b) the average effective rate of protection for exportables can be used as an indicator of trade orientation. (And again, the same results can be obtained with ratios of effective exchange rates, this time evaluated on the basis of value added.)

The use of any aggregate measure of protection has a serious drawback. It is possible that nominal or effective rates of protection for importables or exportables vary widely across industries, yet have an average value of zero—implying no protection. But the variation in nominal or effective rates of protection across industries is itself an important distortion. Full neutrality of a trade regime therefore requires no variation in nominal or effective rates of protection across the tradable goods industries.

165

Box 5.2 Protection and the taxation of exports

It is not unusual for a country to pursue policies of import substitution and export promotion at the same time. The objectives may be seen as independent. Thus, instruments designed to encourage import substitution may be introduced in the belief that they have no impact upon the export sector. But this is not so.

The most crucial characteristic of protection is that it is a *relative* concept. When a particular protective instrument is introduced, it is intended to alter relative prices in order to protect the chosen activity relative to other activities. For example, if an import tariff achieves its objective, resources will be induced to move from unprotected activities to the protected activity.

Recent research has shown that the impact of protection depends on the way it influences the prices of nontradable goods. Although the division of an economy into importables, exportables, and nontradables is somewhat artificial, it is also instructive. (Many service industries and industries with high transport costs may be regarded as nontradable: wages are a large component of their costs.) The introduction of a tariff will raise the domestic price of importables relative to the price of exportables, which will generally be determined by world demand and supply. The manner in which the tariff will cause the price of nontradable

goods to change is less clear. If the factors used to produce importables and nontradables are similar, that is, if they are close substitutes in production, the prices of importables and nontradables would tend to be closely linked and their relative price would not be much affected by an import tariff. The tariff would serve to raise the price of *both* importables and nontradables. Since the price of exportables is externally determined, producers in the export sector would find that the price of their output has fallen relative to both imports and nontradables. The effect is akin to a tax on their production. At the same time, domestic demand will tend to switch to the relatively cheaper products—exportables. Both effects will act to tax exports.

By contrast, if nontradables and exportables are close substitutes in production, the price of exports would still fall relative to imports, but there would be little change relative to nontradables. Tariffs discourage exports to a somewhat smaller extent in this case.

Given information on relative prices for exportable output, import substitutes, and nontradables, the relative price effects of protection can be estimated. Box table 5.2 reports the results of several studies which pertain to Latin American and African economies. The "shift parameter" in the table measures the share of any import protection which, because of relative prices, becomes an implicit tax on exports. This ranges from a low of 43 percent in the case of Côte d'Ivoire to a high of 95 percent in the case of Colombia. In almost every case, more than half of the burden of protection is shifted to the export sector.

Several important points arise from this analysis. First, protecting one sector usually makes another worse off. Second, when export incentives are introduced alongside import restraints, the export incentives may do little more than offset the disincentive effects of import protection. This may be one reason why export processing zones (EPZs) have not lived up to expectations—the EPZ incentives may be insufficient to counteract the implicit tax on exports caused by the restrictions on imports. Finally, the analysis implies that if export promotion is a goal of policy, the most direct means of achieving this goal may be import liberalization.

Box table 5.2 Estimates of the shift parameter in selected developing countries

Country and period	Shift parameter
Côte d'Ivoire, 1970-84	0.43
Uruguay, 1959-80	0.53
Chile, 1959-80	0.55
Argentina, 1935-79	0.57
Mauritius, 1976-82	0.59
El Salvador, 1962-77	0.70
Brazil, 1950-78	0.70
Côte d'Ivoire, 1960-84	0.82
Mauritius, 1976-82	0.85
Colombia, 1970-78	0.95

Note: The lower estimates for Mauritius and Côte d'Ivoire refer to nontraditional exportables; the higher estimates, to traditional exportables.

Source: Clements and Sjaastad 1984; Greenaway and Milner 1987.

Export pessimism

In the early postwar years most developing economies were relatively specialized in the production of primary commodities, which they exported in exchange for manufactured products from industrialized countries. But many economists argued that the producers of primary goods faced a secu-

lar decline in their terms of trade. The income elasticity of demand for primary products was low, synthetic substitutes for natural resources were appearing, and technical innovations were cutting the amount of raw materials needed for industrial production. All this suggested that the real prices of primary goods would fall over time. World demand for manufactures, by contrast, would con-

tinue to grow. To many this provided a justification for encouraging industrial production.

The prediction of declining terms of trade for primary products has been much debated. Critics say it ignored supply conditions: with diminishing returns to limited natural resources, slow growth in demand for primary products will not necessarily cause their terms of trade to decline. The prediction also overlooked the growth of developing countries and their demand for primary products as well as the early industrial transformation of developing economies with poor natural resource endowments, such as Hong Kong, Singapore, and, to a lesser extent, the Republic of Korea. The data in Chapter 2 do show a long-term decline in the terms of trade for exports of primary goods. But they should be interpreted with caution because they take no account of quality improvements in manufactures. And some of the recent surplus in primary commodities arose from investments encouraged by past high prices.

In spite of these uncertainties it may well be true that the relative price of primary commodities is in long-term decline. The question, however, is whether an inward-oriented strategy is the right response to this prospect. The overriding need is for flexibility in shifting the economy's resources to take account of the changing pattern of comparative advantage. Inward-oriented strategies are unlikely to promote this kind of flexibility.

New arguments against nondiscriminatory trade policies and their implicit encouragement of manufactured exports have recently appeared. One is known as the fallacy of composition; it holds that if all developing countries followed an export-promoting strategy modeled on the example of the newly industrializing countries (NICs) of East Asia, industrial countries would refuse to absorb the resulting volume of imports.

This has been challenged on at least four grounds. First, the capacity of industrial nations to absorb new imports may be greater than supposed. Developing country exports currently account for only a tiny share—2.3 percent as of 1983—of the markets for manufactures in the industrial economies. (Of course, the proportion is much higher for certain products and in certain countries.) Second, the idea that a large number of economies might suddenly achieve export-to-GDP ratios for manufactures like those of Hong Kong, Korea, or Singapore is highly implausible. The resource endowments of the East Asian NICs are quite different from those of countries such as Argentina, Brazil, Indonesia, Côte d'Ivoire, Malay-

sia, and Thailand, which are among the next tier of industrializing countries. Third, export-oriented countries would produce different products, and intraindustry trade (as occurred with the lowering of trade barriers within Europe) is likely to be important. Finally, the first wave of newly industrializing countries is already providing markets for the labor-intensive products of the countries that are following.

Policy instruments

Commercial policy, industrial policy, and exchange rate policy can all be instruments of an inward-oriented strategy. Policymakers often prefer direct controls, such as import licensing and quantitative restrictions, to tariffs. In addition, hidden import duties such as stamp taxes, port duties, and advance deposit requirements are common, as are a number of other quasi-tariff measures. Finally, domestic content requirements for certain industrial products have become increasingly common.

Publicly owned firms or industries have expanded rapidly in many developing countries, particularly in industrial sectors such as steel, fertilizers, cement, or petrochemicals (Chapter 4). These give the policymaker administrative control over investments and purchasing, for example. Governments can also use fiscal policy to provide production subsidies, credit subsidies, wage subsidies, and tax holidays of various kinds. In general, these incentives are offered in a discretionary, and hence discriminatory, way. Administrative allocation of foreign exchange is also common in inward-oriented regimes—sometimes to defend the overvalued exchange rates that are partly due to the import barriers themselves. Certain sectors are given preferential access to foreign exchange.

Thus, inward-oriented regimes are generally characterized by high levels of protection for manufacturing, direct controls on imports and investments, and overvalued exchange rates. By contrast, outward orientation links the domestic economy to the world economy. The discriminatory use of tariffs, quotas, investment licensing, tax and credit subsidies, and so on, would be incompatible with the purest sort of outward-oriented strategy. In practice, however, outward orientation does not necessarily mean less government intervention. Some countries have pursued outward orientation by offsetting some of the anti-export bias of import barriers: they have promoted exports while dismantling import barriers only slowly.

Some governments have tried to promote exports by creating free trade zones. For individual firms, bonded warehouses often offer subsidized facilities. But such zones have had little aggregate effect, since they have applied to only a small segment of the economy. In many countries free trade status has also been provided to the export sector in general, through duty exemptions or other administrative measures to allow exporters access to imported inputs at world prices. But this is usually too little to offset the incentives to produce for domestic markets when import protection is significant.

Positive export incentives fall into three groups: rebates in excess of actual import charges on imported intermediate inputs, or excessive "wastage" allowances on imported inputs; access to loans at below-market rates; and other explicit and implicit subsidies. Such policies require institutional sophistication and budgetary resources. They can be discriminatory and are open to abuse. Even relatively nondiscriminatory schemes have proved difficult to administer. Furthermore, they are increasingly threatened by countervailing measures imposed by some importing countries.

Defining trade strategy

Trade strategy has a great influence on industrial performance and economic development. To illustrate this, it is first necessary to classify countries according to their trade policies. In principle, the distinction between an inward-oriented and an outward-oriented strategy is straightforward, a matter of the effective protection provided to production for domestic markets as compared with export markets (Box 5.1). In practice, however, it is rather more difficult, because a trade strategy contains many policies at work simultaneously and because the data are very limited.

An attempt is made here to classify the orientation of a country's trade strategy by combining the following quantitative and qualitative indicators:

- *Effective rate of protection.* The higher the effective protection for domestic markets, the greater the bias toward import substitution (Box 5.1).

- *Use of direct controls such as quotas and import-licensing schemes.* The greater the reliance on direct controls on imports, the more inward oriented the economy.

- *Use of export incentives.*

- *Degree of exchange rate overvaluation.* Inward orientation generally leads to an overvaluation of the exchange rate.

Information for the period 1963 to 1985 has been collected for forty-one countries. (The availability of data limited the choice of countries, but the countries selected nonetheless accounted for 66.5 percent of the total output of developing countries in 1985.) This information was then used to divide the countries into "strongly outward-oriented," "moderately outward-oriented," "strongly inward-oriented," and "moderately inward-oriented" economies. Policies change, and world trade has been unsettled since 1973, so each group was examined for two periods, 1963-73 and 1973-85. The criteria for the four categories follow.

STRONGLY OUTWARD ORIENTED. Trade controls are either nonexistent or very low in the sense that any disincentives to export resulting from import barriers are more or less counterbalanced by export incentives. There is little or no use of direct controls and licensing arrangements, and the exchange rate is maintained so that the effective exchange rates for importables and exportables are roughly equal.

MODERATELY OUTWARD ORIENTED. The overall incentive structure is biased toward production for domestic rather than export markets. But the average rate of effective protection for the home markets is relatively low and the range of effective protection rates relatively narrow. The use of direct controls and licensing arrangements is limited, and although some direct incentives to export may be provided, these do not offset protection against imports. The effective exchange rate is higher for imports than for exports, but only slightly.

MODERATELY INWARD ORIENTED. The overall incentive structure distinctly favors production for the domestic market. The average rate of effective protection for home markets is relatively high and the range of effective protection rates relatively wide. The use of direct import controls and licensing is extensive, and although some direct incentives to export may be provided, there is a distinct bias against exports, and the exchange rate is clearly overvalued.

STRONGLY INWARD ORIENTED. The overall incentive structure strongly favors production for the domestic market. The average rate of effective protection for home markets is high and the range of effective protection rates relatively wide. Direct controls and licensing disincentives to the traditional export sector are pervasive, positive incentives to nontraditional exportables are few or non-

Figure 5.1 Classification of forty-one developing economies by trade orientation, 1963-73 and 1973-85

Period	Outward oriented		Inward oriented	
	Moderately outward oriented	Extremely outward oriented	Moderately inward oriented	Extremely inward oriented
1963-73	Brazil Cameroon Colombia Costa Rica Côte d'Ivoire Guatemala Indonesia Israel Malaysia Thailand			
1973-85	Brazil Chile Israel Malaysia Thailand Tunisia Turkey Uruguay		Bolivia Cameroon Colombia Costa Rica Côte d'Ivoire Guatemala Indonesia Madagascar Nigeria Pakistan Philippines Senegal Sri Lanka Yugoslavia	

Source: Based on Greenaway (background paper) and World Bank data.

existent, and the exchange rate is significantly overvalued.

Figure 5.1 sets out the forty-one developing economies, classified according to the orientation of their trade strategy in two periods, 1963-73 and 1973-85. Although there may be scope for disagreement over the two intermediate subgroups, the countries which are scored as extreme cases are not likely to be ambiguous.

Figure 5.1 is the basis for the analysis in the rest of this section. It shows that, over the period studied, several countries underwent policy shifts toward more outward orientation—Chile, Turkey, and Uruguay, along with Pakistan, Sri Lanka, and

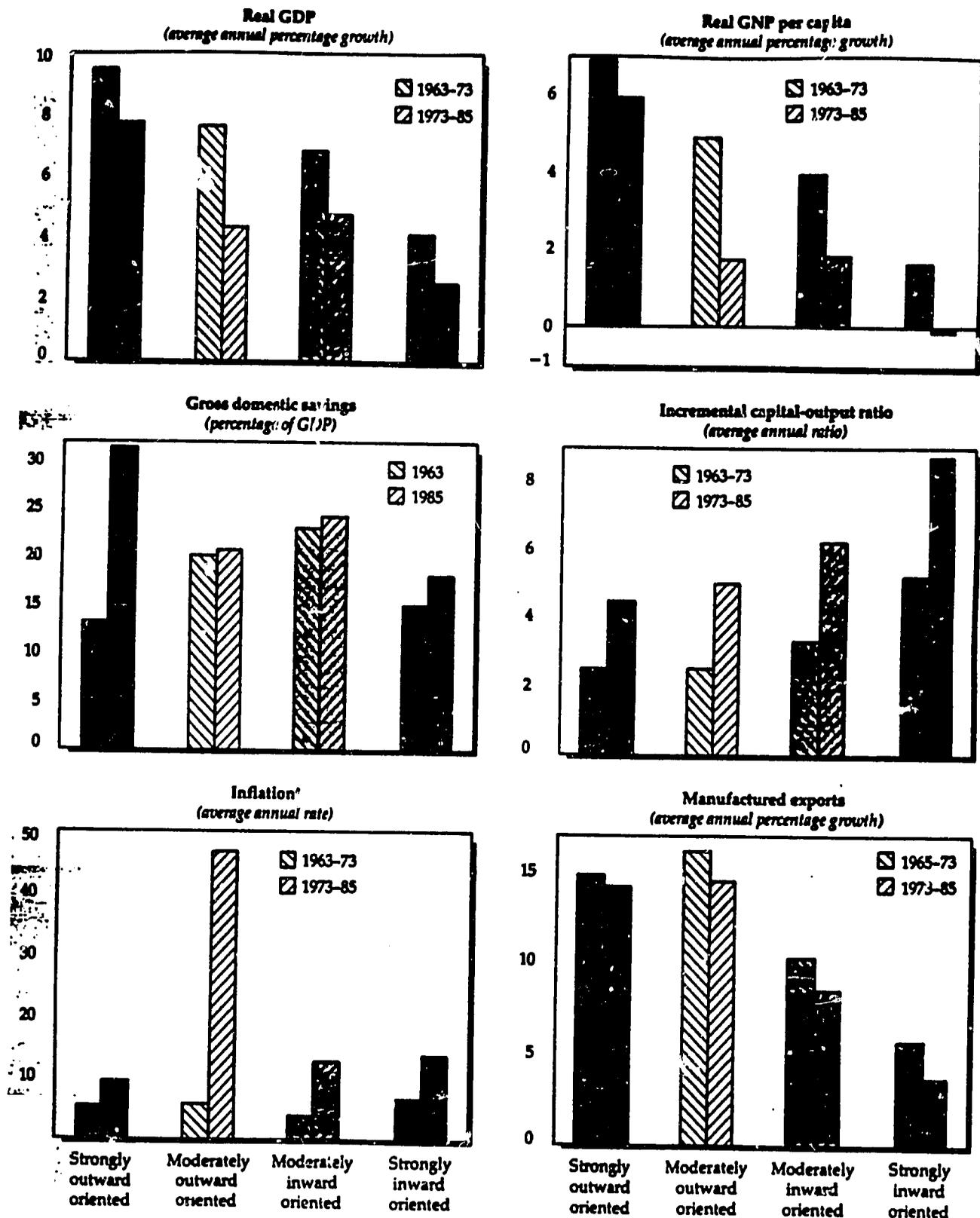
Tunisia. Others moved in the opposite direction, toward more inward orientation—Bolivia, Cameroon, Colombia, Costa Rica, Côte d'Ivoire, Guatemala, Indonesia, Madagascar, and Nigeria.

Trade strategy and economic performance

The links between trade strategy and macroeconomic performance are not entirely clear. Does outward orientation lead to better economic performance, or does superior economic performance pave the way for outward orientation? Nevertheless, Figure 5.2 provides indicators of the macroeconomic performance of the forty-one countries, grouped by the strategies defined above. The spe-

169

Figure 5.2 Macroeconomic performance of forty-one developing economies grouped by trade orientation



Averages are weighted by each country's share in the group total for each indicator. See Figure 5.1 for a listing of the economies in each of the trade groups.

* Inflation rates are measured by the implicit GDP deflator. Values are group medians.

170

cific indicators, given for weighted group averages, are the average annual growth rates of real GDP and per capita income, the gross domestic savings ratio, the average incremental capital-output ratio, the average annual growth rate of real manufactured exports, and the group median of average annual rates of inflation.

The figures suggest that the economic performance of the outward-oriented economies has been broadly superior to that of the inward-oriented economies in almost all respects. First of all, growth rates of GDP show a clear descending pattern from the strongly outward-oriented to the strongly inward-oriented economies. For the 1963-73 period the annual average was 9.5 percent for the strongly outward-oriented group, more than double the 4.1 percent attained by the strongly inward-oriented group. The respective rates for 1973-85 (7.7 percent and 2.5 percent) show that the gap has widened.

As a result of these trends in GDP, the average annual growth rate in real per capita income for 1963-73 was highest in the strongly outward-oriented economies (6.9 percent) and lowest in the strongly inward-oriented economies (1.6 percent). Despite the economic slowdown during 1973-85, per capita income in the strongly outward-oriented economies grew by an annual average of 5.9 percent, whereas in the strongly inward-oriented countries it fell on average by 0.1 percent a year. Performance differences are less marked between the moderately outward-oriented and the moderately inward-oriented economies; this reflects the relatively modest differences in their policy environments. (Figure 5.3 shows the per capita growth performance of each of the forty-one economies.)

GDP growth is influenced by the level of savings as well as by the efficiency of investment. The average ratio of gross domestic savings to GDP of the strongly outward-oriented economies was exceeded by all other groups in 1963, registering only 13.0 percent. By 1985, however, the strongly outward-oriented economies had more than doubled their savings ratio to 31.4 percent, whereas the savings ratios of the other three groups grew only slightly, or stagnated.

Given the gross savings rate, efficiency in the use of additional capital resources in an economy can be reflected in the economy's incremental capital-output ratio—the ratio of gross investment to the increase in GDP. Lower values suggest more productive investment. For both periods, there is a clear association between lower incremental capital-output ratios and increased outward orien-

tation. The average for both strongly and moderately outward-oriented groups for 1963-73 is 2.5, while the moderately and strongly inward-oriented groups averaged 3.3 and 5.2, respectively. In the 1973-85 period, the data register a substantial deterioration for all groups—incremental capital-output ratios are 4.5 and 5.0 for the outward-oriented groups and 6.2 and 8.7 for the inward-oriented groups.

By removing barriers, outward-oriented economies tend to tie themselves to the inflation rates of the international economy. This may restrain their own inflation rates; however, at times of rapid inflation in the world economy, it can result in imported inflation, unless the exchange rate appreciates. In 1963-73, median inflation rates differed little between any of the groups; moderately inward-oriented economies had the lowest rate. In 1973-85, the median inflation rate reached double digits in all groups. The highest median inflation rate is that of the moderately outward-oriented group; four of the eight economies experienced high or hyperinflation in the 1930s—Brazil, Israel, Turkey, and Uruguay. The other economies in the sample with particularly high inflation—Argentina, Bolivia, and Peru—are in the strongly inward-oriented group. In the higher inflation environment of the 1970s and early 1980s, however, the strongly outward-oriented economies were able to maintain relatively low and stable rates of inflation.

The last graph in Figure 5.2 shows the average annual growth of manufactured exports from 1965 to 1973 and from 1973 to 1985. Again, the strongly outward-oriented economies performed best. Between 1965 and 1973 the manufactured exports of the two outward-oriented groups grew by 14.8 and 16.1 percent, compared with 10.3 and 5.7 percent for the inward-oriented groups. Between 1973 and 1985 the growth rates were 14.2 and 14.5 percent versus 8.5 and 3.7 percent. This growth of manufactured exports was probably an important factor in producing rapid overall economic growth.

Finally, a good case can be made for suggesting that outward orientation leads to a more equitable distribution of income. First, the expansion of labor-intensive exports means higher employment. Second, reinforcing this, outward orientation removes the bias in favor of capital-intensive industries which is often implicit under inward-oriented policies. Third, the direct controls of an inward-oriented strategy generate rents that channel income to those with access to import licenses or subsidized credits.

Empirical evidence also indicates that an outward-oriented strategy can improve the distribution of income. For example, the Gini coefficient (a measure of income inequality) declined in Hong Kong from 0.49 in 1966 to 0.45 in 1981 and in Singapore from 0.50 in 1966 to 0.46 in 1980. The Gini coefficient declined in Korea from 0.34 in 1964 to 0.33 in 1970, but it increased to 0.38 in 1976, partly because of credit subsidies to promote certain priority investments during the 1970s (Fields 1984).

Trade strategy and industrialization performance

Governments often adopt an inward-oriented strategy in order to promote industrialization through import substitution. But it seems that countries have industrialized faster under outward orientation. Table 5.1 sets several indicators of industrialization against the four categories of trade strategy. The indicators are the growth of manufacturing and agricultural value added, the share of manufacturing value added in GDP, the share of the active labor force employed in industry (defined to include mining, construction, and utilities, in addition to manufacturing activity), and the growth of employment in manufacturing.

During both periods, average annual growth of manufacturing value added was highest in the strongly outward-oriented group and lowest in the strongly inward-oriented group—15.6 percent versus 5.3 percent during 1963–73 and 10.0 versus 3.1 percent during 1973–85. Although both the moderately outward-oriented and the moderately inward-oriented economies achieved fairly high rates for 1963–73 (9.4 and 9.6 percent respectively), both saw a strong decline in the following period.

The smallest decline was in the strongly inward-oriented economies—but this group's manufactures had grown at a substantially slower rate than all other groups in the 1963–73 period. Even with a one-third fall in the growth of manufacturing in 1973–85, growth in the strongly outward-oriented economies remained higher than in any of the other groups during the more favorable economic climate of the previous period. The strongly outward-oriented economies have clearly coped better than the others with the economic shocks since 1973. (Again, Figure 5.3 shows the growth of manufacturing value added in the individual economies.)

The outward-oriented economies also achieved a higher share of manufacturing value added in GDP in 1963 (20.1 percent compared with 15.2 percent for the inward-oriented economies) and in 1985 (23.0 percent compared with 15.8 percent). The strongly outward-oriented and moderately inward-oriented groups both increased the share of manufacturing value added in their GDP by more than half from 1963 to 1985. The increase in the moderately inward-oriented economies, however, merely brought their share of manufacturing to a level achieved by all other groups two decades before. The share of manufacturing declined by 1.7 percent in the strongly inward-oriented group. The gap between the outward-oriented economies taken together and the inward-oriented economies taken together increased slightly.

Industry provides more of the jobs in the outward-oriented economies than it does in the inward-oriented ones. The share of labor in industry reached 30.0 percent in the strongly outward-oriented economies in 1980, considerably more

Table 5.1 Characteristics of industrialization for forty-one developing economies grouped by trade orientation

Trade strategy ^a	Average annual growth of real manufacturing value added ^b		Average annual growth of real agricultural value added		Average share of manufacturing value added in GDP ^c		Average share of labor force in industry		Average annual growth of employment in manufacturing ^c	
	1963–73	1973–85	1963–73	1973–85	1963	1985	1963	1980	1963–73	1973–84
Strongly outward oriented	15.6	10.0	3.0	1.6	17.1	26.3	17.5	30.0	10.6	5.1
Moderately outward oriented	9.4	4.0	3.8	3.6	20.5	21.9	12.7	21.7	4.6	4.9
Outward oriented (average)	10.3	5.2	3.7	3.3	20.1	23.0	13.2	23.0	6.1	4.9
Moderately inward oriented	9.6	5.1	3.0	3.2	10.4	15.8	15.2	23.0	4.4	4.4
Strongly inward oriented	5.3	3.1	2.4	1.4	17.6	15.9	12.1	12.6	3.0	4.0
Inward oriented (average)	6.8	4.3	2.6	2.1	15.2	15.8	12.7	14.1	3.3	4.2

Note: Averages are weighted by each country's share in the group total for each indicator.

a. See Figure 5.1 for a listing of the economies in each of the trade groups.

b. Data not available for Yugoslavia.

c. Data not available for Costa Rica and Malaysia (1963–73, 1973–84); nor for Thailand and Mexico (1963–73).

than in the moderately inward-oriented (23.0 percent) and the moderately outward-oriented (21.7 percent). In the strongly inward-oriented economies, manufacturing was a source of employment for only 12.6 percent of the work force.

Moreover, employment has grown faster in the outward-oriented economies. Manufacturing employment grew by 6.1 percent a year in 1963-73 (compared with 3.3 percent in the inward-oriented economies) and by 4.9 percent in 1973-84 (compared with 4.2 percent). In the first period, manufacturing employment grew three times faster in the strongly outward-oriented economies than in the strongly inward-oriented economies, 10.6 percent a year versus 3.0 percent. Growth slowed in the strongly outward-oriented group in 1973-84, narrowing the gap between the two extreme groups. But manufacturing in the strongly outward-oriented economies still increased employment at a faster rate (5.1 percent) than the strongly inward-oriented group (4.0 percent) and at a slightly faster rate than the moderately outward- and moderately inward-oriented economies (4.9 percent and 4.4 percent, respectively).

The outward-oriented countries fared better not only in industrialization and manufactured export growth, but also in agriculture. Their agricultural value added grew by 3.7 percent in 1963-73, compared with 2.6 percent in the inward-oriented economies, and by 3.3 percent in 1973-85, compared with 2.1 percent.

Why outward orientation works

The evidence of the previous section strongly suggests that outward-oriented trade policies have been more successful than inward-oriented trade policies. It is a harder task to explain precisely why. The two regimes confront economic decision-makers with radically different signals and incentives. A full answer would call for an analysis of the effect of each of these elements. The best that can be achieved in practice is to consider the broad economic themes that seem to be at work.

It is well known that the protection associated with inward-oriented policies imposes economic costs, not least on the country that puts the policy into effect. Some of this economic burden, which is part of the reason inward-oriented policies have failed, can be seen from the structure of incentives that have resulted from tariffs and other protective measures (see Box 5.3). These incentives are bound to have important influences on the efficiency of resource allocation.

Box 5.3 Trade orientation and the structure of protection

Although estimates of effective rates of protection are widely available for many developing countries, they are not strictly comparable for various reasons. For instance, estimates available for different economies pertain to different years; some are based on tariffs only, whereas others include the effects of other policies that encourage or discourage production; and in some cases the protection-induced exchange rate effects are netted out, but in other cases they are not. These shortcomings notwithstanding, estimates may be suggestive of the relationship between the structure of protection and the trade strategies they followed.

Box table 5.3 provides a glimpse of typical structures of effective protection by sector and by sales destination. Several features are noteworthy. First of all, the structure of protection clearly shows that there was, on average, bias against exports in all countries for which data are available—with the possible exception of Singapore and the Republic of Korea, where the bias was so small that it could easily have been offset by assistance (although the data are insufficient to say whether this was the case). For the rest of the sample countries, the extent of such bias, measured by the difference of effective protection between domestic and export sales, ranges from 9 percentage points for Colombia (1969) to 229 percentage points for Chile (1967).

The data also reveal that there was a clear bias against the primary or agricultural sector and favoring the manufacturing sector in every country considered except Korea, where the opposite was true because of the rising price support for rice production. In the case of Colombia, the negative rate of protection for agriculture in 1969 was largely due to the export tax applied to coffee. Such a negative rate of protection for primary exports may be justifiable when import demand is inelastic so that disincentives to export sales can provide larger export revenues. But such cases are probably exceptional. The extent of bias against the primary sector in relation to the manufacturing sector is more conspicuous in the inward-oriented sample of countries. These figures indicate the negative incentives provided to export sales in countries in which primary goods constituted major exports.

Finally, the range of effective protection rates measures the scale of discrimination between different industries. As indicated in the table, the ranges for the countries are based on different numbers of sectors and are therefore not strictly comparable. Nonetheless, they reveal that ranges tend to be greater in countries where the overall level of protection is higher.

Box table 5.3 Structure of effective protection in selected economies by sector and sales destination
(percent)

Economy and year	Trade orientation	Effective protection rates by sector			Range and number of sectors	Effective protection rates by sales destination	
		Primary	Manufacturing	Overall		Domestic market	Export market
Singapore 1967 ^a	■	5	0	0	-7 to 21 (9)	2	-5 ^b
Korea, Republic of 1968 ^a	■	11 ^c	-17	-1	31 to 119 (11)	-1	-3 ^b
1978 ^d	■	77 ^c	5	31	-38 to 135 (11)	31	18 ^b
Brazil 1967 ^a	□	-4 ^c	45	19	-4 to 123 (12)	..	..
1980-81 ^e	□	-21 ^c	23	..	-48 to -17 (3 primary) -85 to 219 (67 manufacturing)	..	..
Colombia 1969 ^a	□	-23 ^c	4	-15	-23 to 161 (10)	-14	-23 ^b
1979 ^d	■	39	55	44	22 to 88 (5 primary) 25 to 127 (29 manufacturing)	..	..
Philippines 1965 ^a	■	-13 ^c	99	0	-34 to 239 ^f (10)	..	..
1980	■	9	44	36	..	..	..
Chile 1967	■	-7 ^c	217	168	-23 to 1,140 (22)	233	4
Nigeria ^a 1980	■	-12	82 ^f	..	-4 to 31 (7 primary) -62 to 1,119 (107 manufacturing)	..	..

- Strongly outward oriented
- Moderately outward oriented
- Moderately inward oriented
- Strongly inward oriented

a. Estimates are net of exchange rate overvaluation (compared with a hypothetical free trade situation) owing to import protection.
b. Estimates are adjusted for subsidies through credit and tax preferences.

c. Includes agriculture, forestry, and fishing only.

d. These estimates are based on tariff observations only, whereas all other estimates are based on direct price comparisons between domestic and world prices at the border.

e. An extreme case with negative value added in world prices is excluded.

f. Estimate is for 1979-80.

Source: For Brazil 1967 and Philippines 1965: Balassa and others 1971; for Korea 1968, Singapore 1967, and Colombia 1969: Balassa and Associates 1982; for Colombia 1979: Echeverri 1979; for Chile 1967: Krueger and others 1981; for Korea 1978: Nam 1981; and for others: World Bank data.

It may well be, however, that other policies not necessarily part of the inward- or outward-oriented strategies as they have been defined here account for some of the differences in performance. Chapter 4 has already examined the appropriate role of government. Chapter 7 will examine the ways in which other policies affect the allocation of resources and hence the prospects for growth. The rest of this chapter focuses on the links between trade policy and economic growth.

Trade policies and growth

The advantage of an outward-oriented strategy over an inward-oriented strategy is that it promotes the efficient use of resources. The gains from this go well beyond the ones which are re-

vealed by conventional analyses of the costs of protection (see Box 5.4). The rationing of import licenses, credit, and foreign exchange has invariably generated premiums and, in turn, rent seeking. By dismantling these administrative systems entrepreneurs could direct their energies away from unproductive activities, such as lobbying for changes in regulations. Further gains derive when firms achieve economies of scale: in an outward-oriented regime, the size of the domestic market does not limit the output of exporting firms.

Foreign investment is often attracted to the protected domestic markets of an inward-oriented economy—in the form of so-called tariff-jumping investments. But this kind of investment may actually reduce rather than improve the recipient's welfare. An outward-oriented policy will not at-

Box 5.4 Measuring the costs of protection

The objective of import tariffs and quotas is generally to raise the domestic price of a product above its world price and thereby stimulate increased domestic production. The attainment of this objective will not be costless, however. Protection generally imposes costs on the citizens of the protecting economy. Moreover, the magnitude of these costs differs between one instrument of protection and another. For example, quantitative restrictions are likely to impose substantially greater costs on society than tariffs that restrain imports to an equal extent.

Protection imposes a variety of costs on society. Economists frequently divide the efficiency costs into consumption losses and production losses. Consumption losses refer to the losses in real income of consumers of the protected product that occur because protection generally induces consumers to buy less of the protected product while paying a higher price. Producers benefit from the higher price and will often respond by increasing their output. A production loss is involved here to the extent that resources have to be drawn from other activities (including production for export), where they can be more efficiently used. Many studies on the cost of protection have attempted to estimate the magnitude of these production and consumption losses: estimates of less than 1 percent of GDP are common. It should be noted that these are annually recurring costs which apply for as long as protection is in force.

These production and consumption losses are not, however, the sole costs of protection. In addition, there can be losses associated with so-called X inefficiency when protection leads to domestic monopoly. For example, monopoly can permit the entrepreneur to relax

and not undertake the necessary effort to minimize costs. Moreover, monopoly can also cause conventional inefficiencies by restricting output.

The cost of protection is also underestimated if the costs of rent seeking and directly unproductive profit seeking are ignored (Box 4.7 in Chapter 4). Lobbies spend resources enacting protection. Similarly, once protection is enacted, it may lead to further resource-wasting lobbying—for example, in pursuit of import quotas carrying scarcity premiums.

Most of the earlier studies which measured the costs of protection have been conducted using "partial equilibrium" methods. In other words, the analysts focused attention only on the industry or sector being protected. But protection has effects which reverberate beyond the sector or sectors in which the initial restraint is imposed. Some analysts have attempted to estimate the costs of protection in models where such secondary effects are allowed for, that is, using "general equilibrium" methods. In principle, such models incorporate *all* the repercussions of protection on production and consumption, including effects on X inefficiency, the terms of trade and income, and employment beyond the industry under consideration. These studies generally provide substantially greater estimates of the cost of protection than do the partial equilibrium studies. For example, recent studies show that removing quotas alone in Turkey in 1978 would have increased its GDP by as much as 5.4 percent (Grais, de Melo, and Urata 1986) and that eliminating tariffs, quotas, and export taxes in the Philippines in 1978 would have increased its GNP by as much as 5.2 percent (Clarete and Whalley 1985).

tract investment projects which depend on the retention of import barriers.

While protected firms are sheltered, often within monopolistic markets, firms under outward orientation face greater competition—and hence incentives to increase their production efforts. So-called X inefficiency—the economic cost of a quiet life—is likely to be greater under inward orientation than under outward orientation.

All of these factors are important, but the scale and persistence of the growth rate differentials between the strongly outward-oriented economies and the others suggest that more subtle economic forces might also have been at work.

INNOVATIONS. It is tempting to argue that a more competitive environment for firms could lead to more incentives for increased productivity through technological innovations. Equally, it can be argued that “uncompetitive” profits might be needed before firms will engage in the efforts of technological innovations. Little is known about technological innovation in relation to trade policy. Nonetheless, there is increasing evidence that adoption of new technology has been faster in outward-oriented than in inward-oriented developing economies (see the section below on productivity growth). It is worth noting that exporting firms often benefit from a considerable transfer of technology from abroad, including advice on production engineering and aid in product design and marketing. Exposure to foreign know-how may help to speed innovations.

SELF-CORRECTING POLICIES. Arguably, outward-oriented regimes provide self-correcting mechanisms to align the macroeconomic variables that affect growth. For instance, if the exchange rate is permitted to become overvalued, the misalignment is quickly obvious under outward orientation because the balance of trade goes into deficit. In an inward-oriented regime the effect of the misalignment would take the subtler form of rising premiums on import licenses.

Savings, investment, and productivity

Growth performance can be looked at in another way: what has happened to the stock of capital and to its level of productivity? Much work remains to be done on this question, but there are a few indications that outward orientation might have encouraged higher savings rates and productivity growth.

SAVINGS RATES AND TRADE STRATEGY. As noted earlier, some outward-oriented economies have achieved spectacular growth in savings rates (Figure 5.2). Lack of empirical work makes it difficult to establish the relationship between savings rates and trade strategies, but several links seem plausible. First, a policy shift from inward to outward orientation should generate additional real income, partly by reducing the misallocation of resources and partly by raising income through multiplier effects as rising exports bring spare capacity into use. In developing countries the marginal propensity to save tends to exceed the average propensity to save, so that the increase in real income would help to raise the average propensity to save.

Another possibility is that domestic savings rise further under outward orientation because a higher-than-average share of income generated by exports is saved. Several studies found a strong positive correlation between export growth and domestic savings, but the issue remains unresolved.

A third link between trade policy and savings may be that high real interest rates are an important incentive for personal (and especially small-scale) savers. Capital markets are often highly distorted and underdeveloped in developing countries, and they tend to be more so in inward-oriented than in outward-oriented economies, even to the point of offering negative real interest rates in some instances. This could discourage savings in some inward-oriented countries (see Chapter 7).

Investment may be financed by foreign savings as well as by domestic savings. Under inward orientation, tariff-jumping foreign investment is common. In contrast, foreign investment is often attracted to exporting industries in outward-oriented economies. Foreign capital is more likely to generate the income (and exports) for its own servicing in export-oriented countries. Overvalued exchange rates maintained by exchange control systems, which are so common in inward-oriented economies, also deter foreign capital inflow.

PRODUCTIVITY GROWTH. Proponents of import substitution base their policies partly on the infant industry argument. They argue for temporary protection while firms raise their technical efficiency by creating industrial skills and mastering modern technology. But high protection may have the opposite effect. By limiting competition in sheltered domestic markets, it may inhibit specialization and promote risk aversion among managers (see Box

Box 5.5 Productive inefficiency under import protection: an example at the plant level

An intensive examination of the cotton spinning and weaving sector in Kenya and the Philippines illustrates some of the productivity losses that can occur in countries in which import substitution is the dominant strategy. Productivity of individual plants in these countries was calculated in relation to productivity in textile mills using identical equipment in industrial countries. Total factor productivity in the two sets of developing country plants ranged from 55 to 73 percent of that in the industrial country factories. On the basis of both engineering and economic analyses, the source of the difference in productivity was decomposed into three factors: the absence of horizontal specialization; technical expertise in management; and task-level productivity in the work force. The results of this decomposition are shown in Box table 5.5. Each number in the table shows the percentage of best-practice productivity in industrial countries realized in each activity. The sources of deviation from best practice are multiplicative, so that the product of the bottom three rows yields the relative total factor productivity shown in the top row.

The main cause of low total factor productivity was the inability of firms to obtain the benefits that specializing in a narrow range of products brings. Inadequate managerial skills reduce total factor productivity by 9 to 25 percent. Surprisingly, once the other productivity-reducing factors are taken into account, labor produc-

Box table 5.5 Total factor productivity relative to best practice in Kenyan and Philippine textile plants, 1980

Relative productivity and sources of deviation	Spinning		Weaving	
	Kenya	Philippines	Kenya	Philippines
Relative total factor productivity	0.70	0.73	0.68	0.55
<i>Sources of deviation from best practice</i>				
Horizontal specialization	0.85	0.79	0.63	0.70
Technical expertise in management	0.93	0.91	0.99	0.75
Task-level productivity	0.85	1.03	1.11	1.03

Note: The values are a productivity index of developing country plants relative to best practice in industrial countries. Source: Pack 1987.

tivity is close to industrial country levels. Productivity losses from excessive product variety and from inadequate incentives to obtain technical competence have been a standard criticism of import-substituting industrialization. Although it is not correct to attribute all of the shortcomings shown in Box table 5.5 to this strategy, it was undoubtedly an important factor.

5.5). To maintain or improve their market position, however, exporting firms need to keep up with modern technology and bring managerial skills up to international standards.

The empirical evidence is far from conclusive, but postwar experience of productivity growth in developing countries suggests that trade policy is important. Table 5.2 presents data on factor productivity and factor growth in selected developing economies. It shows that total factor productivity increased much faster in the strongly outward-oriented economies than in the strongly inward-oriented economies. The annual growth rate was more than 4.0 percent in Hong Kong and Korea during the 1960s and early 1970s, compared with 1.5 percent or less in Argentina, Chile, and Peru. In India, total factor productivity declined in 1960-79. Singapore is an exception: its total factor productivity declined between 1972 and 1980. But this was a period when the government put an increasing emphasis on industries that required high levels of skill, capital, and technology. The productiv-

ity growth rates of the moderately inward- and outward-oriented groups were similar.

Recent World Bank studies of Turkey and Mexico show that total factor productivity growth was low or declined during periods when foreign exchange control and protection increased. At the level of the individual industry, another World Bank study (covering Korea, Turkey, and Yugoslavia) found that total factor productivity grew faster in most exporting industries than it did in most import-substituting industries.

Trade strategy in perspective

The evidence discussed in this chapter suggests that rapid economic growth and efficient industrialization are usually associated with outward-oriented policies on trade. Outward orientation encourages efficient firms and discourages inefficient ones. And by creating a more competitive environment for both the private and public sectors, it also promotes higher productivity and

Table 5.2 Growth of GDP, inputs, and total factor productivity
(percent)

Trade strategy and period	Average growth of GDP	Total factor productivity		Factor inputs		
		Growth rate	Share in GDP growth	Growth of capital	Growth of labor	Share of total inputs in GDP growth
<i>Strongly outward oriented</i>						
Hong Kong 1960-70	9.10	4.28	47.0	7.60	2.97	53.0
Korea, Republic of 1960-73	9.70	4.10	42.3	6.60	5.00	57.7
Singapore 1972-80	8.00	-0.01	-0.1	9.48	5.52	100.1
<i>Moderately outward oriented</i>						
Brazil 1960-74	7.30	1.60	21.9	7.50	3.30	78.1
Colombia 1960-74	5.60	2.10	37.5	3.90	2.80	62.5
Israel 1960-65	11.00	3.40	30.9	13.10	5.00	69.1
<i>Moderately inward oriented</i>						
Mexico 1960-74	5.60	2.10	37.5	3.90	2.80	62.5
<i>Strongly inward oriented</i>						
Argentina 1960-74	4.10	0.70	17.1	3.80	2.20	82.9
Chile 1960-74	4.40	1.20	27.3	4.20	1.90	72.7
India 1959/60-1978/79	6.24	-0.18	-2.9	4.77	1.65	102.9
Peru 1960-70	5.30	1.50	28.3	4.40	2.70	71.7
Turkey 1963-75	6.40	2.23	34.8	6.82	1.02	65.2

Note: Total factor productivity measures the growth of GDP above and beyond the growth in the use of both labor and capital inputs.
Source: Adapted from Chenery, Robinson, and Syrquin 1986, pp. 20-22.

Box 5.6 Alternative outward-oriented policies

Ideally, the shift to an outward-oriented strategy from an inward-oriented one can best be accomplished by removing existing trade barriers, devaluing the exchange rate, and relying on the price mechanism to allocate productive resources. In practice, many developing countries—including, for example, the Republic of Korea, Brazil, and Mexico—have used export incentives to offset bias against exports without dismantling all of their import barriers and without devaluing their currencies.

There are several ways to justify this approach. First, devaluations are feared because they may be inflationary. Compared with import restrictions, however, it is unclear whether this is so. Import prices under protection already reflect scarcity premiums, which the devaluation could simply cut into. Second, where import tariffs rather than quantitative restrictions are used, the loss of fiscal revenue in shifting to outward orientation may be a problem for some governments. Third, import tariffs and quantitative restrictions can be used selectively, which stimulates focused resistance to their removal.

Empirical studies, however, underscore the folly of resorting to export subsidies to offset antiexport bias. The selectivity of import barriers is economically damaging. Often governments are not aware of this. A study of the incentive system in Korea shows, for ex-

ample, that effective rates of protection ranged from -38 to 135 percent for eleven sectors in 1978, although average effective rates of protection did not significantly differ between domestic and export sales (Nam 1981). Second, when export subsidies are used to offset the antiexport bias, they have sometimes been captured by selective interests. Third, if import subsidies are used through preferential loans at below-market rates, the choice of production technique may also be distorted in favor of capital, which adversely affects employment. Finally, using import tariffs and export subsidies puts a heavy strain on the government's administrative machinery and encourages evasion, rent seeking, and other directly unproductive profit-seeking activities (Box 4.7 in Chapter 4).

In any event, the alternative route to outward orientation in trade—subsidizing exports—faces two problems. First, where the overvaluation of exchange rate caused by high import protection is large, as in Brazil and Mexico, the export subsidies required to offset the antiexport bias are simply too great. Second, subsidies by developing countries have increasingly become subject to countervailing duties in some industrial countries. The developing countries most frequently subject to countervailing measures by the United States include Brazil, Korea, and Mexico—although export subsidies had been removed in Korea by the early 1980s.

hence faster economic growth. Economies that have followed inward-oriented trade policies have performed poorly.

Many arguments for industrialization through import substitution have been advanced at various times. They are questionable, however, for several reasons. For example, suppose that export pessimism were justified, in the sense that when a country expanded its exports of a primary commodity, the price fell in world markets. The appropriate policy response would then be to levy an export tax on that commodity, not provide blanket import protection for the industrial sector as a whole. Or suppose that the infant industry argument applies and that some sort of government assistance is therefore in order. A policy of restricting imports is unlikely to be the best answer. Subsidies directed at the source of any external benefits avoid the costs of protecting an entire industry from import competition.

The new protectionism in some industrial countries (see Chapter 8) raises an important question for developing countries: can an outward-oriented strategy be successfully adopted in these adverse circumstances? Protection by industrial countries reduces the gains from trade both for themselves and for the developing countries, but developing

countries may only make matters worse by turning inward. In other words, however protectionist the industrial countries, from an economic standpoint the best choice for developing countries is an outward-oriented strategy. But as protection increases, such an orientation becomes much more difficult politically. Note that outward-oriented policies involving export subsidies are increasingly threatened by countervailing actions by some industrial countries. This tilts the balance even more in favor of the policy which, on economic grounds, is in any case the better one: import liberalization combined with currency devaluation, rather than protection offset by export subsidies. Often countries such as Korea have adopted the second approach for their transition from inward- to outward-oriented policies, and it is still in use in such countries as Brazil and Mexico (see Box 5.6).

The evidence in favor of outward-oriented over inward-oriented policies may be convincing, but the issue of *how* an economy may be successfully moved from one to the other is a separate question. Recent experience in Argentina, Chile, and Uruguay suggests that the transition to outward-oriented policies should be carefully phased. Chapters 6 and 7 examine this in greater detail.

HOW ADJUSTMENT PROGRAMS CAN HELP THE POOR

The Experience in the World Bank

Soniya Carvalho, Robert Liebenthal, Peter Nicholas,
Helena Ribe (all SPRPA) and Elaine Zuckerman (CECMG).

World Bank

Strategic Planning and Review Department

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Table of Contents

I. Introduction.....1

II. What is Known about the Social Costs of Adjustment?.....1

III. Scope for Solutions.....4

 A. Redesigning Adjustment Programs.....4

 Reallocating Public Expenditures.....5

 Directing Subsidies Towards the Poor.....8

 Targeting Subsidies in the Social Sectors.....13

 B. Implementing Compensatory Programs.....14

 The Role of NGOs.....16

IV. Conclusion.....17

Annex I: Selected Country Experiences with Targeted Food Subsidies

Annex II: Selected Country Experiences with Targeted Programs

Annex III: Main Features and Status of Multi-sector Compensatory Programs

Bibliography

How Adjustment Programs Can Help the Poor

I. Introduction

1. The global economic crisis of the eighties halted the steady advance in poverty reduction in many developing countries. In the early years of adjustment lending there was optimism that adjustment programs would be temporary, and that with the resumption of growth poverty would continue to diminish and the adverse social effects of adjustment would be remedied. But the implementation of adjustment programs has been less successful than anticipated and many countries have experienced prolonged periods of economic stagnation and deteriorating social conditions. This situation has led the international development community to renew its attention to poverty reduction, emphasizing the need for new approaches to long-standing poverty problems within limited growth and budgets.

2. In many adjusting countries the stagnant socio-economic environment has changed the focus of efforts to reduce poverty from ensuring that the poor benefit from growth, to mitigating the adverse social effects of economic austerity. This focus underscores the importance of protecting the welfare of those hurt by adjustment and of the chronically poor (not necessarily the same group) for the success, and the political viability, of the adjustment process itself.¹

3. This paper discusses what we have learned about poverty and adjustment, the current issues and the experience with efforts to mitigate the social costs of adjustment. First, it discusses issues related to the income distribution and employment effects of adjustment and the scope for redesigning adjustment programs to lessen their adverse impact. Then it discusses issues related to public expenditures and the poor, the incidence of adjustment-induced expenditure cuts and what has been done to redirect public programs towards the poor. The poverty impact of reducing subsidies and the lessons from experience with targeting subsidies are discussed next. The paper then considers the role of NGOs. Finally the paper discusses adjustment-induced multi-sector compensatory programs and selected targeted interventions. A concluding section summarizes some central themes and underscores the need to go beyond the issues of adjustment and poverty and put in place parallel efforts to enhance the productivity of the poor.

II. What Is Known about the Social Impact of Adjustment?

4. Despite eight years of IMF and World Bank-supported adjustment programs and several attempts at evaluation,² few unambiguous results have yet been obtained regarding the success of such programs using relatively

1/ See Zuckerman (1988), Addison and Demery (1987) and Development Committee (1987 and 1988).

2/ The most recent and comprehensive Bank study having been the Report on Adjustment Lending (World Bank (1988b)).

123

easily measured indicators such as GDP growth, exports, imports, investment and domestic saving. Despite the ambiguity about the overall success of the programs, one clear lesson has been that failure to adjust is likely to hurt the poor. What Corden³ calls primary (recession-induced) costs inevitably result in lower incomes and employment. Although the poor may bear at least some of the secondary adjustment costs in the short run (resulting from failure to devalue sufficiently, wage resistance or import restrictions), an orderly adjustment process designed to establish a new equilibrium growth path is indispensable to improving the longer-term position of the poor.

5. The impact of adjustment on income distribution, employment and the standard of living of the poor has been even less susceptible to rigorous analysis.⁴ UNICEF⁵ has been the most successful at assembling quantitative empirical evidence on what has happened to the poor in several countries since the early 1980s, but has not clearly succeeded in distinguishing the effects of externally induced recession, still less deep-seated structural and policy problems, from the effects of the program and policies designed to offset them.

6. All SAL President's Reports prepared by Bank staff since FY86 have included a section discussing the social effects of the economic reforms supported by adjustment lending. The Reports recognize that apart from the beneficial medium and long-term effects of adjustment, there are likely to be adverse social effects in the short term which need to be addressed. Groups commonly mentioned as requiring assistance under adjustment comprise government employees who may be rendered unemployed by public sector contraction and the urban poor who are likely to face higher food prices. There has, however, been little systematic analysis of the impact of each adjustment measure (devaluation, rise in agricultural prices, cuts in social expenditures and reductions in public staff and salary reductions) on (i) each poverty group (small and marginal farmers, landless laborers, rural and urban artisans, formal public and private sector workers, informal sector workers and, tenants and sharecroppers), and (ii) welfare at the household level (i.e. impact on women's employment -- both in terms of the number of hours worked and the nature of work -- and the consequent implications for intra-household allocation of time and consumption).

7. Among the problems in undertaking such analysis are the development of robust counterfactuals ("before/after" vs. "with/without"); the existence of various possible patterns of causation, many of which have offsetting effects; and allowing for time lags and supply responses to policy changes.⁶ But constraints on data availability and its quality have

3/ Corden (1988)

4/ Although progress is being made in cases such as Jamaica, Living Standard Measurement Studies (LSMS) addressing this issue have so far been undertaken separately from the design of the adjustment programs.

5/ Cornia et. al. (1987).

6/ Zuckerman (1988 and 1988a).

also contributed to the lack of empirical analysis in this area.⁷

8. It has thus proven difficult to develop stylized expectations or even working hypotheses regarding the effects of stabilization programs on the poor. Contractionary fiscal and monetary policies, for example, are intended to reduce aggregate demand and thereby seem likely to reduce real output and/or prices in the short term. While the impact of lower real output on employment is likely to be adverse, lower income groups may gain from lower inflation. As a second example, expenditure and output-switching policies seem likely to shift aggregate supply and the demand for labor, but no working hypotheses are available regarding how quickly this happens and with what effects on real incomes and employment. The Report on Adjustment Lending found that the positive output effects were, as might be expected, weaker in poor, relatively monocommodity economies.

9. Exchange rate adjustment provides another example of an adjustment measure whose effects on the poor are hard to predict. Real depreciation, for example, is likely to have adverse effects on low-income groups if the exporting or import-substituting sectors are relatively capital-intensive and if a large part of basic wage goods are imported. Countries where the poor are predominantly rural are less likely to be affected adversely, however. If supported by appropriate complementary supply-inducing measures, the lower real wages associated with devaluation will help foster an increase in the demand for labor. Similarly, other substantial price adjustments (energy prices, agricultural prices) are also likely to reduce real wages in the short term, but their effects on poverty groups may or may not be adverse -- in the case of food price increases the short-run effects are adverse where, as is often the case, the poorest farmers and laborers are net purchasers of food. In Ghana and Côte d'Ivoire, for example, cocoa producers have benefited from cocoa price increases, but in both cases the bulk of the low-income farmers are located in regions not suitable for cocoa -- and where the farmers are women they may fear loss of control over the returns to production if they switch to cash crops. Shifting the intersectoral terms of trade in favor of cocoa farmers, while desirable, would not necessarily improve the welfare of poor households. But food price increases are likely to have adverse effects in the short run, at least in countries with large pools of landless laborers.

10. The impact of adjustment policies on the poor depends on the structure of production and consumption and the differentiated effects of expenditure-absorption and switching on different households. Recent work emphasizes the importance of disaggregating the impact of policies at the household level, and of considering those policies' impact on control over income within the household. Food consumption is perhaps the most obvious and most researched area. Households appear to switch expenditures among food items in response to both income and relative price changes. Research

7/ For example, most socio-economic indicators are not disaggregated by income or sector. Developing accurate empirical information about the actual effects of adjustment is essential because the actual social impact of adjustment programs -- and more specifically, the impact on the poor -- depends on the actual profile of the poor in individual countries, on the distribution of the poor across economic sectors and on their ability to respond to the changes in economic policies.

182

also suggests, however, that changes in expenditure on food do not necessarily imply changes in nutrient consumption. In other words, reductions in real income may prompt a return to lower quality food, rather than a reduction in calories. Similar considerations apply to adjustment-induced changes in the supply or price of other commodities or services important in the low-income consumption basket.

11. While few generalizations are possible about the impact of adjustment policies on the poor, experience suggests that there are important country-specific income distribution and employment effects which can be taken into account in adjustment program design. Empirical evidence can be found, or is being developed,⁸ in some countries to suggest what the important effects are likely to be. The returns to undertaking such analysis can be high in terms of avoiding adverse effects to the poor or, at least, being clear about the trade-offs.

III. Scope for Solutions

12. This section discusses options for redesigning adjustment programs so that they hurt the poor less. It also discusses the two most common approaches to designing adjustment programs to help the poor: reallocating public expenditures and directing subsidies towards the poor. The implementation of targeted programs designed to assist vulnerable groups or compensate those directly affected by adjustment is discussed in the next section.

A. Redesigning Adjustment Programs

13. For the most part, little attempt has been made to redesign adjustment programs in order to lessen their impact on the poor.⁹ Reluctance to address the conventional design of adjustment programs is based on an understandable concern not to dilute the essential thrust of such programs by offering loopholes for governments with lukewarm commitment. There is also the concern that "crossing the desert" (i.e., addressing the transitional or frictional costs of adjustment to the poor) is made more difficult if the desert is artificially widened by failure to act firmly and decisively on badly needed adjustment measures.

14. But there are frequently cases where adjustment programs can be designed with employment and income distribution objectives more explicitly in mind. One example would be, within the bounds of the overall reduction in public spending dictated by stabilization programs, to tailor the structure of spending or tax changes (or cost recovery) so as to minimize its effect on the poor. This would allow more progressive taxation and expenditures that promote employment for the poor and expand their access to human resource development programs. And in some cases, pursuing less

8/ For example by the Social Dimensions of Adjustment project (SDA) in Sub-Saharan Africa and several surveys conducted under the Living Standards Measurements Survey (LSMS), which are presented in a separate lecture in this workshop.

9/ But see Addison and Demery (1988).

contractionary policies (and providing external financing) to fuel faster growth may also be a feasible option.

15. A second example would be the deliberate slowing of price adjustments in cases where supply elasticities are low and supply response dependent on a wide range of complementary actions. In such cases, sharp price adjustments are likely to be inflationary and have important effects on income distribution. Risk aversion, incomplete market liberalization and constrained access to production inputs and information, especially in Sub-Saharan Africa, are among the causes of such low elasticities. Where the supply of wage goods remains limited, shifting producer prices upwards may actually reduce supply. But in cases where prices are adjusted slowly, it is important not to send ambiguous signals which may delay the supply response.

16. A third example of an option to redesign adjustment programs would include coordinating subsidy removal with compensating producer price increases. In Malawi, it now seems that fertilizer subsidies were probably removed too quickly with damaging effects on both smallholder production and incomes. In Mexico, removal of fertilizer subsidies has been coordinated with changes in agricultural producer prices.

17. A fourth example is trade reform. A devaluation can be particularly compensated for in its effects on domestic price levels by selective removal of QRs and lowering of effective rates of protection. Lowering tariffs in this way may have fiscal costs, however. These need to be traded off against the lower import costs.

18. The outward-looking policies typically supported by adjustment programs may be largely ineffective in a fast changing and unpredictable international environment. For this reason some -- such as the International Fund for Agricultural Development (IFAD) -- have argued that much more support is needed for policies and investments designed to broaden the base of the domestic market and increase the productivity of small farmers.

19. The experience with the two more common approaches to redesigning adjustment programs, reallocating public expenditures and directing subsidies towards the poor, is discussed in more detail in the next section.

Reallocating Public Expenditures

20. Cuts in public expenditures have been common during adjustment. This has a contractionary effect and many public sector employees and unskilled and semi-skilled workers involved in infrastructure or public service provision are likely to become unemployed or suffer cuts in real wages. The transition into new jobs may be slow and difficult because of constraints to labor mobility (for example urban public sector workers moving into agriculture) or of mismatching skills. This is likely to have an adverse impact on poverty, particularly in urban areas. Several compensatory programs designed in adjusting countries are intended to address this issue (see Annex II for details).

21. Beyond the direct and indirect employment and income effect, cuts in public expenditure -- and changes in its composition -- may slow invest-

ment and have a lasting adverse impact on productive and social infrastructures. Expenditure cuts also constrain the budgets for maintenance, supplies and operation of public services. This has led to a deterioration of public infrastructure and services which may hurt the poor because these services (if well funded and targeted) can be an effective way to reach them and provide a social safety net, particularly in the poorest countries. Reduced allocations for recurrent expenditures often affect the social sectors hardest where recurrent outlays constitute the majority of spending.

22. Since cuts may be unavoidable, the key is for governments to avoid across-the-board reductions, instead allocating available resources to priority investments, operation and maintenance expenditures, or socio-economic activities, while increasing the efficiency of existing ones. The Bank supports these efforts in the course of public expenditure reviews.¹⁰ These sometimes focus on a wide range of expenditures and sometimes only on a sector such as agriculture or education (recently there have been several reviews focusing on the social sectors as a whole for example in Argentina, Brazil and Jamaica).

23. The impact of expenditure cuts on the poor has generated widespread concern, especially because it can exacerbate a situation where expenditures for programs to reach the poor are already inadequate to meet basic needs and have been growing less than the rate of population growth (or have even declined in some cases). There has been little systematic empirical analysis identifying the actual changes in sectoral expenditures and the incidence of such changes on the poor. But on the basis of available evidence many argue that infrastructure and social programs have been cut relatively more than other public expenditures, and that such cuts may have hurt the poor more than other groups. This is the case, for example, in several Latin American countries where there has been a sharp decline in public expenditures per capita which has been associated by many with a deterioration in social indicators.

24. But expenditures that benefit the poor can be maintained during a period of recession and adjustment. In Korea, for example, subsidized medical programs aimed at the poor were expanded during the adjustment period, and other poverty programs were maintained. Korea's mortality and poverty indicators improved steadily during the adjustment period. In Chile, improved targeting of social expenditures, particularly of health and nutrition programs, contributed to a continued decline in infant and child mortality rates despite a 5 percent fall in government expenditures during the period of recession and adjustment.

25. The key question is how can such targeted programs be financed during a period of widespread cuts in government expenditures. Since additional resources are unlikely to become available, priority social and poverty programs must be protected at the expense of other alternatives. Some external financing from multilateral and bilateral donors is often available to support such programs. But it is also essential to increase the efficiency of service delivery, although realistically this is likely to take some time. Measures to raise additional domestic resources can also be pursued, for example increasing cost-recovery in selected activi-

10/ See for example World Bank (1988a).

185

ties and enhancing tax revenues, including the option of earmarking specific taxes to finance priority social services (which in some cases may increase the political viability of a tax increase).

26. In a few selected cases, sectoral adjustment programs to protect and improve the direction of public expenditures and strengthen the institutions in the social sectors, as well as to increase their internal efficiency and their coverage of disadvantaged groups, have been put in place or are under preparation. Typically, these programs support more efficient and more equitable public expenditures. For example, redirecting public resources from higher towards primary education, from curative towards preventive health care, or towards targeted programs such as school feeding and nutrition for mothers and infants. Such shifts in emphasis would primarily benefit the poor. Efforts have been made to reduce unit costs (for example by introducing double shifts) and implement some cost-recovery, but these have proven time consuming and politically difficult to implement. They also include reforms to build institutional capacity such as training of personnel, to improve the quality of the services, such as strengthening school curricula, or to achieve a better balance between capital and operation and maintenance expenditures. Some examples are presented below but experience with their implementation is still limited.

27. In Morocco, a sectoral adjustment loan has supported a reform in the education system. This loan was prepared within the constraints of a stand-by agreement with the IMF which placed limits on public expenditures for education, limiting recruitment and salary increases. The reform supports quality improvements and seeks to make education more cost-effective, and at the same time is devoting a larger share of resources to primary and lower secondary schooling -- with a focus on schooling in rural areas, particularly for girls. In Senegal, an education sector adjustment loan supports reductions in unit costs at all levels and in subsidies at the tertiary level, with the goal of releasing funds to expand access to primary education. In Ghana, pre-university education is being reduced from seventeen to twelve years and the resulting savings -- together with a range of cost-recovery and other cost-saving measures -- are being allocated to expand primary education and increase the provision of books and materials. In Niger, a structural adjustment loan is supporting a restructuring of the public expenditure program. Higher user charges for services used primarily by the better-off, such as tertiary education and curative health care are being introduced, and the savings generated are being channeled into the expansion of services such as primary education and preventive health care which benefit the population as a whole. In Guinea, the Government intends to redirect public resources to rural health care and primary education. IDA, UNICEF, WHO and bilateral donors are providing financial support.

28. But for the most part, little explicit attention has been given during the adjustment process to minimizing the adverse equity impact of public expenditure reductions or to identifying options for mobilizing resources to finance priority social and anti-poverty programs. Increasingly, however, the Bank is addressing this shortcoming through more in depth studies of the composition, effectiveness and incidence of (all or selected) public expenditures and through detailed reviews of the policies and programs for reducing poverty and improving social sector delivery in a

129

number of countries. Examples are the work which has been recently completed or is underway in Bangladesh, Brazil, Jamaica and Indonesia. It is anticipated that these efforts will allow better incorporation of these issues in the policy dialogue both of the Fund and the Bank and in the design of adjustment programs as well as in separate poverty-oriented lending.

Directing Subsidies Towards the Poor

29. Government services are often provided free or well below cost. This is justified on the grounds that many public services provide externalities and are predominantly public goods, or provide higher social than private benefits, and that many are intended for the poor. It is also argued that the administrative and political costs of collecting fees are often unaffordably high. This practice has a high budgetary cost and imposes financial difficulties on state enterprises. Subsidies are often skewed in favor of higher-income groups (although they are also often a larger share of the consumption basket of the poor) and are likely to lead to inefficiencies in consumption. The issue is how subsidies that benefit the poor can be maintained and at what cost.

30. Many stabilization and adjustment programs have included a reduction in consumer subsidies as part of their effort to reduce the deficit. These subsidy reductions have often been controversial, and have sometimes provoked strong opposition, mostly from the middle classes, as well as in some cases considerable hardship for the poor. Estimates for five countries of the real income effect on the poorest decile of a 10 percent increase in food prices vary from 8.5 percent for Sri Lanka to 5.6 percent for Egypt.

31. Two types of consumer subsidies should be distinguished. Marketwide subsidies, which reduce the retail price of a good sold through regular market channels; and targeted subsidies, which reduce the price of a good for individuals based on some indicator of need (typically income or location).

Marketwide Subsidies

32. Marketwide subsidies often have a major role in raising the real incomes of the poor.¹¹ They can, however, be very expensive, and a serious drain on the budget at times of fiscal austerity. And they are sometimes an inefficient means of helping the poor. For one or both of these reasons -- expense and inefficiency -- subsidies are often cut as part of adjustment programs.

33. Widespread cuts in subsidies can severely hurt the poor. This is often forgotten in discussions of the fiscal costs and unintended benefits to the relatively well-off of marketwide subsidies. The effectiveness of a subsidy in raising the incomes of the poor needs to be distinguished from its efficiency. The effectiveness is measured by the percentage increase in the incomes of the poor, the efficiency by the percentage of the subsidy

11/ For a general discussion of subsidies see Berg (1987), IMF (1987) and Pinstrup-Andersen (1988).

190

that reaches the poor. The distribution of income is often so skewed that an inefficient subsidy may still be highly effective -- in other words even if only a small proportion of a subsidy benefits the poor, the income value to them may still be great.

34. Brazil and Egypt in the early 1980s serve to illustrate this point. A rice subsidy in Brazil transferred less in absolute terms to the poor than to the rich, but the benefit to the poor in terms of the percentage increase in their real income was eight times as great. And a subsidy on legumes, a food not favored by the rich, produced a benefit to the poor which was proportionately 25 times as great. In Egypt food subsidies transferred roughly equal amounts to rich and poor alike, but they increased the real incomes of the poor by over 17 percent, as against 3 percent for the rich.

35. Of course subsidy schemes such as the one in Egypt are notorious for their cost and inefficiency. There is often an urgent need to reduce their fiscal burden, either by reducing the subsidy or by more selective targeting. Reducing the subsidy may, as the Egypt example testifies, cause severe hardship for the poor. In such cases better targeting or substitution of alternative, more efficient schemes, is needed. What is crucial is that no subsidy that is effective in reaching the poor should be reduced or eliminated unless and until alternative means of reaching the poor are firmly in place.

36. The issues of effectiveness, efficiency and alternative programs are discussed below. Issues related to the political implications of removing subsidies or of tightening them so that they are more effectively targeted towards the poor are discussed separately.¹²

37. Effectiveness. The most common form of subsidy is one on the retail price of a good or service consumed by the poor. Such a marketwide subsidy is relatively easy to administer and can be effective in reaching all of the poor. How effective the subsidy is in practice depends on three factors.

- The availability to the poor of the subsidized good. Subsidies on consumables (as opposed to agricultural inputs) are typically, but not inevitably, only applied to goods and services sold in towns. And even within towns the supply of the subsidized good is often rationed in a way which benefits the politically influential at the expense of the poor.
- The share of the subsidized good in the expenditure of the poor (assuming that the first condition is fulfilled and the subsidized good is universally available). The real income effect of a subsidy is directly proportional to the share of that good in the expenditures of the poor.
- The size of the subsidy.

38. An effective way to target subsidies to the poor is to use life-line rates for public utilities such as water and electricity. In this way, services can be provided with very low charges to poor (and low

volume) consumers to ensure that they consume a minimum amount required to meet their basic needs. In order to maintain the financial viability of the utility companies, this system entails using tariffs with cross-subsidies from higher income users to lower income users. Although there are possibilities for leakages, targeting in this case is made relatively simple by using geographical residence or consumption level criteria.

39. Efficiency. Marketwide subsidies can also, however, be very inefficient, especially when compared with the "targeted" subsidies discussed below. The Egyptian program, for example, costs 7 percent of GDP (21 percent of current government spending). There are generally three reasons for the inefficiency of marketwide subsidies.

- Misallocation and "overconsumption". Much of a marketwide subsidy typically benefits the better-off. Subsidies also distort market forces more than a direct income supplement and lead to an "overconsumption" of the subsidized good. Where there are large subsidies this can lead to the food being used as feed for livestock or for making alcohol.
- Fraud. Marketwide subsidies on goods require heavy government involvement in wholesale trade. The government must manage a two-price scheme -- a higher price for producers and a lower price for consumers. There is room here for fraud, particularly the recycling of the same produce, picking up a subsidy each time. While this sort of fraud is difficult to police (as the EEC has discovered) it does not arise where the product (bread for example) is processed before it is consumed.
- Disincentive effects. Large subsidies for the poor may mean that real, after tax income rises only very slowly as nominal incomes increase, creating a "poverty trap".

40. Marketwide subsidies can only be efficient when they are targeted on goods with a negative income elasticity -- kerosene, urban mass transport, and sorghum often fit this category. Morocco, for example, is restructuring its marketwide subsidies to emphasize foods eaten by the poor, and expects to give the poor greater nutritional benefits for one-fifth the former cost but progress implementing these reforms has been slow. In Mexico the Government is, with the help of two World Bank loans, replacing its market-wide subsidies by more targeted -- and therefore cheaper -- alternatives. These alternative schemes include: food coupons and targeted milk distribution; subsidies on low income elasticity foods in selected areas; and targeted school feeding programs. The Bank has set as a condition of release of a \$250 million second tranche that these schemes efficiently transfer the same benefits to the poor as the earlier untargeted subsidies, and that -- unlike the earlier subsidies -- they reach the rural as well as the urban poor.

41. Most marketwide subsidies are, however, still applied to goods with positive income elasticities, and the resulting inefficiency means that in times of fiscal austerity their generally high cost can rarely be justified. The critical issue is the speed at which these subsidies are eliminated. Even where a subsidy is inefficient it may nonetheless be

1982

effective in reaching the very poor, and immediate elimination can thus cause severe hardship. Where this is a danger, the subsidy needs to be eliminated slowly while more cost-effective targeted programs are introduced. This is being attempted in Jamaica and Tunisia. But slowing the rate of reduction may seem impossible in a tight fiscal situation.

42. Whatever success a government may have in raising taxes to fend off a drastic cut in marketwide subsidies, cost-effectiveness considerations still demand that such subsidies are phased out (unless they apply to a good with a negative income elasticity) and replaced by more targeted subsidies. Such targeted subsidies can be both less expensive for the government and of much greater benefit to the poor although (as we will see below) there are limitations to their effectiveness.

Targeted Subsidies

43. Targeting of subsidies improves both their efficiency and their effectiveness. It may be a cost-effective and equitable way to reduce general subsidies and to mitigate the costs of adjustment on the poor. Targeted subsidies are designed to reach groups selected (or self-selected) on the basis of need. Greater targeting can yield substantial fiscal savings while maintaining the benefits of the poor. For example, it has been estimated that in Morocco expanding targeted programs could compensate most of the poor who benefit from current subsidies at a budgetary cost of 11 percent of current subsidies. Likewise, in Sri Lanka the shift during the seventies to a more targeted program (including the shift to food stamps and the exclusion of about half of the population from the program) cut by more than half the fiscal costs of the subsidy. Outlined below are some lessons on targeting food subsidies and selected examples showing ways in which different subsidies can be targeted.

44. Lessons from Targeted Food Subsidy Experiences. Since an extensive literature exists on this subject,¹³ only a summary of lessons learned is presented here. Targeting by income groups requires means testing which is administratively difficult (as poverty groups tend to shift) and costly. There is always the danger that households with relatively higher incomes will benefit, especially in schemes which rely on self-reporting income. The most effective types of targeted food programs have been based on: (1) geographical targeting where low-income neighborhoods are selected as in the case of Philippines and Mexico; and (2) identifying types of foods which have negative elasticity of demand (such as less refined grades of wheat in Morocco, of flour in Egypt and of rice in the Dominican Republic).

45. There are only a handful of countries with successful targeted food subsidy programs.¹⁴ The following are some of the reasons:

13/ See, for example, Berg (1987), Kanbur (1988), Pinstруп-Andersen (1988), IMF (1987).

14/ The experiences of Mexico, Philippines and Sri Lanka are presented in Annex I. Other examples of targeted food programs examined in Berg (1987) include Brazil, Colombia, Tamil Nadu (India) and Sri Lanka. Per Pinstруп-Andersen (1988) covers Colombia, the Philippines and Sri Lanka.

112

- Many countries lack the institutional strength required for efficient implementation.
- Political commitment is essential and is often difficult to sustain.
- Some leakages are inevitable (Philippines) and even desirable to the extent necessary to obtain political acceptance and reduce disincentive effects among the non-poor.
- Geographical and commodity targeting are more effective than targeting by income group and/or nutritional status because income and nutrition data are difficult to collect and monitor. However, the effectiveness of this approach depends on the accuracy of identifying poverty areas and foods preferred by low-income groups.
- Indexing food subsidies to cost of living increases is essential to ensure their values are not deflated (Mexico and Sri Lanka) but may conflict with the objectives of adjustment programs.

46. Among targeted food subsidy programs, the most cost-effective have targeted readily identifiable groups, such as pregnant and lactating women, and poor districts or regions, or they have distributed food through existing facilities or programs, such as health programs or schools, that already serve the poor. Thailand and Brazil, for example, now focus on regions where malnutrition is concentrated, in the northeast of both countries. Several Brazilian states have gone further. They target the favelas (very poor neighborhoods) by subsidizing basic foods for customers of small stores. Because better-off Brazilians prefer not to journey into favelas, even for lower prices, the benefits go to those who need them.

Tamil Nadu, a state in India, has, with Bank assistance, targeted a food and nutrition education program in the poorest areas for those at greatest risk. Nutrition workers in 9,000 villages weigh children monthly and provide daily feedings for 90 days to those whose growth is faltering. At the same time, they teach mothers of underweight children how to improve nutrition at home within their means. High-risk pregnant and breast-feeding women also receive food. The benefit of the Tamil Nadu project has been dramatic and enduring. Serious malnutrition has declined by about 50 percent. Two years after children complete the program they are, on average, four pounds heavier than children who did not participate. By thus accurately targeting those at greatest risk, the supplementary feeding could be highly selective and responsive to the recipients' changing nutritional status -- two features that enhance cost-effectiveness and avoid long-term dependence on food assistance. Even if the program were expanded to cover the whole state, the total cost would be less than 1 percent of the state budget.

47. In Colombia, the Government, also with the Bank's assistance, targeted a nationwide food subsidy program to households with young children or pregnant women in designated poverty areas. Health centers distributed the subsidy by means of food coupons. At its peak in 1981, the program benefited 68 percent of households with incomes below 30 percent of the average. Administrative costs were less than 2 percent of the subsidy.

48. An alternative to distributing food at little or no cost is rationing -- having the government sell food to target groups at a subsidized but still substantial price. This can often be achieved through food

stamps or coupons, although other types of targeting -- by season, by neighborhood, by type of food -- have been tried and merit further exploration. The target groups for rationed food tend to be much larger than for supplementary feeding programs, with a focus on households rather than individuals. Ration programs thus need to be carefully managed if they are to be cost-effective. Bangladesh (with the support of several of the Bank's Import Program Credits in the early 1980s) moved to enhance the efficiency and equity of its food distribution system. It targeted the food subsidy programs more to the poor, changed the mix of foodgrains distributed toward more nutritional and lower cost varieties, and reduced the cost gradually over a number of years.

49. A problem with ration programs is that they are typically -- but not necessarily -- static. They tend not to discriminate carefully enough to exclude people whose circumstances improve or to draw in those whose circumstances worsen. Another danger is that political pressures may force a government to widen the program's scope so that it ceases to be efficient in reaching the most needy. Moreover, such programs have high administrative costs and are rare for the rural poor because of the difficulties in managing distribution in sparsely settled or inaccessible areas. Despite these potential difficulties targeting has often been efficient, even in predominantly rural areas.

50. In deciding which program is appropriate, governments need to consider the situation and composition of the group to be compensated. Food rations can work if the group is small and easily identifiable. They can be effective to benefit groups whose real income falls below a minimum level because of a rise in food prices. If the targeted group is large, it may be cheaper (and more efficient) to subsidize the price of a basic food-grain consumed primarily by the poor.

Targeting Subsidies in the Social Sectors¹⁵

51. Most prices for publicly provided educational and health services are very low or non-existent. Even if prices are defined to include any charges levied on users of a service, the proportion of a government's cost that is recovered through pricing revenue remains small. In 28 developing countries, the public cost recovered through prices for higher education is 9 percent; secondary education, 15 percent; and primary education, 5 percent. In health, the recovered cost is 7 percent. Even if the figures are adjusted upwards to account for the proportion of the cost borne by students (for example time and supplies), the proportion of social cost recovered from users remains small.

52. But free provision of all public services does not mean that everyone, and particularly those who would benefit the most, will be able to use the services (for example, despite the subsidies, the poor are underrepresented at higher levels of education). Another problem with these policies is that, contrary to intentions, they have made educational and health services less efficient. They may also contribute to the observed underinvestment in these sectors relative to others and to over-

15/ This section draws from: Jimenez (1987), Vogel (1988) and Gertler and van der Gaag (1988).

195

investment in services with low social returns (which usually have high unit costs such as tertiary education).

53. For these efficiency and equity reasons, and because of the stringent budgetary conditions faced by many governments, it has become increasingly apparent that some amount of user charges in the social sectors is necessary if the public sector is to provide acceptable health and education services. And there is a growing number of examples indicating that some cost recovery is practicable (this is, for example, the case in West-African countries where church missions have had to charge for their services as a condition of existence).

54. But many questions remain about how to implement selective cost-recovery while ensuring equitable access for the poor. These questions include: the structure of fees and the potential for revenue collection; the individual's response to the introduction of user charges; and administrative problems and collection costs. The limited experience in this area indicates that user fees have to be introduced slowly, starting with fees at the higher levels of education and health care. Such changes are also probably more likely to be successfully implemented, and politically viable, if they are introduced as a part of a broader (long-term) package including other reforms to reduce costs and improve effectiveness of social services.

B. Implementing Compensatory Programs

55. Targeted programs represent an attractive option for ameliorating adverse social effects of adjustment. This is, first, because they are (or attempt to be) limited ("targeted") to a narrow and unambiguously deserving group of beneficiaries; secondly, because they attempt to be highly cost-effective and efficient.

56. Since FY86 several targeted compensatory programs have been designed in adjusting countries. However, Government commitment to specific programs, the quality and specificity of the proposed interventions, and the institutional arrangements for the implementation of specific programs, differ widely across countries.

57. Most targeted programs prepared to mitigate the social costs of adjustment rely on traditional designs and targeting techniques. They have included credit schemes, nutrition programs, public works, retraining, severance payments and resettlement in agriculture. Some countries have utilized (or proposed) innovative approaches involving NGOs (for example Bolivia, Ghana, Madagascar, Senegal, Burundi, CAR, Togo and Guinea) and created new administrative structures (for example Bolivia). Annex II describes the main features and experience with these programs in adjusting countries and contrasts them with relevant experiences elsewhere.

58. But they also face the same difficulties. These include insufficient political commitment, institutional weaknesses, shortages of funding, poorly trained staff and difficulties in reaching the target groups. So, even when these programs are reasonably well designed, they often do not have a good chance of successful, lasting implementation.

176

59. Nevertheless, there is considerable experience accumulated by developing country governments, the Bank and other development agencies in designing and implementing targeted programs. Adjusting countries could gain a great deal from this experience. Relevant features of available models could be adopted depending on the specific country characteristics. The credit programs in El Salvador, Calcutta or Bangladesh, the targeted nutrition program in Tamil Nadu, the training project in Mexico or the BRAC training scheme in Bangladesh provide good examples. These examples are discussed in Annex II.

60. In some cases, several targeted interventions have been assembled into multi-sector compensatory programs. Only one, the Emergency Social Fund (ESF) in Bolivia, which is under two years old, is being implemented. Ghana's Program of Actions to Mitigate the Social Costs of Adjustment (PAMSCAD) was designed last year but (for the most part) its implementation has been delayed. Madagascar will soon launch a program and other countries are designing them. The status of these three programs and of others being proposed is presented in Annex III.

61. These multi-sector compensatory programs are distinguished from other programs targeted to the poor by their (1) intended short-term nature -- they are designed to respond rapidly to a social emergency caused by an economic crisis and to bridge the transition between the crisis and adjustment-induced growth; (2) multi-sector packaging -- they consist of packages of fairly traditional employment, retraining and social interventions; (3) multi-donor financing -- many donors are keen to finance emergency programs to cushion the poor from adjustment; and (4) mixed public sector and NGO implementation. Some programs are strictly short-term compensatory ones while others are hybrids, combining short-term interventions with long-term traditional investment components. No two programs are alike.

62. Progress with actual implementation of compensatory programs has been limited. There have been many practical difficulties and remarkably few clear-cut cases which can be pointed to. A particularly problematic aspect of targeted and compensatory schemes is the difficulty of designing and implementing them in the short time period generally available to design adjustment programs. This problem is particularly acute in situations where the infrastructure needed to identify the poor, deliver services, and administer appropriate schemes is absent. In general, periods of adjustment are not the best for discovering the existence and identifying the needs of poor people for the first time. In addition, there may be political costs to targeting; the better controlled the leakages of benefits from needy groups, the less likely it is that there will be a broad constituency for adjustment measures.

63. Targeted poverty programs have often been delayed by lack of institutional capacity to implement them (Ghana). There are trade-offs between strengthening existing institutions and creating new ones. New institutions may promote more speedy implementation (Bolivia), but there is a danger that the new institutions will not last. In some cases, programs have been modified or dropped for political reasons (for example some targeted programs under the Social Intervention Fund (FIS) in Madagascar). In some cases, arranging financing for specific projects has been difficult. In Ghana donors have earmarked specific projects (rather than whole

packages) and sometimes portions of projects, and so some projects have been over subscribed while funding for others is lacking.

64. Another reason for the difficulties experienced with the implementation of compensatory programs is that, typically, these programs have constituted an addendum rather than an integral part of the adjustment program.¹⁶ To remedy this shortcoming, the Social Dimensions of Adjustment (SDA) project in 25 Sub-Saharan countries and several Living Standards Measurement Surveys (LSMS) are underway. The main features of, and experiences with SDA, are presented in a separate workshop. It is expected that they will be instrumental in improving the way in which future adjustment programs are designed as well as the effectiveness of targeted compensatory programs to ameliorate the adverse effect of adjustment on the poor.

The Role of NGOs

55. Countries with well developed non-governmental institutions can often usefully involve their NGOs in efforts to mitigate the social costs of adjustment. A number of adjusting countries have already taken initiatives in this area.¹⁷ Apart from forming an important pressure group to prevent drastic cuts in social expenditures that predominantly benefit the poor, NGOs can play a positive role in identifying, designing, financing, implementing and monitoring targeted poverty programs.

66. The following factors account for the important role that NGOs can play in helping governments to undertake poverty programs:

- their ability to reach poor communities and remote areas that have few basic resources or infrastructure and where government services are limited or ineffective;
- their ability to promote local participation in the design and implementation of public programs by building self-confidence and strengthening the organizational capability among low-income groups;
- their low cost of operation by using low cost technologies, streamlined services and low operating budgets;
- their innovativeness and adaptability in identifying local needs, building upon existing resources and transferring technologies developed elsewhere.

67. But the nature and degree of NGO involvement has to be carefully planned. The following are major limitations of the NGO approach which should be given due consideration:

16/ One exception is Sudan where the PASCAP (Program for Alleviating the Social Costs of Adjustment and Poverty) mission overlapped with and participated in the work of the pre-appraisal mission for the proposed Economic Recovery Credit and found that the government supports implementing PASCAP as an integral part of the proposed adjustment program. The program, however, has been delayed and is still under preparation.

17/ For example Bolivia, Ghana, Madagascar, Senegal, Burundi, CAR, Togo and Guinea. The major areas of intended involvement include public works, retraining programs, credit schemes and nutrition projects.

- limited replicability of many NGO sponsored activities that are too small and localised to have important regional or national impact. In attempting to scale up their operations with support from the public sector some NGOs may lose their innovative quality and may become top-down, non-participatory and dependent on external government support;
- limited self-sustainability of many NGO activities because they are conceived as being relief-oriented rather than developmental;
- limited managerial and technical capacity of many local NGOs;
- lack of a broad programming strategy for a region or a sector and poor coordination of activities of NGOs at different levels;
- controversial political or religious dimensions of some NGOs.

68. Many NGOs are skeptical of adjustment programs' overall effect on the poor and may hesitate to collaborate in the implementation of relatively small "add-on" social programs. Consultation with NGOs on adjustment policy questions may elicit important insights and develop political support for the adjustment program generally, and especially for its anti-poverty dimensions. The government of Ghana has expressed interest in the views of both national and international NGOs regarding PAMSCAD and its overall adjustment program. In a recent initiative to involve NGOs on the social dimensions of adjustment in Chad, the Bank found that a meeting with NGOs to explain the adjustment program itself was a necessary first step.

69. With due attention to these issues, NGO support could be utilized to advantage by adjusting countries in their poverty programs. The lack of institutional capacity to organize targeted programs for the poor in most adjusting countries could, at least in part, be circumvented by NGO involvement. The Bolivian Emergency Social Fund project is a case in point. Municipalities, cooperatives, NGOs and other community organizations have been successfully used as executing agencies¹⁸ for a national poverty program -- although in some cases it has been found that community groups may need assistance in organizing themselves and in managing finances.¹⁹

IV. Conclusion

70. Relatively little attention has been given to introducing changes in program design to address the impact of adjustment on the poor. Some attention has been given to identifying and supporting long-term policy options that help the poor (for example through reallocation of public resources or through measures designed to enhance poor people's access to and rate of return on assets). For the most part, efforts to mitigate the social costs of adjustment have involved compensating those affected directly by adjustment (for example laid-off public sector employees) or providing temporary employment and income generation or relief for the chronically poor. But less emphasis has been given to establishing the administrative structures needed to help implement these schemes successfully.

18/ Program design as well as implementation has been their responsibility.

19/ The Emergency Social Fund proposes to encourage technical assistance and training to community groups for this purpose as a sub-project

199

71. Programs to help those hurt by adjustment ("compensatory" programs) have proven difficult to implement effectively, and are, by definition, transitory. Adjustment programs themselves typically put severe strains on government's implementation capacity, and additional measures to help the poor only add to those strains. New approaches to poverty programs that create new institutions (group lending) or utilize existing ones (NGOs) can help to circumvent some of these problems and should be explored.
72. As mentioned above, relatively little attention has been given to introducing changes in program design to address the impact of adjustment on the poor. This is of particular concern since, even when well implemented, compensatory programs may not be enough to ensure sustainable benefits for the chronically poor. Besides, the adjustment process may take several years and may not, even if successful, guarantee that the productive potential, and consequent real income gains, of the chronically poor are realized. It is therefore important that due attention also be given to putting in place more developmental programs aimed at reducing poverty. It should aim at achieving social adjustment simultaneously with economic adjustment.
73. Adjustment programs need to be redesigned when there is an immediate danger that the poor would suffer unnecessarily from one or more of their component policies. Examples discussed in Section II of how adjustment programs could be redesigned are: tailoring the structure of spending or tax changes (or cost recovery) so as to minimize its effect on the poor; deliberately slowing price adjustments in cases where supply elasticities are low and supply response dependent on a wide range of complementary actions; coordinating subsidy removal with compensating producer price increases; compensating for the effects on domestic price levels of a devaluation by selective removal of QRs and lowering of effective rates of protection.
74. Threats to the well-being of the poor can come from three sources. (1) Reductions in that part (often a small part) of public expenditures that actually help the poor. (2) Changes in prices of basic commodities (mostly food) and of basic productive inputs (mostly fertilizer). (3) Increases in un- or underemployment and reductions in wage rates, whether caused by changes in economy-wide incentive structures or by reductions in public sector employment.
75. Reductions in Public Expenditures. The impact of expenditure cuts on the poor has generated widespread concern. Even existing public expenditures are often inadequate to meet basic needs. So maintaining those expenditures that benefit the poor is crucial. This may seem impossible at a time of wholesale cutbacks, but it can be achieved by a careful setting of priorities. Priority social and poverty programs must be protected at the expense of other alternatives. Some external financing from multilateral and bilateral donors is often available to support such programs. But it is also essential to increase the efficiency of service delivery, although realistically this is likely to take some time.
76. Increases in Prices. Many stabilization and adjustment programs have included a reduction in consumer or producer subsidies as part of

their effort to reduce the deficit. Wholesale cuts in subsidies can severely hurt the poor. The distribution of income is often so skewed that an inefficient subsidy may still be highly effective -- in other words even if only a small proportion of a subsidy benefits the poor, the income value to them may still be great. So it is crucial that no subsidy that is effective in reaching the poor should be reduced or eliminated unless and until alternative means of reaching the poor are firmly in place.

77. Changes in Employment and Wage Patterns. Adjustment programs can cause reductions in wages and employment for some workers through macro-economic changes (causing, for example, switching between traded and non-traded goods) and through retrenchment in the public sector. These effects need to be kept in mind in designing adjustment programs, and remedial actions considered.

Selected Country Experiences with Targeted Programs

1. Targeted programs to mitigate the social cost of adjustment have included credit and nutrition schemes, public works, retraining, severance payments and resettlement in agriculture. The main features and issues related to program design and implementation of these targeted programs are described below as well as similar types of programs, adopted by some non-adjusting countries, which have relevance for the future design of such programs in the adjusting countries.

Credit schemes

2. A number of adjusting countries have attempted to facilitate the absorption of newly retrenched workers into informal sector activities by introducing credit schemes. Guinea, Gambia, Ghana, Mauritania, Senegal, Congo, CAR, Gabon, Togo, and Madagascar have schemes providing loans to those rendered unemployed by public sector contraction to enable them to invest in small business. Similar programs have also been envisaged for the chronically under- and unemployed poor. Credit schemes proposed in some adjusting countries are described below with a brief analysis of the problems they may face and some possible solutions.

3. Mauritania. The government has put in place a scheme to increase special credit to help young technicians, former public employees and workers returning to the country to create small scale enterprises. A small fund (FIRVA) is providing this kind of credit through FND (Fonds National du Developpement) and will be replenished. So far, the FIRVA has granted 265 loans, with 1200 applications awaiting review. Preliminary reports about the scheme are, however, not encouraging. The FIRVA (like most institutions affiliated with government agencies) has proven to be overly bureaucratic, inflexible and slow to respond to the needs of small scale enterprises. A streamlined loan application procedure and efficient approval and oversight procedures have been lacking. The organization is understaffed and inefficient and has proven to be unresponsive to the needs of its clients by failing to provide management and technical training, marketing analysis, outreach and promotion systems. Besides, the interest rate charged by FIRVA has been unduly low varying between 5 and 6 percent. This may not ensure that funds are directed to the most productive activities. Besides, it may also not prevent the loan fund from becoming decapitalized and overhead costs may remain uncovered. Further, the current program provides loans for 8 to 10 years. Experience with other intermediary organizations indicates, however, that the most effective time period for initial loans should be from one to six months. When clients pay back their initial small loans they become eligible for larger amounts over longer periods. Finally, the repayment rate on the FIRVA is at present around 31 percent, which is rather low. It could be improved if self-monitoring groups of clients were formed.

4. Guinea. The government of Guinea created an employment advisory service (the BARAF) in March 1987 to provide assistance in preparing bankable projects. Under this scheme, departing civil servants can use their

severance pay as down payment to secure loans up to five times that amount at favorable rates of interest. By August 1988, nearly 1,400 project ideas had been presented of which 500 projects had been submitted for financing. Although an evaluation has not yet been carried out, it is evident that the scheme was not well designed. Some important issues, particularly, project selection criteria, interest rate levels and incentive mechanisms to ensure quick repayment, have received very little attention. It is expected that banks will cut back loans because they envisage problems with repayment.

5. While the credit schemes described above have been based on traditional approaches, the programs in Senegal and Ghana propose to involve NGOs.

6. Senegal. International donors are playing an important role together with local NGOs in assisting the government's credit schemes for the newly unemployed. The Employment and Development Department of the ILO is currently assisting in the creation of small-scale enterprises for those made redundant from the public sector. ILO's assistance covers credit, training and identification of new growth sectors. USAID is also providing \$2 million in separation payments for retrenched workers to establish small enterprises. Discussions are on-going between the Bank and NGOs for organizing village communities which could form the basis for a community based credit scheme eligible for borrowing from the traditional banking sector. In this way the private sector at the grassroots level could be invigorated by the infusion of credit. The Bank would make the initial funds available to community groups through the banking sector.

7. Ghana. The credit scheme in Ghana also envisages involving NGOs in assisting loan receiving entrepreneurs in the preparation of feasibility reports, and in follow-up assistance for purchasing, financing and marketing inputs and outputs. The beneficiaries will be the redeployed and other unemployed. A \$2 million scheme has been proposed. The funds will be channeled through the Bank of Ghana to local banks, who will appraise the loans. A spread of 8 to 10 percentage points is proposed to be provided to the banks to encourage lending to small-scale enterprises. It is expected that the credit line will help set up 340 enterprises every year, and will help generate 4,000 person years of employment each year.

8. Without such (and other) innovative approaches to credit lending, adjusting countries are likely to have limited success with their credit schemes. Promising approaches to lending for the poor can be found in India, Bangladesh and El Salvador.¹ These countries have successfully implemented credit schemes with one or more of the following unique features: (a) heavy reliance on grass-roots organizations (cooperatives, NGOs, neighborhood associations, municipal staff) to serve as a bridge between borrowers and financing agencies; (b) little emphasis on implementing discreet and costly technical assistance programs; (c) reliance on formal or informal group responsibility for loan repayments; (d) frequent loan collection, preferably at the place of business of the borrower; and (e) no subsidization of credit.

1/ The schemes in these countries have their limitations but they represent the most successful approaches to the problems so far.

203

9. India. The Small Scale Enterprises Project in Calcutta, India, exemplifies the advantages of the NGO approach, especially in areas of loan repayments and borrower identification. The SSEP² sought out voluntary organizations and, provided they were registered (which requires elected leadership), briefed them about the program and encouraged them to identify and pre-screen potential borrowers. With the help of the city metropolitan staff, the projects were then appraised and loan application forms filed in. Once loans were approved by the bank and disbursed, local organizations also took an interest in repayment. In a few cases, loan collection itself was reportedly contracted out to them for a 2 percent collection fee. This innovation helped reducing arrears.

10. Bangladesh. The Grameen Bank in Bangladesh shows how the joint liability approach can help achieve prompt and high repayment rates. A borrower is asked to form a group of five people who would like to borrow from the bank. Then loans are made to the two neediest and the bank directs the remaining to keep watch. If the first two fail to start repaying their loans, the bank will do no more business with any member of the group. If after six weeks all payments are in order, two more of the group of five may borrow. Finally, if all is in order, in six more weeks the leader of the group may borrow. All five must keep up their repayments if they are to continue taking advantage of the credit scheme. This model, based on group guarantees, has proved an extremely efficient way of providing credit to some of the poorest people (now almost exclusively women) without collateral. A repayment rate of over 95 percent has been achieved. Another important feature of the Grameen Bank is the absence of a subsidized interest rate subsidy. High repayment rates were achieved in spite of an interest rate as high as 16 percent.

11. El Salvador. In El Salvador, women's participation in the credit scheme accompanying the Small Business Support Component has been phenomenal (over 78 percent of borrowers). This has been achieved by concentrating the program in the largest and poorest settlements (government housing and squatter areas), which have a higher than average concentration of female heads of household and where the majority of men work or seek work outside. Concentrating on artisanal activities, which is a predominantly female realm, also accounts for the high percentage of women's participation.

12. Such innovative approaches provide models for strengthening the design of credit schemes supported under adjustment. They have proved that the poor can be an excellent credit risk even in the absence of collateral. They have also proved that creating new institutions and promoting a more careful design of credit schemes can be much more effective than mere credit subsidies, the predominant policy instrument so far.

Nutrition programs

13. Through effects on household income and purchasing power, adjustment can have a nutritionally negative impact on those poor people already living on the margin. Nutrition programs offer a way to carry out tightly targeted programs to cushion the shocks on the poor. Nutrition programs

2/ Interest rates were highly subsidized on this project.

have been proposed in a number of adjusting countries. Some of them are described below.

14. Bolivia. Under the ESF project in Bolivia, a number of targeted nutrition programs have been identified. A soup kitchen will be set up in Sucre's central market to serve the children who earn money through delivering people's purchases. The target population is estimated to be 100 children of both sexes between the ages of 4 and 15. A fee of Bs 0.10 (US\$ cents) per day will be charged. In Santa Cruz, a day care centre now serves 100 children from 4 months to school age in a poor neighborhood. In addition to eleven hours care, the children receive breakfast, lunch and an afternoon snack and basic health checkups and care from the affiliated hospital. Efforts are ongoing to reduce the fee from Bs 1 per child per day at present to Bs 0.8 per child. As part of another program, a dining room with kitchen and money for food purchases to feed 70 children from toddlers through primary age children five days a week will be provided. A fee is charged but it is not paid frequently. Closer links to schools might be desirable.

15. Sao Tome and Principe. In Sao Tome and Principe the World Food Program (WFP) provides basic foodstuffs equivalent to one third the daily wage for over 11,500 workers in a cocoa rehabilitation project and directly distributes free lunches for 20,000 school children. Total employment will amount to over 11 million workdays per year and cocoa enterprises are expected to benefit from a stable supply of labor. WFP will fund \$10.9 million and the Government \$1.1 million over a period of four years.

16. A major problem with nutrition schemes is their ad hoc nature and the lack of continuity. Apart from financial constraints, an important reason for this, is that nutrition is largely seen as a consumption or welfare issue rather than as a development concern. Improvements in nutrition have to be sustained over long periods if they are to make any lasting impact on the health of the target group.

17. India. The experience from the nutrition programs implemented in Tamil Nadu could be valuable to strengthen the design of future programs. These approaches have led to efficiently targeted programs and have proved cost-effective so that the length of time for which they are operational can be increased without a rise in resources. The Bank sponsored Tamil Nadu Nutrition program is an example. By stimulating enthusiasm for the program, the scheme relied on women's groups to help with the task of preparing food supplements, thus reducing administrative costs substantially. Another major departure from earlier programs was that the number of components in the project were limited. Nutritional supplements were directly provided to low-weight children between the ages of six and thirty-six months in six districts with the lowest caloric intake. The recruitment and training procedures for supervisors and workers were also carefully designed.

18. Colombia. The Integrated Nutrition Improvement Project in Colombia is another replicable approach. Health posts were designed as a conduit for nutrition surveillance and delivery of integrated nutrition/health services. The simultaneous delivery of health and nutrition services was not only found to be compatible but also seemed to have a significant synergistic effect.

203

Public Works³

19. A number of adjusting countries have initiated public works in order to create employment for the newly unemployed and the chronically unemployed. Many of them have aimed, simultaneously, at building infrastructure. Food aid or international grants have generally been used to finance public works projects. Some schemes are described below.

20. Madagascar. Under the EMSAP in Madagascar, targeted labour intensive employment generation projects are intended to be undertaken. The objectives of this component are (i) to increase incomes by employment generation in economically disadvantaged areas; (ii) to provide a temporary source of income to employees losing their jobs because of public enterprise closures or restructuring; and (iii) to provide jobs through the development of regional, economically sound infrastructure, particularly roads, using HIMO (i.e labour intensive) techniques. The proposed EMSAP would finance the construction or rehabilitation of rural roads in those counties where the agricultural employment opportunities are limited by the low availability of arable land per inhabitant. The EMSAP would also support the development of criteria and parameters for construction of other rural infrastructure, such as irrigation and well sub-projects. Further, the EMSAP would provide resources to the Public Works Training Centre (CATP) to expand the training programs on labour-based methods, quality control, and operation and maintenance of equipment for small domestic contractors.

21. Bolivia. In Bolivia the Emergency Social Fund (ESF) provides a mechanism for identifying and funding public works programs within a short time. The administrative structure created to implement the program has some interesting features: (a) objectivity in project monitoring is to be ensured by entrusting supervision and monitoring of public works projects to a state institution which is not the direct executing agency; (b) project execution is the responsibility of groups that are likely to possess useful local knowledge such as public or private entities, cooperatives, community units, civic, military or religious groups or associations expressly contracted for the purpose; and (c) in order to enhance government support to the projects and ensure their maintenance, completed projects are to be transferred to appropriate public entities who are expected to assume responsibility for their administration.

22. Ghana. Under the PAMSCAD in Ghana, food-for-work (FFW) projects are to be initiated to provide employment to the rural unemployed, and to help build and rehabilitate the economic and social infrastructure of rural communities. The projects that will be selected for the FFW program will be in the areas of agriculture, construction, water supply and infrastructure development. The program is intended to support labour intensive work projects with food rations to be paid to workers and with tools and materials provided for the completion of the individual projects. There will also be an education and training component to train workers in basic nutrition and sanitation, and in areas directly associated with the work

3/ Public works are defined as special employment augmenting schemes for the poor which simultaneously aim at infrastructure building. They are distinct from infrastructure projects executed by the government which have as their primary goal the creation of public utilities.

206

that they will be doing such as construction and agricultural skills. The support of local NGOs will be sought for implementation. The food rations will benefit 8,000 families for a period of six months each.

23. Also in Ghana, a Priority Public Works project (FPW) is intended to generate 10,000 urban jobs over a two-year period.⁴ This is a central component of the PAMSCAD (the only one whose implementation has started) and is financed by IDA (63 percent of project costs). Responsibility for project implementation would reside with the Ministries of Roads and Highways and the Works and Housing. These ministries in turn will report to the PAMSCAD secretariat which will monitor the overall project implementation. The main problem with this program is likely to be that the short-run implementation capabilities of existing agencies may be over extended, leading to implementation delays and the breakdown of supervision and financial control. Close monitoring of critical project activities will be essential.

24. Typically, public works projects have faced the following problems:

- The urgency to maximize employment has prompted countries to adopt highly labour-intensive employment programs and build relatively poor quality infrastructure. This may be detrimental to employment creation from the long-term perspective. Under the FFW project in India,⁵ for example, the ratio of wages and materials was rigidly set at 50:50. This resulted in the creation of non-durable assets for the sake of some additional immediate employment. With the requirement that local manpower should account for at least 60 percent of the total cost on ESF public works projects in Bolivia, a similar performance as in the Indian FFW project may be expected.
- Short term considerations or interference in project design and implementation from vested interests often lead to weak spatial planning (roads may be built in areas where no economic activity is possible) and temporal planning (erosion works may be undertaken after the monsoons). The result is that low priority works are initiated.
- Public works generally tend to worsen the relative access of the poor to assets because the ultimate benefits go disproportionately to those having the maximum land close to an irrigation canal or the best access to new roads. This may still, however, be desirable since absolute welfare in the economy improves: the poor become better off with none becoming worse off. What is important, though, is whether the position of the poor improves to an extent that justifies the costs of the project. Could some other way be designed which could give the same benefit to the poor and generate the same (or better) assets at lesser cost?

4/ Major projects under infrastructure rehabilitation and maintenance will be: drainage, road works, traffic management, sewerage and street lighting. House construction and servicing of land for sale to organizations for low income housing will be the other projects.

5/ The FFW project in India was initiated in 1977. National food stocks were utilized for payment of wages on the projects.

207

- The level of wages on public works may also create problems. A low wage ensures sharp targeting by attracting only the very poor but defeats the purpose of the program which is to help the poor to achieve a reasonable level of living. On the other hand, a high wage, besides attracting the non-poor, creates pressures on the budget and may not permit the creation of a sufficient volume of employment.

25. In order to strengthen the contribution of public works to the creation of productive assets and to the purchasing power of the poor, apart from more attention to the above mentioned issues, the following measures will be desirable: emphasis on projects of direct and long term interest to the target group; the latter's full involvement in all phases of the projects; strict supervision of labour recruitment and of project site operations; ensuring high labour productivity through use of a sufficient quantity of capital equipment; greater attention to maintenance of assets once created; a strong control and performance audit function from the centre; regular monitoring and impact evaluation to test cost effectiveness and viability of projects; and careful selection of the wage level.

26. Given the government's scarce administrative capacity, mobilizing the organizational capacities of local communities and NGOs is one way to improve the effectiveness of public work programs.

Retraining

27. Retraining schemes have been envisaged in a number of adjusting countries for those rendered unemployed by public sector contraction. CAR, Ghana, Guinea Bissau, Senegal, Gabon, Sao Tome and Principe, Togo and Madagascar have tried to provide retraining facilities to those dismissed from the public sector to facilitate their absorption into other expanding activities. Some countries have also proposed these schemes for the chronic poor. The Retraining schemes in Ghana and Madagascar have already been designed and are described below.

28. Ghana. In Ghana the retraining scheme under PAMSCAD will provide simple, brief training courses for the retrenched and other unemployed to upgrade their skills and to help them market their skills for self-employment or employment in the informal sector. Phase I of the proposed scheme will entail training of the people retrenched in 1987, through on-the-job training in private enterprises and through part-time courses at training institutes. Phase II of the project will involve an evaluation of the relevance of the existing training programs; brief training of trainers and redesign of courses; and training of the next batches of redeployees. In order to strengthen the design of courses, consultants will identify the skills that are likely to be in demand and identify projects where employment opportunities are likely to emerge.⁶ Consultants will also investigate the prospects for on-the-job training.

29. Many of the training institutes already have counselling and placement units and additional counselling and placement centres will be created

6/ Some simple projects have been prepared and the Small Scale Industries Board has identified 200-300 projects for suitable enterprises.

208

to help the trained redeployees and other unemployed by providing information about job prospects. There will be a special emphasis on assisting groups of trainees to use their compensation payment as well as the special credit line for establishing small-scale enterprises. Efforts will also be made to mobilise the support of NGOs who are already providing investment promotion and extension services in the informal sector. The total cost of training the redeployees is estimated at about \$4 million over the three year redeployment period.

30. The primary problem with this project is likely to be that the skills provided in the training courses may not be relevant to existing or emerging employment prospects. In addition, the quality of training may be poor due to lack of funds, equipment, logistical support and qualified staff in the institutions that will carry out the programs. Unless these problems are addressed, the training scheme in Ghana and other similar schemes are not likely to have the intended long term impact.

31. Madagascar. Training schemes have been designed for the newly unemployed in Madagascar. It is estimated that 30 percent of the laid-off workers would not use the training programs; two-thirds of those would retire or leave to seek different opportunities; and the remaining one-third would be provided with immediate employment opportunities following the interview process. Two types of training programs would be initiated for the remaining 70 percent laid-off workers: (a) on-the-job-training and (b) retraining through specialised institutes.

32. On-the-job-training: Approximately 15 percent of the remaining laid-off workers would be placed in enterprises for retraining for a period not exceeding six months. Their salaries during retraining would be shared equally by the enterprises and the Ministry of civil service and labour (MFOP), for a total not exceeding two minimum salaries. The enterprises would be paid a retraining fee under a standard retraining contract. The average cost of retraining per worker, including the salary, is estimated at \$480.

33. Retraining through specialized institutes: These programs would absorb 85 percent of the remaining laid-off workers. The government has prepared an action plan to strengthen the training institutes and programs offered by the Chambers of Commerce and the professional schools. The objective of these programs is to help laid-off employees acquire expertise that increases the likelihood of their finding employment elsewhere in the economy, including in the informal sector. The employees would receive the equivalent of a minimum salary during the retraining period for a maximum of six months. The average cost of the retraining program per worker, including the salary is estimated at \$800.

34. The Madagascar scheme is designed well but administrative and financial problems could hinder effective implementation. Problems may also arise if the original assumptions about the numbers wanting to opt for the various options prove inaccurate. Already, it is expected that due to the recent surge in employment in the labour-intensive clothing business, on-the-job retraining may well absorb a greater proportion of the laid-off workers than the originally anticipated 15 percent.

209

35. Ideally, every training program should have a system through which information about the learning capacity of the trainees and the needs of the economy are fully assessed. There must also be mechanisms to assess the progress of the trainees during the training period and there should be follow-up after completion. Some approaches to training programs that have evolved in recent years, incorporate some of these features. Adjusting countries would gain by introducing the novel features of these approaches into their programs. The Mexican manpower training project and the BRAC training scheme in Bangladesh are two replicable models. They are described below:

36. Mexico. The proposed Manpower Training Project in Mexico aims at reducing the social cost of adjustment by increasing labour productivity and by training workers for jobs which exist or are likely to emerge as a result of adjustment. By doing so, it simultaneously aims at reducing the human resource constraint to economic growth. The project envisages improving and expanding the already ongoing Bank supported pre-training, in-service and re-training programs by introducing the following important features:⁷

- the selection of trainees on the basis of new criteria designed to identify the most trainable and motivated candidates in order to enable the poorest of the unemployed to be retrained;
- introduction of an innovative and very selective use of stipends to trainees;
- the involvement of concerned enterprises as cost-sharers and program designers and implementators in order to ease the financial and administrative burden on the government; and
- strengthening labour market and manpower monitoring to ensure that marketable skills are imparted to the unemployed.

37. Bangladesh. In Bangladesh, BRAC (Bangladesh Rural Advancement Committee) has developed a promising system combining group formation and training in practical skills, functional literacy and numeracy. Simple functional skills such as rudimentary literacy and numeracy are essential both to enable sound decision making and to prevent exploitation by more powerful groups. The need to give extension workers in-depth knowledge about the problems of the poor and to develop flexibility to adjust to the learner's learning capacity, has been recognized and will be given attention.

Severance payments

38. Compensatory cash payments have been proposed to compensate retrenched public sector workers in several adjusting countries. These payments are meant to prevent standards of living of dismissed workers from falling below socially acceptable levels during the period of transition while they find another job. The amount of compensation has in most cases depended upon the number of years of service and the grade attained at the time of retrenchment.

7/ The Bank has two successful projects which have provided training and have aimed at facilitating self employment as well as employment in the formal sector, have had a favourable experience.

210

39. Different methods have been adopted to finance these severance payments. In cases where staff reductions have coincided with divestiture/privatisation of public sector organizations, funds from the divestiture/privatisation have been used. In other cases, governments have relied on their own national budgets and (or) on financing from international donors.

40. While severance pay schemes in most adjusting countries are still under preparation, the schemes in Ghana, Togo and Guinea have started and are described below. The scheme in Madagascar is in the late stages of program design and is also described below.

41. Ghana. A civil service census undertaken by the government of Ghana in 1986 revealed a large concentration of civil servants in the lower strata of the civil service. This group became the target of the 1987 staff reduction exercise.⁸ The compensation package designed for those who would be retrenched comprised: (i) severance pay equivalent to four months of gross terminal salary and (ii) end-of-service pay equivalent to two months of gross salary (at the time of termination) for each year of uninterrupted public service. The goal was to reduce the size of the teaching and non-teaching staff of the Ghana Education Service (GES) and the civil service by 15,000 people by the end of 1987. A further reduction of 15,000 was planned for each of the following two years, 1988 and 1989. The Redeployment Management Committee (RMC) under the Ministry of Mobilization and Productivity was given overall responsibility for managing the scheme.

42. So far the targets have not been fully achieved but progress has been good. By May 1988, the secretariat had released and paid over 12,000 surplus staff. Only around 25 percent of the retrenched had, so far, expressed a desire to avail of the government's redeployment scheme implying thereby either that the severance payments had been generous or that they were able to find alternative employment fairly easily.

43. However, since the program depended on the existing administrative structure for its implementation, there had been bureaucratic delays. Information from the retrenched employees about the choice of future vocation (retraining or redeployment in agriculture) was not forthcoming at the desired speed. Delays had been caused mainly by lack of finance, transport facilities, office equipment and relevant documentation about the affected persons. Another area of concern is that out of the total cost of the compensation package for the 1987-89 period (which was estimated at \$50 million for the civil and teaching service alone) only one-fifth of the expenses would be financed through the PAMSCAJ and it was not clear where the remaining amount would come from.

44. Togo. Proceeds from divestiture/privatisation were used to finance compensation packages for the retrenched. While proceeds from the sale of assets have in many cases been sufficient to cover the severance

8/ The target groups identified for retrenchments were: (a) labourers, cleaners, charwomen, drivers, stewards, cooks, porters, sweepers, messengers, security personnel and analogous grades and (b) clerical officers, secretariat personnel, store officers and analogous grades.

payments, the outstanding debt of the former enterprises, originally contracted directly on their behalf by the government or under its guarantee, remains with the government. The retrenchments have not been large because no closures of enterprises were undertaken. The few who lost their jobs were able to find alternative employment either in the public or private sector. The social cost of adjustment arising from privatisation has been relatively small.

45. Guinea. Voluntary departure bonuses have been given to departing civil servants. The bonuses are equivalent to five years of salary with 30 percent of the payment being made upfront and the remaining over 20 months. Those with bankable projects have received access to loans at favourable rates. The severance pay scheme has proceeded fairly smoothly so far, although, a civil service pay roll roster that should have been drawn up before the retrenchments were effected, is only now being prepared. In the absence of such a roster it may not have been ensured that the most cost-effective decisions were taken and that the dismissed civil servants did not reenter public sector employment through the back door.

46. Madagascar. In Madagascar, the redeployment fund out of which severance payments are to be made will be managed by the Ministry of Finance and Economy, on the basis of inputs from the Ministry of Civil Service and Labour which has conducted a survey on the number, regional distribution, qualification, seniority and salary of the employees likely to be affected over the next two years. The average severance pay cost per worker (including advance notice, unemployment benefits and accumulated leave) is estimated at \$350 equivalent. The redeployment fund will be financed out of the government budget. The IMF has agreed to a special allocation for this purpose in the framework of the ongoing stand-by arrangement.

47. The EMSAP proposes to develop a job-related referral service for workers being laid-off. The referral service would offer information and orientation services, about job openings and training options.⁹

48. Administrative problems are likely to delay or distort the implementation of severance pay schemes. In view of the weak central institutional mechanisms to implement, co-ordinate and monitor severance pay schemes, they would be more successful if local public bodies assumed some responsibilities such as maintaining records about retrenched workers and calculating the amounts due for compensation. Financial arrangements will also need to be put in place to ensure prompt implementation of these schemes.

Resettlement in agriculture

49. Countries with a comparatively low pressure on land have proposed to mobilize the newly unemployed towards agriculture. Guinea Bissau, Mauritania, Sao Tome and Principe, Ghana and CAR are some examples. The schemes in Ghana and Mauritania are in advanced stages of designing and are described below.

9/ The training scheme is described in paragraphs 32-35 above.

2/2

50. Ghana. In Ghana, the resettlement project has recommended that food aid and extension services be provided to enable 9600 redeployees and other unemployed to move into unused but arable fields in 19 locations in 7 regions. Food aid available for a year will enable these families to sustain themselves until they have cleared the land, grown accustomed to agricultural practices, and have grown sufficient food. This will facilitate the mobility to agriculture - the prime growth sector under the economic recovery program. The project is expected to cost \$6.3 million, of which \$5.3 million will be in food and it is expected that 48,000 individuals will benefit. The scheme also envisages the provision of inputs and extension services (i.e. providing information about the correct use and application of farm inputs and the more efficient farming practices). Group lending will be encouraged by facilitating groupings of between 10 to 15 farmers.

51. Mauritania. In Mauritania, the government intends to help re-trenched SNIM (Societe National Industrielle et Miniere) workers to use their severance pay to resettle as private farmers in the South. Vast areas have become irrigable in the South making agriculture a profitable venture. The government is to work out tenurial arrangements by which the land can be transferred to this new group but this is likely to prove difficult.

52. Apart from difficulties of moving urban civil servants into agriculture and resettling them into rural areas, there is the question of whether the land made available for distribution (abandoned coffee plantations as in CAR or land not currently in use as in Sao Tome and Principe) is of a quality that will enable profitable farming. If the land distributed to the poor is insufficiently fertile, this measure is unlikely to have lasting beneficial effects. Besides, as the scheme in Mauritania has proven, the distribution of land to "outsiders" is likely to meet with resistance from existing vested interests. Target groups may find it increasingly difficult to acquire and retain the newly distributed lands.

213



World Bank Discussion Papers

Managing Economic Policy Change

Institutional Dimensions

Geoffrey Lamb

The World Bank
Washington, D.C.

264

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215

	<u>Page</u>
SUMMARY	vii
I. INSTITUTIONALIZING POLICY REFORM	1
A policy-focussed approach	2
II. THE ECONOMIC POLICY PROCESS	6
Analyzing the policy process:	6
- components of policy decision-making	6
- tracking the policy process	7
- institutional intensity of policies	7
The politics of policy decisions	8
Illustrations from Bank experience:	10
- public investment	10
- debt management	12
- exchange rate and pricing policies	13
- food security	14
- trade policy	15
- economic policy coordination	17
III. IMPLICATIONS FOR EXTERNAL ASSISTANCE.....	22
Policy analysis	22
Financial and Technical Assistance	23
Professional Issues.....	26
IV. CONCLUSIONS	27

SUMMARY

In recent years a great deal of work has been done on the analysis and design of economic policies to support the new emphasis in development strategies on policy reform and adjustment. In comparison with this effort on the substance of economic policy, however, knowledge about how best to strengthen the institutions in developing countries responsible for those policies is less developed. We do not yet have adequate knowledge or fully appropriate operational techniques to improve the management of economic policies--that is, to build up government structures and processes to support effective economic policy-making and implementation, and in particular to make sure that sustained rather than episodic policy improvements occur. Developing the institutional capacity for timely and flexible policy response is clearly central to successful policy reform and structural adjustment, but the sophistication of policy analysis has not yet been matched with corresponding knowledge about how to assist governments to strengthen and institutionalize their own processes of policy decision-making and implementation.

This paper is a preliminary effort to bring the issue of institutionalizing policy capacity into sharper focus, and to suggest ways of improving approaches to adjustment lending, public sector management assistance, and economic analysis in support of policy reform. It is intended to increase awareness of the institutional and political factors in economic reform, and to indicate how these factors may be better dealt with.

The paper deliberately separates policy management from the more general business of government by concentrating on economic management functions and on the state agencies critical to policy reform. This selective approach may well imply acceptance of some transitional institutional costs as a result of assigning lower priority to broader institutional problems and routine administrative functions, but these costs are justified by the urgency and leverage of better policy performance. The approach here stands in sharp contrast to that of conventional public administration reform, which has had indifferent success and is generally not sufficiently timely, focussed or powerful to have a significant impact on the performance of economic policy institutions. The paper focusses on the institutional dimensions of the economic policy process essentially by asking three questions:

- What are the key components of policy decision-making? This provides a rough checklist of the functions which governments' policy institutions need to perform, and which external assistance should seek to strengthen and make more disciplined within recipient countries.
- Which institutions control critical aspects or phases of the policy process? This involves tracking the policy process through the institutional structure, identifying weak points or bottlenecks in the flow of essential decisions, and devising appropriate action. This "policy process analysis" must identify

specific units or parts of institutions which are involved in policy formulation and implementation, rather than entire ministries or agencies.

- How can different policies be managed in ways which are less institutionally intensive or demanding? Since economic policies differ widely in the demands they impose on a government's administrative capacity, it is important to assess the extent to which markets or market signals can substitute for administration, the degree of central control essential for effective policy formulation and implementation, and the range of public agencies and interest groups with a stake in the relevant policy decisions. Administrative intensity can vary in several ways: number of agencies involved, therefore complexity of coordination and management requirements; size of operation, therefore numbers of staff and cost of administration; and sophistication of operations, demanding different mixes of high-level and more routine technical and managerial skills.

These questions must also be viewed in political context. There needs to be more systematic understanding of the political process as it affects policy reform. Judicious choice and timing of policy recommendations and institutional interventions can take account of the political life cycle of governments, the institutional alliances and differences always present within governments, and the political interests to which different decision-makers respond.

The paper draws for illustration on experiences in several areas of economic management--public investment decision-making, debt management, exchange rate and trade policy, and economic policy coordination. While assistance by the World Bank and others for reform of these functions is mostly very recent, the cases cited demonstrate the importance of the institutional arrangements for policy management, and indicate ways in which the Bank is learning to deal more systematically with constraints in this area. In many instances this involves gradual progression from limited initiatives to more ambitious ones--e.g., assistance with planning methodology in Zambia leading to broader reforms of budgeting and planning arrangements, or support for better debt management in Thailand helping to promote institutional changes which have tightened policy coordination between central bank, finance, budget and planning agencies over public investment and budgetary decisions as well as over borrowing policy.

As these examples demonstrate, coordination of economic policy is a difficult institutional challenge. It is an intensely political issue, but is usually too complex and detailed to be dealt with effectively at Cabinet level except for a very few major decisions. At the same time, bureaucratic interests often make it difficult to secure effective coordination at the technical level, except over very limited crisis periods when these can usually be over-ruled. Successful intervention therefore needs to combine persistence with a degree of opportunism--i.e. persistence in drawing attention to the problem and putting forward possible solutions, and opportunism in building on whatever coordination mechanism present themselves, even if flawed or partial.

The paper suggests several implications for countries undertaking economic reform programs, and for international agencies assisting in their design and financing.

First, institutional requirements need to be more systematically addressed in the analysis and design of policy reform programs, specifying the framework of policy management in each case, and the organizational and other changes necessary to effect the policy improvements sought. This entails a change from an institution-centred approach (e.g., "weaknesses in organization, staffing and procedures of Ministry X") to a policy-centred approach (e.g., "through which specific organizations, people and processes is Policy Y formulated, decided and implemented, and how should each of these be changed?").

Second, given the long time horizon and political sensitivity of these changes, there needs to be a careful sequencing of institutional reforms, dealing first with the most urgent and tractable policy management issues, and then gradually broadening to tackle the underlying structural constraints. External assistance can then be designed to match these phases of policy-centred institutional reform--by degree of urgency and/or feasibility, and (in the case of the World Bank) by an appropriate combination and sequencing of lending instruments such as structural adjustment and sector adjustment loans, and by public sector management and technical assistance projects.

Third, technical assistance for strengthening economic policy management should concentrate on specific policy management problems rather than provide general institutional support; should use assistance primarily to institutionalize national rather than expatriate policy expertise; and should include activities to educate potential policy-makers and to broaden the informed policy community. Such approaches require careful calibration to the circumstances of individual countries. In some more advanced countries, for example, it may be feasible to concentrate on supporting quasi-independent policy institutions which have good access to policy-making. In other circumstances, however (such as those obtaining in much of Africa), assistance has to be concentrated in the shorter term on building up the day-to-day policy capacity of government agencies, and on providing incentives and logistic support for this capacity to become institutionalized: establishing centers of high-quality policy analysis and innovation should however remain an important objective.

This perspective on the institutional dimension of policy reform does not imply an abandonment of traditional institutional development efforts, which remain important. But a major effort to develop assistance for policy management will entail difficult choices for decision-makers in aid agencies, particularly in selecting countries on which to focus effort, committing the resources necessary to maintain that effort over some years, and accepting a degree of risk from changes in institutional and political conditions. It is also important to note that good work in these areas is staff-intensive, requiring detailed knowledge and sustained commitment of design and supervisory time and effort by operational staff. Particularly in African countries, for example, a case can be made for increasing Bank staff's direct support to governments to strengthen policy performance, and for acknowledgement of a staff technical assistance role in improving policy processes which is often perceived within member countries as both more authoritative and more accountable than expatriate consultancy.

The conclusion is that the Bank and other agencies should make the institutionalization of economic policy reform a cornerstone of institutional development work. This requires a more systematic focus on the institutions necessary to support better economic policy performance--a focus which is justified by its importance and urgency, and by the indifferent record of improving policy capacity through broader processes of administrative reform. There has in the past been a relative neglect of the institutional dimension in policy reform efforts and, conversely, a neglect of the policy function in most approaches to institutional development and public administration.

The approach should be policy-centered rather than institution-centered--that is, it should aim at improving the effectiveness of key processes of economic policy decision and implementation, and not merely at generally strengthening agencies which deal with only part of a particular economic policy problem but which deal with many other, lower-priority, matters as well. Assistance should be concentrated on direct support for national cadres of policy personnel, and on carefully designed policy work programs within recipient agencies. The main operational responsibility has to be assumed by specialist staff working on public sector management, an area to which the donor community has been devoting increasing attention. Support for economic policy reform should be a central component of their work, and should be closely coordinated with the external financing of adjustment programs.

There is also an important role for bodies such as the UN regional economic commissions, the Economic Development Institute (EDI) of the World Bank and others, to provide a forum for broadening and improving understanding of the management of economic reform at senior levels of government. EDI, for example, is playing an increasing role in developing policy analysis capacity--through its senior policy seminars, its support for national and regional training and development institutions, and its growing program of activities in economic management and development administration.

WORLD BANK STAFF WORKING PAPERS
Number 375

**The Design of Organizations for Rural
Development Projects — A Progress Report**

William E. Smith
Francis J. Lethem
Ben A. Thoolen

The World Bank
Washington, D.C., U.S.A.

Chapter 2: Some Principles for Designing Organizations
for Rural Development Projects

2.01 Our task now is to relate the design problems encountered in the interviews within the Bank to the emerging theories and experiences of the design specialists. We will attempt to produce a conceptual framework that will enable us to develop a more systematic approach to organization design. Finally we will try to draw out implications for the Bank and Borrowers.

Conceptualization of Organizations

2.02 A first problem lies in the models we use to understand organizations. Ackoff^{1/} has pointed out how our concepts of organization have shifted from machine models, through models of organisms and now to more complex social systems models. The Machine Age was characterized by an explosion of knowledge in the physical sciences. Its enormously successful application of science and technology, from the Industrial Revolution to the placement of the first man on the moon, has given us tremendous confidence in the analytical paradigm at the core of Machine Age thinking. In the physical sciences all relationships were potentially knowable and measurable. We could take any problem, break it down into its component parts, understand each part and its structural relationship to all other parts and we could understand the whole. This is how we design machines and solve the problems we have with them.

2.03 We have extended this thinking to the design of our social organizations. Humans are the parts, their interrelationship is standardized through routinization, job descriptions and bureaucratic rules and regulations. However, the variable human being somehow resists or defies such programming. But the Machine Age analysts continue their refrain: "If only we could find the right structure for the right situation and mix of personalities, knowledge and skills, then how much more effective we would be."

2.04 Ackoff argues that the Machine Age has given way to the Systems Age and analytical thinking is no longer enough to tackle the major problems: we need more "synthetic" thinking. Our problems do not come in simple unitary entities; they come in huge clusters or "messes." The solution of any problem tends to give rise to whole new sets of problems to be solved. Synthetic thinking demands that we take an "expansionist" view of problem solving and systems design. We must begin looking for solutions outside the boundaries of the problem or system and bring the environment into equal predominance with the organization. Synthetic thinking attempts to understand the problem or organization as a whole operating in complex interrelationship with its environment. Analytic thinking tends to concentrate on the internal environment to the exclusion of the external.

^{1/} R. L. Ackoff, Redesigning the Future. John Wiley, 1974.

022

2.05 Finally, synthetic thinking recognizes that the interrelationships between parts of a problem or organization and its environments are so complex that simple cause-effect relationships are almost impossible to trace. No event is the single cause of any other event. Events together with a particular state of the environment "co-produce" rather than cause other events and other states of the environment.

2.06 The move from the more classical infrastructure projects to the newer rural development type projects makes demands on project designers to think both synthetically and analytically. The typical infrastructure project required tight definitions of project boundaries, clear definitions of the parts, and a structural definition of how the parts were to be related in the unfolding of the project. Using analytical thinking, the typical design outcome is a Project Unit, controlling most of the resources needed for implementation. It has all the advantages of machine design principles. Clear boundaries are set around the problem and the major project effort takes place within these boundaries. The unit operates as autonomously as possible. It attempts to control all necessary resources for project completion. It specifies all parts needed and the required structure of their interrelationship before project start-up. Criteria for success are based on the closeness of adherence to the blueprint. The larger the physical component of a project, the more such a priori knowledge is likely to work out in practice; the more the project relies on the interrelationship of human motivations, perceptions, and skills, the less the project design is subject to such a priori blueprinting.

2.07 Evaluation of the more traditional projects is relatively easy -- the physical output is achieved in some measurable degree, the output is a direct result of the inputs and the design of the methodology. However, the newer projects, as illustrated by Lilongwe, are not so easy to evaluate. The project produced a different "state of the environment." The design effort linked with other efforts to co-produce new sets of relationships, new capacities. Cause and effect relationships were too complex to trace. The participants were unable to explain or justify them in a systematic way.

2.08 Thus, in the newer multi-sectoral projects success is determined not so much by the most logical or efficient arrangement of internal organization and resources but by an appropriate co-alignment with external agencies. Project success depends on actions taken by local, regional, and national government agencies, private business and religious groups, and - most of all - the project beneficiaries.

Human Resources

2.09 A second problem results from our focus, in the process of organization design, on the production of physical and material resources. Emerging design concepts stress equally the development of human resources and community capabilities. Designs emerging from analytical models have encouraged human passivity and dependence. New designs stress the need for people to become involved in and committed to what they undertake in

the community.^{1/} Under these conditions productivity has risen in places where older approaches have failed.

2.10 Organization design that stresses human resources and community capability finds ways to increase the control of all participants over their environments and gives them greater choice of action consistent with their own motivations, perceptions, and skills. Knowledge rather than resources becomes the key to development. Ackoff^{2/} has pointed out that development is more a matter of competency than wealth. A man can build a better house if good tools are available to him. On the other hand, a fully competent man with a wide range of skills can build a better house with whatever tools are available to him.

Inter-organizational Relations

2.11 The third major problem is that organization design practitioners have tended to focus their attention on the single organization (as opposed to groups of them which may be mutually dependent). Much of the criticism of bureaucratic systems stems from their inability to adapt to changing environments. Perhaps the failure lies as much in our social structure that expects too much of the single organization. We have not found ways to link single organizations to others into supportive structures that direct their energies toward commonly shared goals.

2.12 That such inter-organizational support structures can be generated has been amply demonstrated by Trist and others.^{1/} In Jamestown, New York, in an economically declining community, institutions (i.e., private businesses, labor unions, and the municipality) which have been traditionally regarded as inimicably opposed to each other were brought together in cooperative approaches. Labor-Management Committees were formed, companies in difficulties have been salvaged and new industry attracted.

Conclusion and Diagnosis

2.13 The design of new organizations or redesign of existing ones for the achievement of rural development goals is a difficult matter. Indeed, the Bank seems to be operating at the leading edge of knowledge of organization and management theory. The problem is not so much one of application of known management techniques, but the development of new ones, or the recombination of known elements into new approaches. The task entails no less than the development of a new conceptual framework that would encompass the major dimensions of the World Bank's learnings. The framework would provide practitioners with reference points against which they could chart their own experience and would provide a common base and language upon which to build new knowledge as it was gained from experience with new projects. This is the objective of the second part of this paper.

^{1/} E. L. Trist, "A New Approach to Economic Development: an American Experience." Linkage TWO. Tavistock Institute, London, 1978.

^{2/} R. L. Ackoff, Draft chapter on Development, based on Mexican experience. University of Pennsylvania, August 1978.

224

Part II: A NEW FRAMEWORK FOR ORGANIZATION DESIGN

Chapter 3: Organizing the Project Environments

3.01 One of the major findings of this study was that many of the problems labelled "management" are really problems of design. Many of the factors that influenced management performance were not in fact subject to management control. This finding supports those of "The East African Problem Projects Review, fall 1978" which noted:

"It has become evident with experience that 'management' has various dimensions. At one level it can mean the ability to organize and plan project activities efficiently, get the inputs to the farmers on time, deploy staff resources well.... Increasingly, however, one is aware that the broader environment in which management functions is also a factor.... The socio/cultural environment of the project area determines how rapidly innovations will be accepted, how much cooperation is given to project personnel, how project objectives will be perceived by the intended beneficiaries."

Considering that a surprisingly low percentage (10%) of rural development managers are rated low in competence, the report concludes that the source of the problem may not be so much a lack of management ability as it is the environmental aspects cited above.

3.02 Part of the problem lies in our concept of environment. We tend to think of the environment as "everything out there," i.e., all those elements outside the organization that we cannot control. Thus our organizational world consists of those elements we can control (i.e., those within the boundaries of the organization) and those we cannot (i.e., everything else out there, the environment). Viewed this way the problem of organization design is one of defining boundaries around a number of elements and designing the interrelationship between them so that they remain under control (choice of project components, staffing, job responsibilities, resource allocation, review mechanisms). The organization thus conceived is summed up by a two dimensional chart showing the allocation of job responsibilities through job descriptions and their relationship to each other through hierarchical reporting relationships. The design, then, essentially ignores the environment as uncontrollable.

3.03 Management's job is to look inwards towards the organizational elements that can be controlled. Such implicit thinking is reflected in the early designs for rural development projects which tended to stress the

225

use of project management units that "controlled" all key resources for the implementation of project activities. Project units were virtually autonomous with minimal connections to their environments. The earliest project, Lilongwe, was based in a region, hired its own staff, purchased its own equipment, had its own funds. In all respects it was internally self-sufficient. Increasingly, rural development practitioners found that such projects, in spite of their design, were subject to influence from entities outside their organizational boundaries and in turn had to exercise influence over those entities (e.g., marketing entities, input suppliers, other ministries, beneficiary organizations). Moreover, project success was determined as much by skillful handling of such external influence relationships as it was by project resources under the control of management.

3.04 Clearly there is a level between the organization and the "uncontrolled" environment which is external to the organization but is subject to influence by the organization's management. Organization designers have, then, to be concerned with three levels of environment^{1/} (Charts 1 and 2):

- (i) The boundaries around the controlled elements define the organization's own boundaries, its internal environment. In Chart 1, we describe this as the "controlled" environment. It consists of the baseline activities that produce the results intended (the selection of objectives, strategies, and actions; for example, construction of a road, planting of seed, construction of a well).
- (ii) The second consists of the entities external to the organization whose activities can influence organizational and management performance. Such entities have ongoing relationships with the focal organization; for example, they provide inputs, or receive outputs. The basis of the relationship is a source of mutual influence between the focal organization and the external entity. We will call this the "influenceable" environment; for example, for an implementing agency, these might be marketing boards, credit associations, government agencies, and so on. See Chart 2.
- (iii) The third level includes institutions that produce activities affecting organizational performance, but that can neither be controlled nor influenced by its management. We have labelled this environment "appreciated" because

^{1/} The existence of these three environments has been recognized in the literature. They are referred to as internal, transactional, and contextual. See Emery, F. E., and Trist, E. L., Towards a Social Ecology. Plenum Press, 1975.

226

the two components of the meaning of the word, understanding and valuing, convey exactly what we expect of management in relation to this environment.

3.05 A clear distinction has to be made at this point between the general concept of the environment and our concept of the appreciated environment. The appreciated environment is not "everything out there." It is much more precise in meaning. It includes only those entities whose actions affect organizational performance directly or indirectly, and are not subject to control or influence of organizational members. In effect the appreciated environment becomes the starting point for organization design. It specifies the givens that will facilitate or hinder the design effort. The projects studied show, however, that it is never possible to completely specify the elements of the appreciated environment in advance of project or organizational design. The very act of design and implementation uncovers new sources of influence and adds to knowledge about the appreciated environment. A sample of elements produced by such entities or institutions are: (a) price policies affecting incentive to produce; (b) overvalued currency and balance of payments difficulties; (c) finance, budgeting and procurement procedures affecting inputs to projects; (d) centralized nature of administration; (e) Government hiring policy; (f) land tenure systems and impact on farmer motivation; (g) research and technological breakthroughs and limitations; and (h) cultural attitudes, e.g., to credit risk.

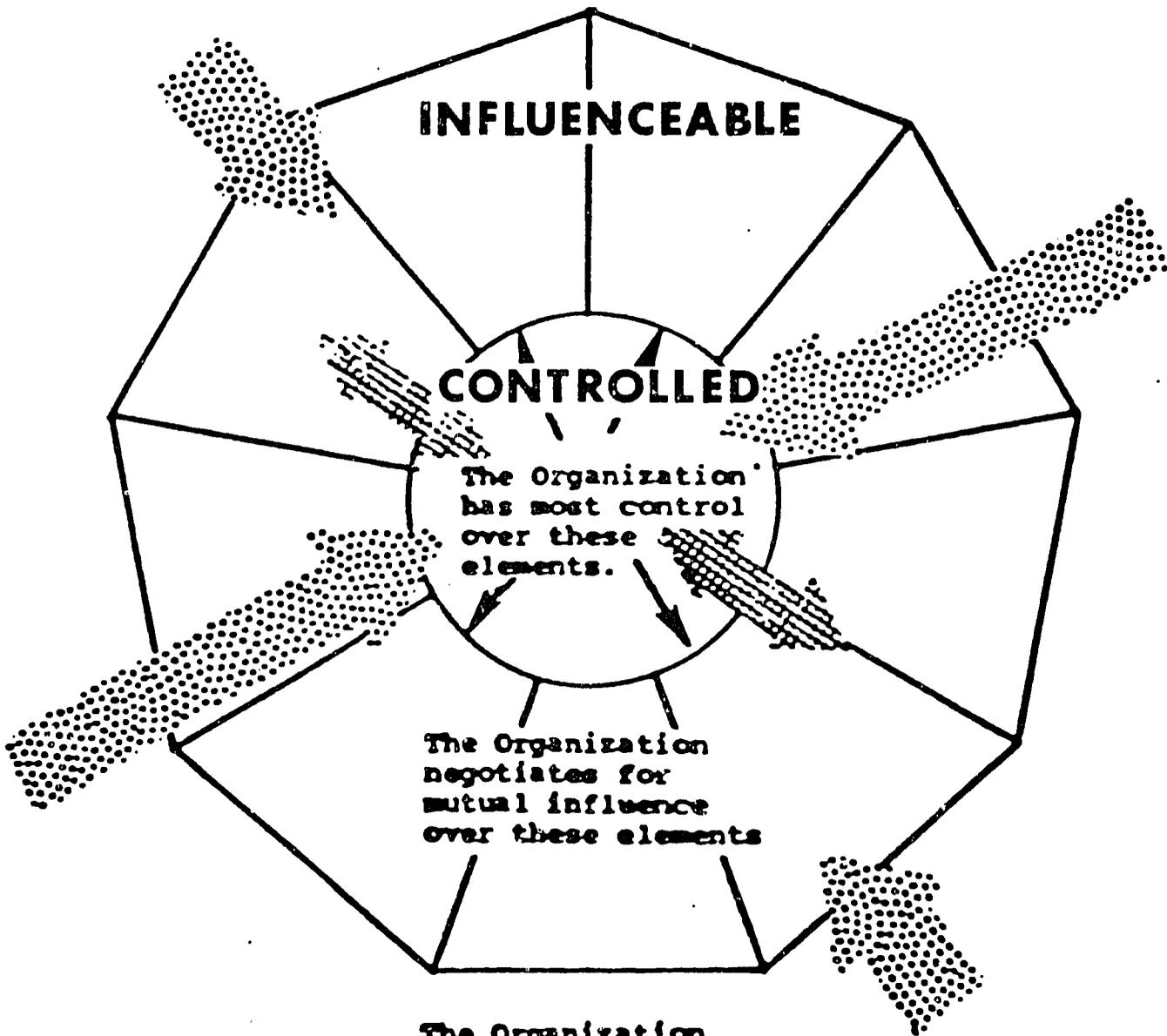
3.06 For any project, the relative importance of each environment differs. For example, in a single-sector, physical-infrastructure project (building a dam), mainly concerned with inputs and outputs, the relative importance of the controlled environment would be high. However, in an integrated, multisectoral rural development project, concerned also with effects and impact, the activities under direct control of project designers would be relatively fewer (Charts 3 and 4). In addition, as a project evolves from its design phase, through its construction period, into an operational phase, it is achieving certain results. The very results obtained from the project alter the pre-existing patterns of control, influence, and appreciation. Hence, there is a need for an organization design that is sufficiently flexible for adaptation to environments that are likely to change.

3.07 In sum, the first dimension of our conceptual framework is a more precise definition of the organization in relation to its environment. The key insight is the addition of an intermediate level of environment consisting of external elements subject to management influence. The practical implication for organization design lies in the need to identify these entities that produce them as part of the organization design process. The implications for management are profound. The management role can no longer be seen as primarily inward looking. The manager must focus not only on those internal elements subject to his control, but equally -- and often even more -- on those external elements of the environment that are subject to his influence and that he has to appreciate.

227

AN ORGANIZATION'S RELATIONS TO ITS ENVIRONMENTS

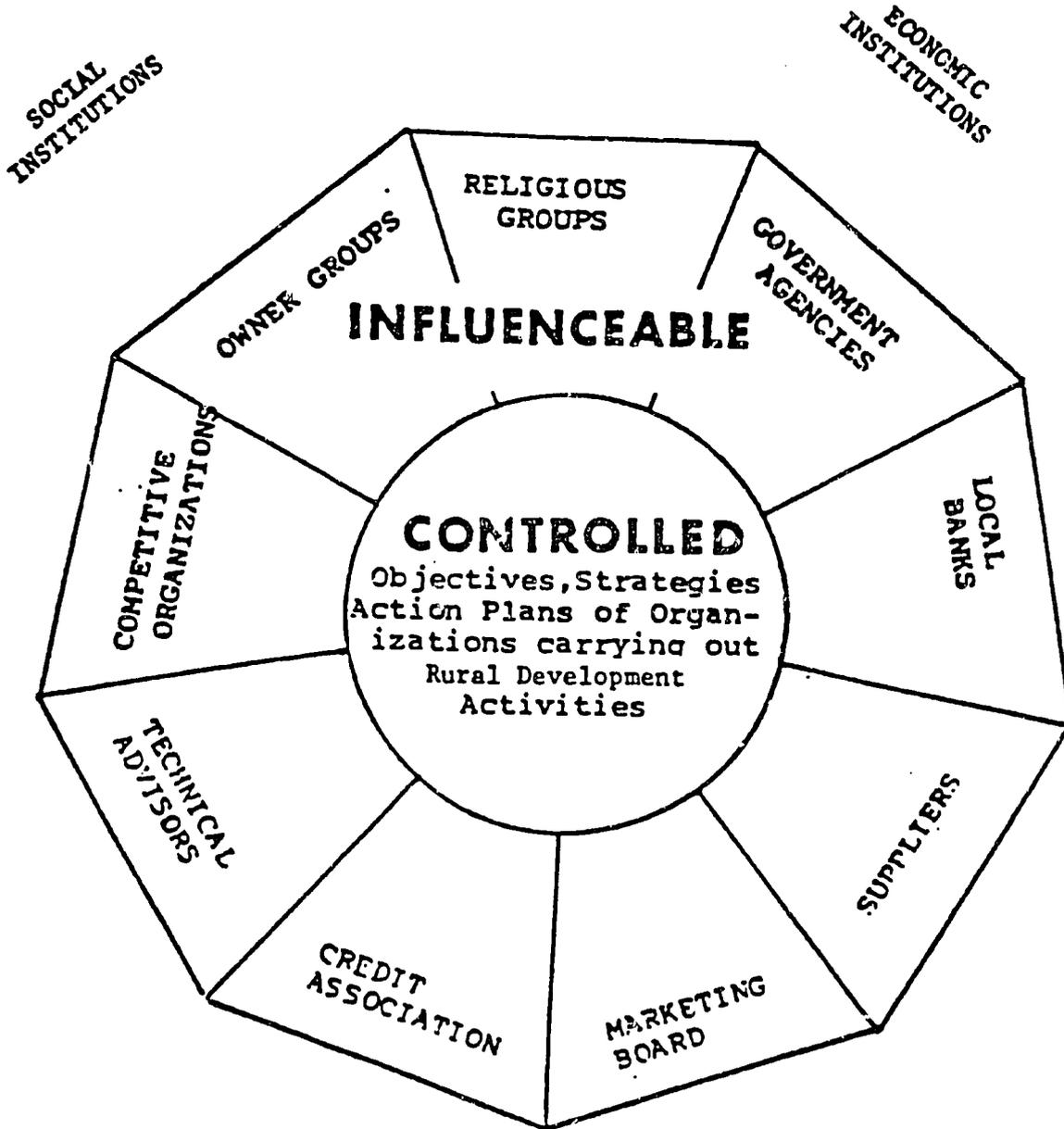
APPRECIATED



228

PROJECT ORGANIZATION AND ENVIRONMENTS IN
RURAL DEVELOPMENT PROJECTS

APPRECIATED

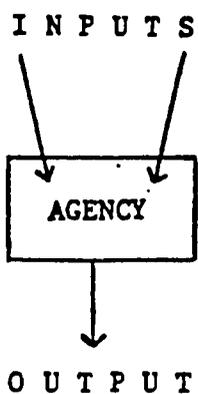


POLITICAL **TECHNOLOGICAL** **CULTURAL**
----- **I N S T I T U T I O N S** -----

229

HIERARCHIES OF OBJECTIVES:
INFRASTRUCTURE VERSUS MULTISECTORAL PROJECTS

A. Physical Infrastructure Project

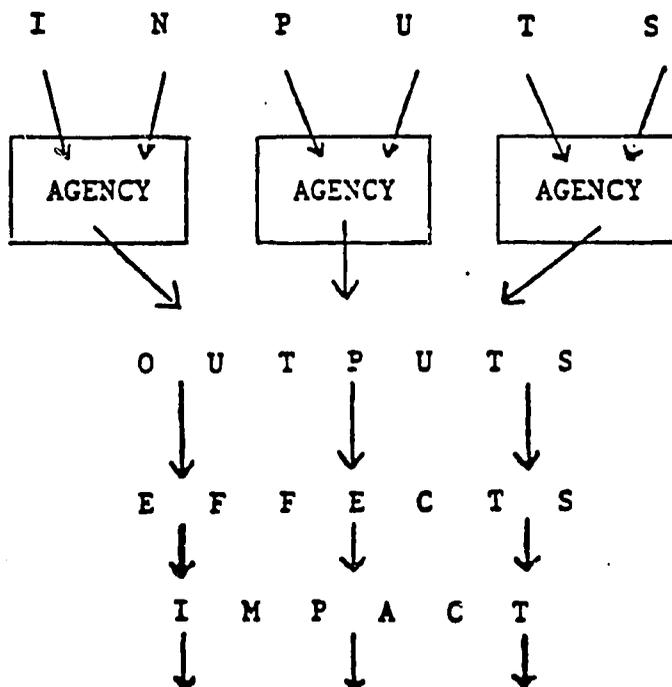


(labor, materials, equipment)

(kilometers of roads, irrigation canals)

B. Multisectoral Rural Development Project

Participating Agencies



(labor, materials, equipment)

(technical advice; marketing channels; physical infrastructure)

(incremental agricultural production)

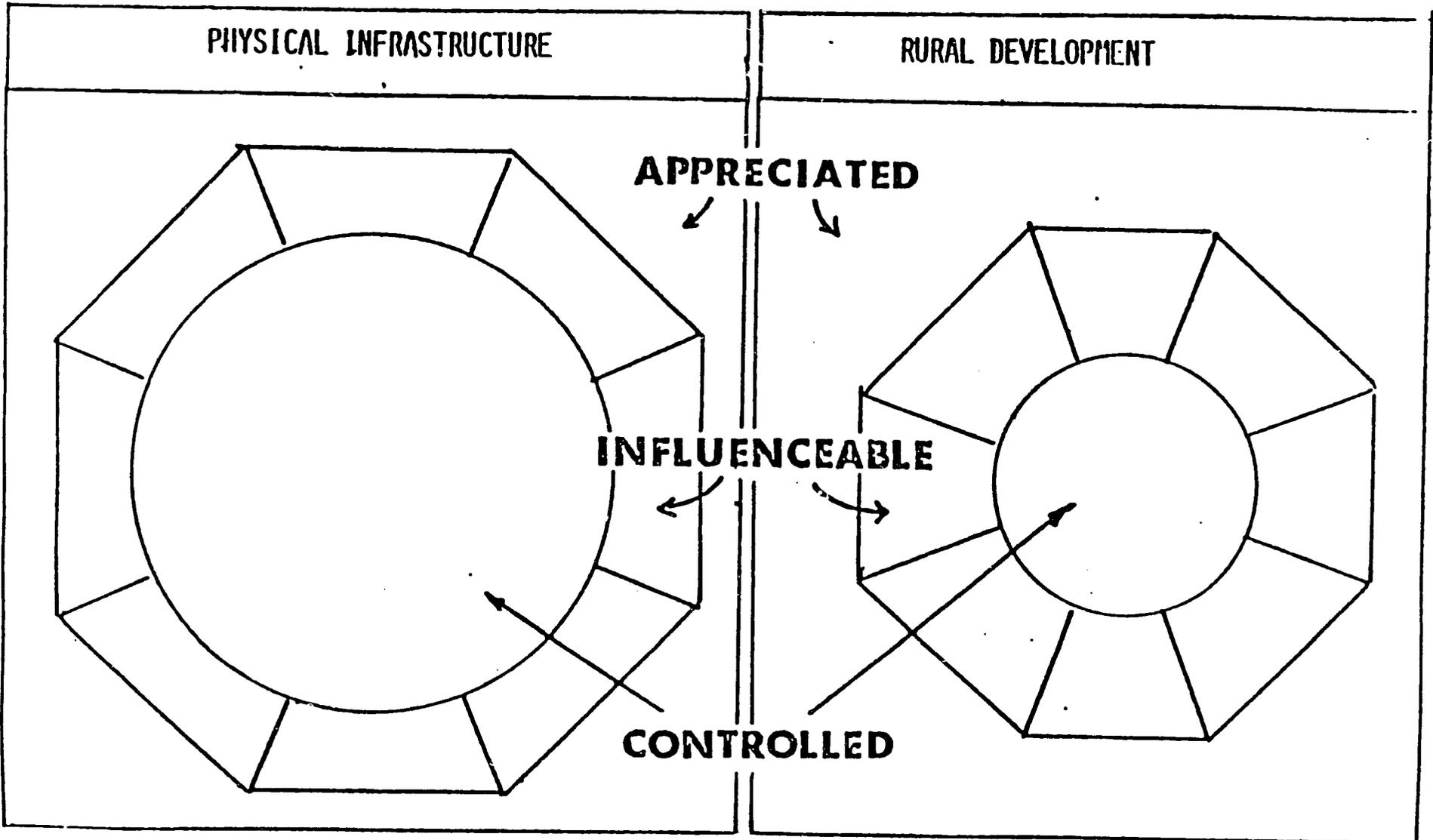
(incremental incomes)

Beneficiaries

220

COMPARISON OF EMPHASIS ON PROJECT ENVIRONMENTS

IN INFRASTRUCTURE AND RURAL DEVELOPMENT



23

Chapter 4: Project and Participants' Purposes
as a Basis for Organization Design

4.01 Clearly, it is impossible to design a project or organization unless we know its purpose. In this sense, clarifying the purpose is the springboard for organizational design. What people want, and how strongly they want it, determines how much energy and commitment they put into activities that allow them to achieve their purposes. Organizations are instruments for bringing together people who see their involvement as a means of achieving their purposes. Participation in organization is always partial and conditional. It is partial to the extent that what the individual achieves through the organization is only a part of his total purpose. It is conditional on the organization being able to continue to supply the inducements necessary to his continued contribution.

4.02 If we take this argument one stage further we can develop the second link in the conceptual framework. The process of organizing is a political one. The relationship between the organization and its environments has a political base. The key steps in the organizing process are:

- (a) the establishment of a purpose, which gives direction for the exercise of power;
- (b) the development of an appreciation, i.e., an understanding and valuing, of the opportunities and risks involved in moving in the selected direction;
- (c) the development of a network of influence, that is, joining with others whose own purposes suggest the possibility of mutual transactions that will aid in the achievement of the selected purpose; and
- (d) the choice of actions and resources that can be controlled to achieve the purpose.

4.03 Each of these steps represents an increase in the degree of power. In this sense we use power as an umbrella concept. Appreciation, influence, and control can be seen as successively increasing degrees of power.^{1/} (The perception of appreciation as a source of power may seem strange, but it is already acknowledged in the saying "knowledge is power.") The steps can readily be traced in project design. For example, at the identification and preparation stage of a project, the World Bank, in pursuit of its purposes, negotiates with member governments, in pursuit of theirs. They attempt to find a set of project components and a means for implementing

^{1/} This concept of power was developed by R. L. Ackoff and W. E. Smith (Social Systems Sciences, University of Pennsylvania) as part of some as yet unpublished work on concepts of power.

- 232

them that will satisfy the purposes they share. But in the negotiations that ensue, the relationship may not always remain equal. If the government is very dependent on World Bank funds to achieve its purposes and the Bank is not under strong pressure to increase its lending in that country, then the Bank will be more powerful. And reciprocally, if the government felt that its purposes were not being adequately served by the ensuing agreement, then its degree of commitment and its energy invested in the project are likely to be diminished. During this process both sides have to understand and value the other's situation. This includes appreciation of personal variables and technical ones. It includes the personal skills, perceptions, and motivations of the negotiators as well as the technical, legal, economic, and cultural factors relevant to the selected project components.

4.04 An agreement on the project components having been reached at the identification stage, a decision has to be made about which ministry or agency should be responsible for the project. Depending on how each ministry sees the potential of control of the project for the achievement of its purposes, it will vie for its ownership. The problem with rural development is that it requires the involvement of so many ministries (Agriculture, Health, Irrigation, Public Works, etc.) that control of rural development projects by a single ministry is problematic. The art of designing rural development projects becomes that of devising a network of influence among organizations and individuals that will ultimately lead to a set of controlled activities producing the desired outputs. For example, in the Philippines Land Settlement project, control of rural development was housed in the Department of Agrarian Reform (DAR). However, a countervailing source of influence was created through an Interagency Project Coordinating Committee (IPCC). The committee, though chaired by the Assistant Secretary of the DAR, was composed of senior staff from agencies involved in the project. They could exercise influence over DAR through work plans, approval of programs, and settlement of interagency disputes.

4.05 At the individual level, the power process is not less evident. Individuals can be seen as power centers exerting their own degrees of control, influence and appreciation in pursuit of their purposes. Project designers, for example, who fail to take into account the career-seeking motivation of bureaucrats, are likely to be surprised when bureaucrats choose behaviors more designed to increase their own visibility to superiors than behaviors that might be more conducive to improved project performance. Because such political manoeuverings are based on personal desires, motivations, and perceptions, we tend to dismiss them as a part of the formal design effort. We even declare them to be impossible to deal with because they are somehow "irrational." Many cultures, particularly non-Western ones, wish to avoid conflict and confrontation and so find it difficult to obtain resolution to problems of design that are based on differences of purpose and motivation.

4.06 This way of looking at organizing as a political process is equally applicable to the beneficiary, and is helpful in evaluating the performance of a rural development program. Development has taken place if the beneficiary achieves any one or combination of the following:

- (a) He has more control over activities that contribute to his purpose. (He has more equipment, a marketable surplus that allows him to take risks.)
- (b) He has more influence over the external environment. (He can bargain for supplies, has influence on the price he gets for his goods or where and how he markets them, he can join forces with others to increase his influence.)
- (c) He has more awareness of the external environment he cannot control or influence, and how it affects the achievement of his purpose. (He is informed about the legal, economic, technological factors relevant to his work and way of life.)

If development is defined in this way it is clear that development itself has a political dimension. Through development the beneficiary increases his control and influence over, and his appreciation of, his environment.

4.08 The practical implication of this viewpoint for organization and management of more complex projects is that design cannot proceed without an understanding of the "political" field as it relates to the project. This entails an understanding of the purposes of the project or organization in terms of who is promoting it and why; an understanding of how the purposes of those involved in implementing the project, including beneficiaries, will be affected by any proposals. These are the organization's stakeholders. In designing or redesigning organizations we must examine their existing sources of power and how they would be changed by project proposals. We must also accept that any design is subject to changes in the political base on which it is built.

*Pricing Policy
in the Social Sectors*

*Cost Recovery for Education and Health
in Developing Countries*

Emmanuel Jimenez

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235

secure those jobs than would be socially efficient.⁴ (In technical terms, the marginal social benefit of a unit of education is less than the marginal private benefit.) These negative externalities imply that a price greater than marginal cost should be imposed. Negative externalities tend to offset the positive externalities discussed earlier and to reduce the need for price subsidies in education.

Equity

Much of public intervention in the health and education sectors has been justified on equity grounds. Some argue that public expenditures on social services can be used as a method of income redistribution, particularly if the services are financed by progressively collected revenues. Others claim that health and education should be considered "basic human needs," and therefore the public sector should guarantee access to some minimum threshold amount.

Challenging Traditional Justifications

The efficiency and equity arguments outlined above and summarized in table 2-8 imply a departure from marginal cost pricing. Appendix A presents the reasoning behind each recommended pricing scheme and gives specific examples. These arguments have traditionally been used to justify heavy public subsidization. The last column of table 2-8 presents the conditions under which efficient pricing schemes imply subsidization. As long as the average cost of providing a service is constant with respect to scale, marginal cost pricing is equivalent to cost-recovery pricing. Thus, prices less than marginal cost imply the provision of subsidies. If there are scale economies, even marginal cost pricing implies the provision of subsidies.

In recent years, however, many developing countries have been forced to tighten their budgets, and other conditions have changed substantially since their education- and health-financing policies were first established. Thus, it is time to investigate the record of public investments in meeting goals of equity and efficiency. There is wide room for improvement in both areas. The next three chapters reexamine traditional assumptions behind public intervention in education and health, and their findings lend support for greater private participation.

4. This might be so even if the limited number of government jobs resulted in unemployed graduates. If the decision to enter school were based on expected wages, there might still be an incentive to overinvest in schooling (Blomqvist 1982).

3

The Financial Crises and Underinvestment in the Social Sectors

BECAUSE OF LOW or nonexistent prices, publicly provided educational and health services have had to rely on the budgetary allocations of central governments. The fiscal crises recently experienced by many developing countries have slowed the flow of resources into the social sectors at a time when social objectives have been far from met. Even for those countries that have been able to expand their social services, the gap between available resources and social demands is expected to widen.

Social Objectives and Fiscal Constraints

Education

As table 3-1 shows, the social rates of return or the net returns that societies receive on their educational investments are high for all forms of education, especially primary education. The rates are generally computed by comparing the gain in earnings because of schooling with costs of providing that schooling.¹ The figures show, on average, that these rates are greater than the benchmark return on physical capital.

1. Many rate-of-return analyses in education require empirical refinements because of the unavailability of data. For example, estimates of social rates of return for alternative types of education represent only the monetary benefits of gains in earnings. They account for opportunity costs plus provider-incurred direct costs. Thus, the social rates of return to primary education are likely to be underestimated because private and social benefits are presumed to be equal, while the opportunity cost is probably overestimated. At all levels of analysis, tuition payments are ignored. In addition, several methodological problems arise from the use of aggregate data; from inattention to the effects of ability, employment, and the variance of income distribution; and from the underreporting of income. Nevertheless, these figures provide a generally accepted guide for investment priorities. For a complete discussion of social rates of return on education, see Psacharopoulos and Woodhall (1985).

Level of education and country	1978			1988		
	Actual expenditure (1)	Expenditure needed to meet goals		Legitimacy gap		Projected expenditure (5)
		(2)	Amount ^a (3)	Percent ^b (4)	Amount ^c (6)		Percent^{d} (8)
Primary						
Brazil	33,300	44,000	10,700	24	103,000	58,000
Egypt	74.2	131.9	57.7	44	120.3	162.8
India	4,450	7,700	3,250	42	6,500	9,500
Kenya	1,150	1,300	150	12	2,800	1,850
Mexico	25,600	25,900	300	1	46,500	36,500
Thailand	6,600	13,300	6,700	50	13,700	17,500
Secondary						
Brazil	12,400	47,900	35,500	74	37,800	63,200
Egypt	175	216	41	19	280	270
India	10,600	23,000	12,400	54	15,500	28,300
Kenya	315	1,180	865	73	770	1,680
Mexico	16,000	22,000	6,000	27	28,900	31,300
Thailand	2,300	6,500	4,200	65	4,700	8,600

Note: 1988 currency expressed in 1978 prices.

a. Column 2 minus column 1.

b. Column 3 divided by column 2, times 100.

c. Column 6 minus column 5.

d. Column 7 divided by column 6, times 100.

Source: Adapted from Carnoy and others (1982), table 1, p. 56.

An unhealthy workforce can result in low productivity. For example, a World Bank study showed that, in Indonesia, the prevalence of hookworm infestation in construction and rubber plantation workers was 85 percent, and 45 percent of the victims suffered from a resulting iron deficiency. Treatment of the anemic workers with elemental iron for sixty days, at a total cost of US\$0.13 per laborer, increased productivity by approximately 19 percent. The resultant benefit-cost ratio is 280 to 1 (World Bank 1980b, 31).

Health is related not only to productivity but also to education because illness impairs students' ability to learn (Selowsky and Taylor 1973).

The World Health Organization's Alma-Ata declaration of 1978 outlines a "global strategy" for health for all by the year 2000 through primary health care systems (WHO 1981). WHO estimates that the annual per capita cost of implementing these systems would be an additional US\$15 for most developing countries. Since per capita public spending is currently US\$2.30, there is an average annual resource gap of US\$50 billion for all the developing countries. Even if developing countries could fund as much as 50 percent of this amount, which would mean a quadrupling of average annual per capita domestic spending, they would have to seek external funding about seven times the present level of international transfers (WHO 1981). The growth of per capita domestic public spending, therefore, is not anywhere near the levels required to meet the goals of the global strategy.

The Cumulative Budgetary Impact

Even though governments and international organizations have decided that universal education and health care systems are desirable, they have not been able to cope with the financial problems associated with providing them.

Table 3-3 relates the combined government costs of basic human development packages to the resources that governments can collect. The financing of individual components "will normally range in costs from at least 11 percent to 21 percent of GNP" (Meerman 1980, 122). These figures imply that it is possible for low-income countries to provide comprehensive social service packages, but many will be unable to do so through government finance.

The recent worldwide recession has restricted the ability of many governments to mobilize resources to meet the health and educational needs of their growing populations. Per capita GDP growth rates from 1970 to 1980 have fallen in low-income countries (excluding China and India) by more than 50 percent from the previous decade (table 3-4), while population continues to grow. The gap between income and population growth is widening, which makes it more difficult for governments to meet society's health and educational goals.

Table 3-3. Hypothetical Government Costs to Provide Human Development Services in Low-Income Countries

<i>Human development services and costs</i>	<i>Percentage of GNP</i>
Adequate nourishment (to cover average food deficit in caloric requirements)	2-4
Universal primary education	3-5
Health care, hygiene, family planning (Malaysian standard)	1-2
Pure water and sanitation (universal water supply)	1-2
Subtotal	7-13
Associated investment	1-3
Adjustment for underfunding of recurrent costs	1-2
Subtotal	9-18
Incremental costs of covering the most expensive 85th to 95th percentile of the population	2-3
Total government costs	11-21
Total resources mobilized	10-20
Resources available for human development services	4-14
Shortfall (costs less resources available)	0-17 ^a

a. Limiting cases of high resource generation and low resource requirements.
Source: Meerman (1980), pp. 124-29.

In addition, high administrative costs prevent many developing countries from reaching their "taxation potential"—the maximum proportion of national income that can be diverted for public services by means of taxation (Meier 1976, 271). Because inflation taxes do not need to be administered, they might be an easy alternative to mobilize resources for the public sectors, but there still may be severe adjustment costs as well as regressive incidence. Thus, many countries are left with the option of diverting increased resources to education and health at the expense of other sectors.

There is no evidence, however, that the average share of the public budget devoted to education and health has been increasing at an adequate pace. In fact, for many countries this share has been declining. Table 3-5, based upon data from the International Monetary Fund and other sources, indicates the extent to which the education and health share of the government pie has been shrinking for some developing countries. Although the share of education and health in total government expenditures has risen or remained stable

Table 3-4. Growth Rates of GDP per Capita by Country Group

<i>Country group</i>	<i>Number of countries</i>	<i>Population (millions)</i>	<i>GDP per capita growth rates</i>	
			<i>1960-70</i>	<i>1970-80</i>
Low-income	33	2,161	2.3	2.5
Excluding China and India		511	2.0	0.9
China and India		1,650	2.4	3.0
Middle-income	63	1,139	3.4	3.2
Net oil exporters		497	3.7	2.9
Net oil importers		642	3.4	3.3
Industrial market economies	19	714	4.2	2.4

Source: World Bank (1983), calculated from table 2, p. 150, and table 17, p. 180.

for the world, especially for industrialized countries, it has fallen, on average, for the non-oil-exporting developing countries since 1973. The downward trend in education, which was more pronounced between 1977 and 1980 because of the declining share of education in Latin American countries, is different from that in health, which seems to have been most affected between 1973 and 1975 by the adjustment to oil price shocks.

These trends differ somewhat across regions. The steadily declining share of health expenditures is most evident for Africa. Although the share of education expenditures in Africa rebounded some between 1977 and 1980, it has yet to reach 1973 levels. A recent African strategy paper by the World Bank attributes performance in both sectors to the "crisis management of recent years [that] has resulted in widespread neglect of programs dealing with the long-term constraints on development. In an environment of overall financial tightness, intersectoral competition for resources has made large social sectors the inevitable victims of budget cuts" (World Bank 1984b, 6).

These figures do not necessarily mean that the real public resources available for education and health have declined only during those periods when total public resources have declined. Frequently, educational and health expenditures suffer in relative terms, especially when total government spending increases or remains unchanged. For nineteen countries that experienced an average drop of 11 percent in real government expenditures, the average decrease in social sector spending was only 4 percent (Hicks and Kubisch

1984). Although this study used a broader definition of social sectors than just publicly provided education and health, data for those two sectors alone appear to corroborate its qualitative findings.

Table 3-6 lists the average growth rates of real per capita government expenditures for education and health. It shows no evidence that the social sectors have been more adversely affected than others when total government expenditures have been reduced. Between 1972 and 1975, when per capita total government expenditures fell an average of 30 percent for seven countries, average per capita health expenditures fell by approximately the same amount, and educational expenditures fell by only 3 percent. The same trend can be found between 1975 and 1979 for the twelve countries with declines in per capita total expenditures of 45 percent. Health declined proportionately, while education declined less than proportionately. These tentative findings indicate that although social sectors have been "squeezed" in favor of other government expenditures over the past decade, this has not occurred when governments have had to decrease total per capita spending. Rather, social sector spending has grown less rapidly during times of government expansion.

For example, more than half of the twenty-eight countries in table 3-6 experienced declines in per capita expenditures in education or health (or both) between 1972 and 1975, while eight experienced declines in total govern-

Table 3-5. Expenditures on Education and Health as Percentage of Total Government Expenditures by Country Group and Region

Country group and region	Education				Health			
	1973	1975	1977	1980	1973	1975	1977	1980
World	6.31	6.81	6.67	6.39	9.07	9.98	10.16	10.36 ^a
Industrial	5.08	5.70	5.54	5.20 ^b	9.94	11.28	11.47	11.73
Oil exporting	11.60	11.49	10.90	13.07 ^a	5.20	4.20	4.07	4.72 ^a
Non-oil developing	11.76	11.42	11.45	10.47	5.45	4.49	4.86	4.73 ^a
Africa	18.62	15.71	15.68	16.76	6.12	5.35	5.46	5.09
Asia	9.31 ^b	8.45	8.90	8.38	2.89 ^b	3.26	3.27	2.82
Middle East	8.38 ^b	7.41	8.17	8.72 ^a	2.95 ^b	2.96	3.33	2.73
Western Hemisphere	12.64	12.28	12.21	11.50 ^a	6.03	5.41	6.15	6.10 ^a

a. For 1979.

b. For 1974.

Source: International Monetary Fund (1981, 1982).

ment expenditures between 1972 and 1979. During the latter part of this period (1975-79), sixteen of the twenty-eight experienced real declines in per capita spending in education or health (a fourth experienced declines in both), while twelve experienced declines in total government expenditures.

These trends indicate that many countries are (and will continue to be) unable to allocate sufficient funds to meet their stated health and educational goals. According to the World Bank's 1984 *World Development Report*, the resource requirements to meet these goals are expected to increase rapidly because of unprecedented high population growth rates. To meet their goals in the face of troublesome financial constraints, governments often make unfortunate tradeoffs between quantity and quality that lead to a severe misallocation of very limited resources.

Alleviating Underinvestment

Because health and education in many developing countries are considered responsibilities of the state, users are often charged minimal fees or none at all. And since users' fees are limited, so is cost recovery. This means that the health and education sectors can turn only to the central government for help. But, as demonstrated earlier, governments' abilities (or willingness) to allocate more funds to these sectors is limited, even though demand continues to grow. The result has been underinvestment in both of these subsectors.

At the same time, the private sector has often been prohibited by law from operating in health and education, so it cannot compensate for inadequacies that arise in the purely public systems. Ironically, laws intended to shield society from the underprovision of a completely private market have prevented the sectors from responding to demand.

Simple tools of economic analysis illustrate the crucial role of pricing policy in alleviating underinvestment. Although this technical section can be skipped without losing the flow of the later analysis, it does show how economic analysis has been applied to pricing in the social sectors.

In figure 3-1, the private demand for a service is depicted as D_p and the social demand as D_s . These are not equivalent for reasons outlined in the previous chapter: externalities, failures in related markets, and concerns about equity. The total social marginal cost of providing the service is assumed to be constant at c . This unit cost is the sum of directly incurred private costs, c_p , exclusive of prices, and the unit costs borne by the government provider,

c_g . The socially optimal amount of the social service that should be provided and consumed is that amount at which the additional gain to society from another unit of consumption is equal to the additional cost. In figure 3-1, this

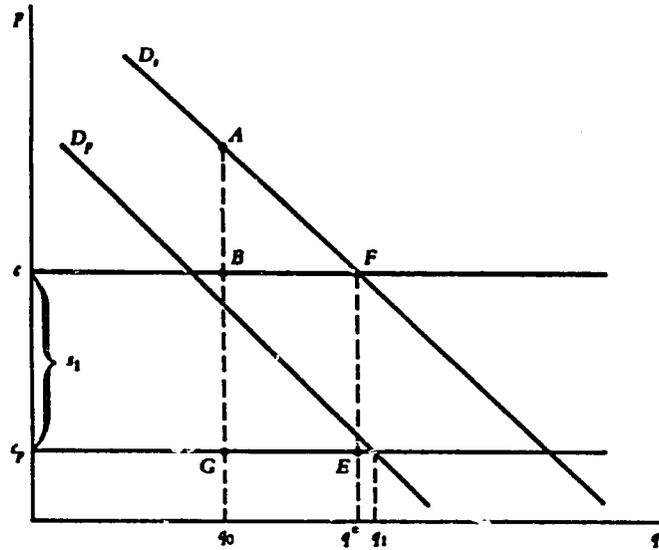
Table 3-6. Average Growth Rates of Real Per Capita Government Expenditures for Education and Health by Income Group and Country

Income group and country	1972-75			1975-79			1972-79		
	Total	Education	Health	Total	Education	Health	Total	Education	Health
Lower income									
Malawi	1	-41	3	29	29	38	39	-24	33
Nepal	-2	4	22	24	48	42	39	108	52
Tanzania	54	11	60	-18	1	-83	66	24	—
Lower-middle income									
Bolivia	23	-27	-7	16	49	10	20	10	10
Costa Rica	-12	-20	5	50	83	736	32	46	778
El Salvador	14	27	-14	14	-6	22	31	20	4
Guatemala	2	-15	17	34	4	19	37	-12	10
Honduras	4	-1	31	43	20	-10	49	19	18
Kenya	0	1	1	34	0	21	35	10	23
Korea, Rep. of	-10	-10	-23	55	29	64	40	16	26
Morocco	85	45	4	17	38	-1	118	100	39
Paraguay	-3	7	-23	23	16	64	19	24	25
Upper-middle income									
Peru	5	-6	-14	-86	91	-83	-85	-91	-86
Philippines	17	-13	50	-12	14	4	3	-1	56
Syria	99	-42	15	-25	2	32	49	-42	52
Thailand	0	1	-1	43	47	78	44	48	76
Tunisia	75	22	49	32	10	37	130	34	104
Turkey	8	36	-2	-36	-49	-39	-31	-30	-40
Zambia	39	2	9	-52	-49	-43	-33	-49	-38
Argentina	-72	-67	-77	-99	-99	-98	-99	-10	—
Brazil	-5	-4	-4	-65	-72	-59	-65	-73	-61
Chile	—	1	-1	-1	-80	-85	-99	-99	-10
Iran, Islamic Rep. of	85	39	63	17	21	-12	17	68	42
Malaysia	32	28	33	54	13	10	54	44	47
Mexico	35	49	13	-6	-28	-36	-6	6	-27
Uruguay	-76	71	-42	-92	-74	-63	-92	-92	-80
Venezuela	26	18	-2	21	4	-9	21	23	-11
Yugoslavia	16	—	—	-44	16	-1	-44	—	-99

— Not available.

Source: International Monetary Fund (1982).

Figure 3-1. Pricing a Social Service



is q^* , which is the amount of the service where the marginal gain, measured by the social demand curve D_1 , is equal to the social marginal cost, c . Although for some countries q^* may be equivalent to declared social objectives, such as universal primary education or universal access to primary health care, these objectives may imply magnitudes beyond q^* . They are frequently formulated without regard to c —the cost to society of providing them.

Suppose that prices are nil. (According to the previous chapter, this is true for many public providers in developing countries; almost all charge prices close to nil.) To ensure that the socially optimal amount of the service is provided, the public sector must offer a unit subsidy (s_1) equal to c_p . At this level of subsidy, it must also restrict access to q^* , and there will be excess demand q^*q_1 . The total subsidy allocation (S) required to finance optimal consumption would equal the area $cFEc_p$, which is $S_1 = (s_1)(q^*)$.

The problem arises because governments allocate subsidies of an amount S_0 less than S_1 . Suppose this subsidy is equal to $cBGc_p$, less than $cFEc_p$. Given s_1 , the total quantity that can be provided is q_0 less than q^* , and there will be social losses of an amount ABF .

4

Inefficiencies in the Social Sectors

CURRENT PRICING POLICIES have also contributed to inefficiency within each of the education and health sectors, as well as to underinvestment in relation to other sectors. In particular, prices are low, which implies that services are provided with heavy public subsidies. Moreover, prices are uniformly low regardless of the type of service or consumers' willingness to pay. As a result, governments have tended to allocate less to services with high rates of return, a lack of accountability has decreased internal efficiency, and spending has not been successfully targeted to those who could benefit most from the services.

The Mix of Services

Within the education and health sectors, various types of services are provided. Their different characteristics are important factors to consider in resource allocation. These characteristics depend upon whether the services exhibit externalities, whether users are knowledgeable about their benefits, and whether markets that affect them are distorted (see chapter 2). Using these criteria, analysts have grouped educational services into primary, secondary, and tertiary levels, and health into preventive and curative services.

According to the efficiency criterion for investing in social services, the most resources should flow to those services with the highest social rates of return. Although estimates of social rates of return are, at best, imprecise, especially for education and health, some quantitative and qualitative evidence suggests that the current pricing structure in many countries contributes to an inefficient mix of social services. Educational and health services with low social rates of return are generally more attractive to consumers and are provided more readily than are services with high rates of return.

Education

The pattern of subsidies leads to a great stimulation of demand for higher education. Households make judgments about sending children to school on the basis of the private rate of return, which differs from the social rate of return because of externalities on the benefit side or because of subsidies on the cost side. If households faced the true social costs of obtaining more education, they would confront a lower rate of return; instead, they are induced to obtain more schooling.

Table 4-1 reveals that for Africa the difference between private and social rates of return is greater for higher education relative to primary education. Much of this difference reflects direct payments to students for living allowances, which amount to 35 percent (East Africa) and 67 percent (West Africa) of the recurrent budget for higher education (World Bank 1986).

Yet, the social rates of return on investment in education decline as the level of education for all country groups increases (table 3-1). According to those rates, it would be most efficient to give priority to investments in primary education, particularly in countries in sub-Saharan Africa.

For any level of education, the social rates of return reported in table 3-1 were based on the difference between average earnings of graduates at that level and earnings at the previous level. These earnings were not adjusted for the possible effects of externalities or distortions in related markets, which may differ by schooling level. If these factors influence earnings, differences between social and private rates may be justified on the basis of economic efficiency. But even if externalities and labor market distortions are considered, the larger difference between private and social rates cannot be fully

Table 4-1. Ratio of Private to Social Rates of Return in Education

Region and country group	Level of education		
	Primary	Secondary	Higher
Africa	1.42	1.34	1.77
Asia	1.57	1.10	1.33
Latin America	1.28	1.15	1.17
Average developing country	1.32	1.19	1.73
Intermediate ^a	1.38	1.15	1.55
Advanced	— ^b	1.55	1.32

a. Cyprus, Greece, the Islamic Republic of Iran, Israel, Spain, Turkey, and Yugoslavia.

b. — Not available because of the lack of a control group with no education.

Source: Psacharopoulos (1985), tables 1 and 2.

explained. Positive externalities, such as good citizenship and the benefits to social transactions from a literate population, are apparent at primary levels of education but would likely diminish at higher levels. In contrast, the benefits of a greater amount of higher education are realized primarily by the individuals who consume the education and who are paid according to the value of their additional contribution to production. Therefore, externality arguments for subsidization of higher education are weak.

In many countries, reallocation of resources from higher education to expand primary and basic education would lead to gains in efficiency. In fact, estimates indicate that if public resources were reallocated to equalize the social rates of return at all educational levels, the efficiency gains would amount to 2.6 percent of GDP in certain African countries and more than 3 percent in some Latin American countries (Dougherty and Psacharopoulos 1977). These gains are comparable to a doubling of the public budget for education. Although this analysis does not advocate an immediate and drastic reduction in resources allocated to secondary and higher education, it does show that the present pattern of subsidies favoring secondary and higher education at the expense of primary and basic education is inefficient. In other words, current subsidies are not distributed in relation to expected social returns. There is a need, therefore, to increase the relative proportion of public resources devoted to primary education over other levels of education.

Health

In the health sector, it is important to distinguish between curative and preventive services. Curative health care involves the treatment of the sick. Preventive health care might include all services that ensure good health, such as immunizations and nutritional advice.

Some preventive health services have attributes that inhibit the role of prices in promoting efficiency: high levels of consumption externalities (immunization and disease control programs), unidentifiable individual beneficiaries, and a lack of information among users regarding benefits. As de Ferranti (1985) points out, it is probably impossible to implement national user fees for many types of preventive health services. For example, when a government agency sprays an area to combat insect infestation, it is impossible to identify who benefits and who is to pay for this service.

User fees may be appropriate for certain kinds of preventive and curative health care, such as in- and outpatient treatments, drug sales, and water supply; in these cases positive externalities are negligible since most benefits accrue to the individual. This is especially true for curative treatment of nonin-

242

fectious illnesses. Society as a whole obtains no additional benefits from the curative treatment of ailments such as stomach disorders. And when patients return to work after this type of illness, there would be no additional social benefits if they were paid the competitive wage—the value of their marginal product (de Ferranti 1982; Blomqvist 1979).

Yet many countries charge uniformly low unit prices or give uniformly high subsidies regardless of the type of service. The greatest proportion of government health expenditures in developing countries goes for curative care, probably owing "in part to the professional bias of physicians and the mystique and popular appeal of hospital-based health care" (World Bank 1980b, 40). In Senegal and Brazil, for example, 72 percent and 85 percent of the health budgets of the central governments are devoted to curative care (de Ferranti 1983, 68–69). These figures indicate that governments may be investing the majority of their health care resources in services that promise only negligible positive externalities. This does not automatically mean, however, that all curative care should be abandoned or charged at full cost.

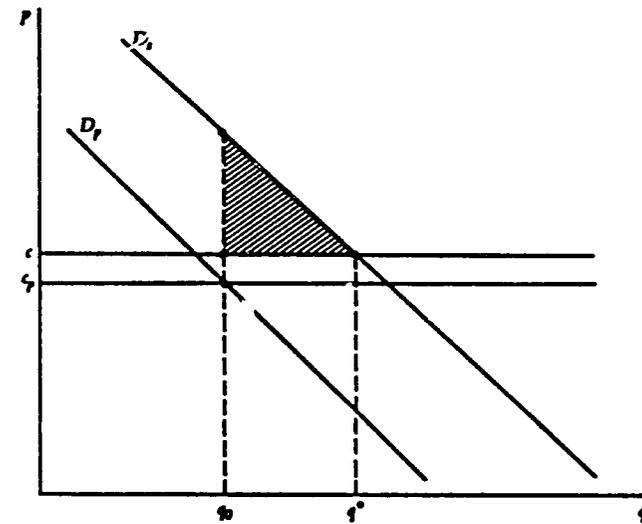
A comprehensive curative health care system can be very expensive for both consumers and providers. Consumers must incur private costs, such as transportation and opportunity costs, even when curative health facilities charge no fees. Also, curative services, such as hospitals, require huge initial investments, even though they are likely to experience decreasing costs—their average costs would decline as the quantity of services provided increased. Thus, within curative health care there appears to be little effort to differentiate prices according to the private costs of services and the individuals who must incur them. In particular, the rates charged for services in rural and urban areas tend to be uniform.

A Graphic Presentation

The differential welfare effect of a uniform pricing scheme on any two types of services can be illustrated with standard economic techniques. For this example, assume that prices are nil for all types of service. As before, D_1 and D_2 depict the respective private and social demand curves; c and c_1 are constant total marginal costs and private costs, respectively.

In figure 4-1, zero prices result in an inefficiently low use of the service, since the presence of private costs inhibits demand too much. Thus, q_0 is less than q^* . One can argue that this figure depicts the case for primary education or primary health care, particularly in rural areas. Transport and, in the case of primary education, opportunity costs would be the principal components of private costs. The shaded area represents the social loss.

Figure 4-1. Underutilization of a Free Social Service



In figure 4-2, zero prices result in overutilization of the service but for different reasons. Some services, such as secondary education, may have substantial externalities, but private costs are a small proportion of total costs because of scholarships. In figure 4-2A, this results in overutilization of q_1 greater than q^* . Other services, such as curative outpatient care or university education, may imply high private costs but with little externalities. In figure 4-2B, this results in overutilization of q_2 greater than q^* . In both cases, the shaded area depicts the service losses if the service is not rationed.

The Mix of Inputs

A high level of unit subsidy has contributed to inefficiencies in the ways that various educational and health services are provided. Reliance on subsidies from central governments has led to inappropriate input mixes. In particular, this method of financing has caused underutilization of variable factors of production, such as nonlabor inputs, relative to other factors. There is a growing body of evidence that recurrent expenditures are being crowded out, even in cases where total health or educational expenditures are not being eroded. In addition, resources tend to be misallocated among variable factors, with labor inputs being favored over material inputs.

243

5

Inequities in the Provision of Services

THE SUBSIDIES INHERENT in publicly provided educational and health services have not been equitably distributed. Only a small proportion of the population is able to obtain access to these subsidies. Moreover, the poorest socioeconomic groups are not given priority. Indeed, at least for education subsidies, the richest income groups obtain a disproportionately large share.

The Distribution of Subsidies

Education

A great proportion of government subsidies for education is directed at the highest level. Table 5-1 compares the unit public subsidies for primary, secondary, and higher education. On average over all developing countries, unit subsidies at the higher level are twenty-six times greater than at the primary level and nine times greater than at the secondary level. The discrepancy is largest for the two African regions. At the same time, the proportion of the world regional populations with no education or only primary schooling compared with the proportion with higher education is very small—72 percent versus 6 percent, respectively—as shown in the last four columns of table 5-1.

These figures can be combined to derive a picture of the shares of subsidies acquired by different proportions of the populations (table 5-2). The figures account for the subsidies received by those in higher education throughout their school career, including subsidies at the primary and secondary levels. In the developing countries, 71 percent of the population in each generation receive only primary schooling or less and obtain only 22 percent of the resources devoted to education. The proportion receiving higher education is

Table 5-1. Per Student Public Subsidy on Education and Educational Attainment of the Population in Major World Regions, ca. 1980

Region	Per student public subsidy as percentage of per capita GNP			Enrollment ratio			
	Primary education	Secondary education	Higher education	No schooling	Primary education	Secondary education	Higher education
Africa							
Anglophone	18	50	920	23	60	15.8	1.2
Francophone	29	143	804	54	32	11.6	2.4
South Asia	8	18	119	29	52	14.6	4.4
East Asia and Pacific	11	20	118	13	44	33.9	9.1
Latin America	9	26	88	10	46	32.0	12.0
Middle East and North Africa	12	28	150	18	46	26.6	9.4
Developing countries	14	41	370	25	47	22.0	6.0
Developed countries	22	24	49	0	20	59.0	21.0

Source: Based on Mingat and Tan (1985a). Reprinted with permission; copyright 1985 the University of Wisconsin Press.

only 6 percent, but it obtains 39 percent of total resources. In francophone Africa, 2 percent of each cohort in the population attain higher education and receive 40 percent of the public resources devoted to education. In anglophone Africa, 1 percent of the cohort receives more than one-quarter of the public educational resources allotted to it.

The main reason for this disproportionate allocation of resources is the large public reimbursements for out-of-pocket personal costs, such as transport and books (Eicher 1985; Hinchliffe 1985; Mingat and Psacharopoulos 1985). For example, in anglophone Africa, "student subsidies represent 14 percent [of total subsidies] at secondary and higher education levels, while in francophone Africa the figures are much higher, 23 and 43 percent respectively" (Mingat and Psacharopoulos 1985, 36). Also, per student scholarships as a percentage of per capita GNP are 120 percent in the Côte d'Ivoire, 160 percent in Senegal, 700 percent in Mali, and 800 percent in Niger and Burkina Faso.

The rich get a larger proportion of the subsidy because they have more children in school, particularly at those educational levels where subsidies are

Table 5-2. Population and Total Educational Resources by Terminal Level of Schooling in Major World Regions, ca. 1980

Region	Primary education or less		Higher education	
	Population	Resources	Population	Resources
Africa				
Anglophone	83	39	1	26
Francophone	86	16	2	40
South Asia	81	23	4	39
East Asia and Pacific	57	19	9	40
Latin America	56	16	12	42
Middle East and North Africa	64	19	9	45
Developing countries	71	22	6	39
Developed countries	20	8	21	37

Source: Mingat and Tan (1985a). Reprinted with permission; copyright 1985 the University of Wisconsin Press.

highest. The total monetary effect of this on various world regions has recently been estimated by Mingat and Tan (1986a). Table 5-3 shows the proportion of total public resources appropriated for education by different socioeconomic groups. Because of the paucity of income data in developing countries, the distribution figures are categorized on the basis of occupation rather than income. The figures take into account the cumulative effects of subsidies obtained at previous levels of education. A comparison of the share of resources received by three socioeconomic groups with their share of the total population of school-age children provides a measure of the benefit that each socioeconomic group derives from education subsidies. This comparison, which is termed the "subsidy-benefit ratio," is much higher for the white-collar group, indicating that it enjoys a disproportionate share of all education subsidies. In most developing regions, the children of white-collar workers gain nearly six times more benefit from public education subsidies than do the children of farmers. In francophone Africa, the contrast is even more marked—ten to one. Thus, the provision of free or heavily subsidized education does not ensure equity in the distribution of public resources.

Health

Information on the distribution of public health subsidies by income class is even more limited than for education subsidies. Table 5-4 summarizes the

Table 5-3. Public Resources Appropriated for Education by Different Socioeconomic Groups in Major World Regions, ca. 1980

Region	Percentage in the population (1)			Percentage of public school resources (2)			Ratio between proportion of resources and population (2)/(1)		
	Farmers	Manual workers and traders	White-collar workers	Farmers	Manual workers and traders	White-collar workers	Farmers	Manual workers and traders	White-collar workers
	Africa								
Anglophone	76	18	6	56	21	23	0.73	1.19	3.78
Francophone	76	18	6	44	21	36	0.58	1.15	5.93
Asia	58	32	10	34	38	28	0.59	1.19	2.79
Latin America	36	49	15	18	51	31	0.49	1.04	2.03
Middle East and North Africa	42	48	10	25	46	29	0.60	0.35	2.87
OECD ^a	12	53	35	11	46	42	0.95	0.87	1.20

a. Organization for Economic Cooperation and Development. Source: Mingat and Tan (1986a). Reprinted with permission.

245

Table 5-4. Public Health Subsidies by Income Group in Selected Countries

Country	Survey year	Type of health subsidy	Percentage share by income group ^a				
			Poorest 20%	20-40%	40-60%	60-80%	80-100%
Chile	1969	Public health	31 ^b	35			35 ^c
Colombia	1974	National health service	30	23		18	12
		Social security system hospital	8	15	29	24	23
		Health center	25	29	23	15	8
Indonesia	1980	Overall public	20	21	20	20	20
		Overall public	19 ^d		36 ^e		45 ^f
Iran, Islamic Rep. of	1977 ^f	Overall public	30	21	19	18	13
Malaysia	1974	Inpatient hospital	19	27	10	24	20
		Outpatient hospital	22	20	23	14	6
		Rural clinic	28	27	19	19	8
		Overall public	21	26	15	22	17
Philippines	1975 ^f	Overall public	14	13	15	18	40
Sri Lanka	1978 ^f	Overall public	25	21	20	19	14

a. All rows sum to approximately 100 percent.

b. Poorest 30 percent income group.

c. Income group 70 to 100 percent.

d. Poorest 40 percent income group.

e. Income group 40 to 70 percent.

f. Year of original study. The figures in this row are quoted from an International Labour Organisation (ILO) review (Richards 1982).

Sources: Fosley, Animat, and Arellano (1979) for Chile; Sclowsky (1979) for Colombia; Meesook (1984) for Indonesia; Meerman (1979) for Malaysia; and Richards (1982) for Islamic Republic of Iran, Philippines, and Sri Lanka.

distribution of overall public health subsidies for seven countries. Health subsidy distribution is not as regressive as it is for education. But neither is it progressive, with the possible exception of prerevolutionary Iran; it tends to be neutral. If one adds the first two columns of percentage shares, the poorest 40 percent in Colombia, Malaysia, and Sri Lanka receive, respectively, 41, 47, and 46 percent of the public subsidy for health. This is due mostly to the progressive incidence of public expenditures on rural health care. The distribution is more regressive in Indonesia and the Philippines, where the poorest 40 percent receive only 19 and 27 percent, respectively, of the subsidies from public health centers and hospitals.

The distributions are even more dramatic when one considers the relative needs of income groups. Although space does not permit a thorough review, the bias against lower-income groups in the distribution of public educational and health expenditures is more pronounced when one considers the larger number of school-age children and the incidence of disease for the poorer household.

Overall Distribution of Resources

It is sometimes argued that the regressive distribution of education and health subsidies may be mitigated because most of these subsidies are drawn from general revenues that are financed by a progressive tax system. Although some income tax revenue may be based on a progressive schedule, a large proportion of central government revenue, which funds most health and educational expenditures in highly centralized developing countries, is raised through indirect taxation. Thus, when all sources of tax revenue are taken into account, the tax systems in these countries are not strongly progressive and may even be regressive (see table 5-5).

In summary, the distribution of government subsidies in education and health is, at best, neutral with respect to household income. Indeed, for most types of education the distribution is highly regressive. Thus, current policies regarding the public provision of educational and health services have not succeeded in substantially improving the national distribution of resources.

Reasons for Inequities

Under current pricing arrangements, rich households have greater access to public subsidies in educational and health services than do poor households for several reasons. First, the presence of private costs implies that income constraints limit consumption choices, even if the public authorities do not charge for the services. Second, for any given type of publicly subsidized ser-

246