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THE EFFECTS OF POLICY REFORM ON THE POOR: CLARIFYING THE ISSUES

BUREAU FOR LATIN AMERICA & THE CARIBBEAN
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The **Development Issues Discussion Papers** series of the Bureau for Latin America and the Caribbean provides to economists and non-economists within USAID relatively non-technical expositions of important current policy issues. We have dispensed with footnotes and bibliographies to help make these papers easy to read. Most of the papers in this series will be relatively short (fewer than 10 pages), although some may be as long as 20-25 pages. The longer papers will include a brief executive summary.

We welcome your comments.

EXECUTIVE SUMMARY

I. Introduction. One of the most important lessons of the worldwide experience with economic development over the past several decades is that economic performance is directly related to the quality of economic policy. The newly industrializing economies of Asia, as well as China, are positive examples of this relationship; Africa, Latin America, Eastern Europe, and the former Soviet Union provide negative examples. The negative cases were all characterized by an inability to adjust to a radically changed international environment after 1980.

II. Latin America's "Lost Decade": A Development Strategy Becomes Untenable. The Latin American and Caribbean (LAC) region grew by 5.4% in the 1960s and 5.9% in the 1970s; but the post-1980 international economic environment dealt a mortal blow to the strategy on which that growth was based. Two elements of that strategy deserve highlighting: import substitution and external indebtedness. The second oil-price shock of 1979-80 and the world recession it triggered created large external (balance-of-payments) and internal (fiscal) deficits in the LAC region. The initial response to these problems was even more borrowing from abroad. But access to loans from commercial banks virtually dried up after the Mexican debt crisis in 1982, and some countries lost their eligibility to borrow from the international financial institutions. Because of policy shortcomings, LAC economies were too inflexible to respond quickly to the debt crisis (as then-heavily-indebted South Korea did) by diversifying exports and otherwise improving resource allocation.

III. Economic Growth and Poverty. There is now a widespread consensus that economic growth is the best way to reduce poverty. However, growth does not automatically address poverty issues. It must be accompanied by measures that:

- increase competition;
- eliminate or sharply reduce global subsidies;
- target remaining subsidies to low-income groups;
- promote investment in human capital;
- provide social safety nets;
- reward people on the basis of merit; and
- promote the rule of law.

IV. Stabilization, Structural Adjustment, and Poverty. Stabilization policies are designed to eliminate fiscal and balance-of-payments imbalances that reflect unsustainable bursts of economic growth. This often requires an "austerity" program. But planned austerity is better than the kind of unplanned austerity inflicted on Peruvians after their government's unsustainable policies in 1986-87 collapsed over the next three years, with per capita GDP falling by 29%. Blaming Peru's 1990 stabilization measures for subsequent increases in poverty is like blaming the messenger bearing bad tidings.

Structural adjustment measures are designed to accelerate economic growth by increasing the efficiency of resource allocation. These may be grouped into three categories:

- Price liberalization, including trade liberalization and exchange rate reforms;
- Institutional reforms such as eliminating barriers to trade and investment, deregulation, privatization, clear and enforced property rights, and measures to improve labor mobility;
- Societal reforms such as the removal of discriminatory barriers, and shifts in government spending away from military outlays in favor of social services.

Much of what structural adjustment accomplishes is the elimination of subsidies that in the LAC region have benefited middle- and upper-income groups much more than the poor. These include tariffs and other import barriers, negative real interest rates, low public utility charges, and free university tuition.

V. Policy Reform and Poverty: Asking the Right Questions. A common theme in the literature is that structural adjustment has hurt the poor, either absolutely or relatively. But such assertions usually are not backed up with good empirical evidence. Where the poor have been hurt, the deterioration in their status is often wrongly attributed to structural adjustment when the true causes are unfavorable trends in the world economy, natural disasters, political instability, the legacies of prior policy shortcomings, or half-baked programs that don't deserve to be called structural adjustment. Other effects on the poor attributed to structural adjustment are more appropriately linked to the temporary effects of stabilization programs that are needed to set the stage for economic recovery.

More care is needed to distinguish stabilization from structural adjustment; identify and if possible quantify direct and indirect relationships between policy reforms and poverty; define more clearly what we mean by "the poor"; and disaggregate the poor to the extent possible. In seeking to make plausible inferences about how policy reform affects poverty, we should focus on long-term rather than short-term trends, examine a wide range of socioeconomic indicators, look at existing but neglected time series data, initiate new data collection efforts, and add modules to existing survey instruments.

VI. Policy Reform and Poverty: Trends since the Early 1980s. Per capita GDP in the LAC region declined by 10% between 1980 and 1983; but little of this decline can be linked to policy reforms, because in most countries major policy reforms had not yet been implemented. Since the initiation of major policy reforms, trends in poverty and income distribution indicators are mixed. The Appendix provides brief discussions of policy reforms (or lack thereof) and their effect on poverty in six countries:

Argentina, Bolivia, Colombia, Costa Rica, Guatemala, and Mexico. Briefly, the data show the following:

- **Argentina:** No structural reform effort truly deserving of the name until 1991; sharply rising poverty and widening income disparities in the 1980s;
- **Bolivia:** A comprehensive and sustained reform effort since 1985; real wages in the private sector fell steeply initially but rose 27% between 1987 and 1991; rising unemployment; mixed evidence on the relatively income status of the poor; mixed trends in social indicators;
- **Colombia:** Only modest policy reforms until 1990, but less of a need than elsewhere; annual GDP growth of 2.2% for 1980-85 and 4.5% for 1990—one of the best records in LAC; real wage growth slowed after 1984, but employment grew rapidly; income inequalities narrowed; strong gains in social indicators;
- **Costa Rica:** Gradual process of reform beginning in 1982; average GDP growth of 4.3% over the next eight years; recovery of real wages to pre-crisis levels; significant reduction of poverty; no deterioration and possible improvement in income distribution; most social indicators improved;
- **Guatemala:** Poor policies through 1985; per capita GDP fell 20% during 1980-86, with poverty and probably income inequality increasing; significant reforms in 1986-88; some weakening since then, but GDP growth has still averaged 3.7% during 1987-92; overall poverty fell during the reform period;
- **Mexico:** Major policy reforms in 1983, but recovery halted by earthquake and lower oil prices; significant structural adjustment since 1986; GDP growth rose to 3.7% during 1989-91; real manufacturing wages fell 36% during 1982-88 but have since risen; strong employment growth; mixed trends for social data.

VII. Concluding Observations. Reducing poverty in the short run requires creative social safety nets, while establishment of a more equitable pattern of long-term economic growth depends to a large extent on <u>investment in human capital</u>. How to finance such investments will be a key challenge for LAC countries in the 1990s.

I. INTRODUCTION

One of the most important lessons of the worldwide experience with economic development over the past several decades is that economic performance is directly related to the quality of economic policy. The outstanding positive examples illustrating this relationship are the newly industrializing economies of East Asia (Hong Kong, Singapore, South Korea, and Taiwan) and, more recently, China. On the negative side, the need for policy reforms became glaringly evident in Africa and Latin America in the early 1980s, and in Eastern Europe and the former Soviet Union toward the end of that decade.

The negative cases were all characterized by an inability to adjust to a radically changed international economic environment. The problem in the early 1980s was not simply a severe recession in the industrialized countries—although that downturn significantly limited developing countries' export potential in the short run. Other major changes in the world economy—which were to have a more lasting effect—included a sharp rise in interest rates, a steep (and prolonged) decline in commodity export prices, and a precipitous reduction in commercial bank lending to developing countries in response to debt repayment problems. All of these changes increased the importance of good economic policies, as the effects of policy shortcomings were no longer offset by the unusually favorable external environment that characterized most of the 1970s.

II. LATIN AMERICA'S "LOST DECADE": A DEVELOPMENT STRATEGY BECOMES UNTENABLE

Nearly all countries in Latin America and the Caribbean (LAC) experienced a significant and prolonged downturn in economic activity beginning at various times in the late 1970s and early 1980s. For the LAC countries as a group, per capita gross domestic product (GDP) fell by 10% between 1980 and 1983, and in 1991 it was still about 10% below its 1980 peak. While the region had experienced historically high annual growth rates in the two previous decades--5.4% in the 1960s and 5.9% in the 1970s (2.5% and 3.3%, respectively, in per capita terms)--the strategy on which that growth was based left it highly vulnerable to the radically changed economic environment of the 1980s. Indeed, this new environment dealt a mortal blow to the viability of the strategy followed in the 1960s and 1970s.

Two elements of that strategy deserve highlighting:

- Import Substitution. The LAC countries were by no means closed economies prior to 1980, for much of their growth had been generated by the export of primary products such as bananas, sugar, coffee, beef, cotton, cacao, fish and seafood, petroleum and natural gas, and a variety of minerals. But joined to this outward-looking element of their strategy was a set of policies designed to replace imports of manufactured goods with the output of domestic industries whose production would be protected from outside competition by high tariffs, cheap credit, tax incentives, and other types of subsidies.

- <u>External Indebtedness</u>. Particularly after the first oil price shock in 1973-74, LAC governments and parastatal enterprises increased their external borrowing. Most of the new loans were obtained from commercial banks, which were flush with "petrodollars" deposited by the public and private sectors of the oil-exporting countries. Oil-importing LAC countries sought loans to maintain the flow of imported current inputs and capital goods needed by their import-substitution industries, while oil exporters borrowed because interest rates were low and their creditworthiness had been boosted by the widespread expectation that oil prices would stay high indefinitely. Rising foreign exchange holdings resulting from a boom in non-oil commodity prices enhanced the creditworthiness of other LAC countries. The total debt of the LAC region—the great bulk of it contracted or guaranteed by governments—rose from $48 billion in 1973 to $243 billion in 1980. In some countries, borrowed funds were used to finance recurrent expenditures as well as capital projects; and many of the latter had low economic rates of return.

The second oil-price shock of 1979-80 triggered a sharp world recession in 1980-82 that radically transformed the international economic environment. LAC countries began to suffer serious external and internal imbalances:

- Externally, <u>balance-of-payments deficits</u> tended to increase because of:
  - lower prices for commodity exports, a reflection of reduced demand in the industrial countries;

- increased debt servicing burdens, as world interest rates rose sharply and loans from commercial banks had been contracted on variable-interest-rate terms; and
- capital flight, due to both unsettled political conditions and rising real interest rates abroad, while real interest rates at home often turned negative as they were not allowed to move upward in the face of accelerating inflation.

• Internally, fiscal deficits rose because:
  - revenues from taxes on foreign trade fell in the face of declining exports and imports;
  - debt-servicing requirements rose rapidly; and
  - other revenues fell as economic activity declined.

At first many countries tried to cushion the decline in economic activity by borrowing even more money from foreign commercial banks, temporarily easing their balance-of-payments constraints but adding to their fiscal deficits. This source of money began to dry up after August 1982, when Mexico's suspension of debt servicing triggered a hemisphere-wide debt crisis. Balance-of-payments problems thus worsened, especially for countries whose loss of creditworthiness left them with no access to funds from the international financial institutions.

It would be a mistake, however, to attribute the LAC countries' problems in the 1980s only to the world recession and the debt crisis. Economic policy shortcomings were important, too. LAC countries' economies were too inflexible to respond quickly to the debt crisis by diversifying exports and otherwise shifting resources into more efficient uses. By contrast, South Korea, one of the world's biggest debtors in the early 1980s ($37 billion and rising in 1982), suffered only a small and brief decline in GDP (-3.3% in 1980). Since its industrial output—unlike most of Latin America's—was fundamentally competitive in world markets, resources were quickly shifted into production for export. South Korea's exports grew from $17 billion to $63 billion between 1980 and 1990, and its GDP grew by 9.3% annually over this period. Its external debt, meanwhile, diminished in importance, falling from a peak of $47 billion (52% of GNP) in 1985 to $34 billion (14% of GNP) in 1990.

III. ECONOMIC GROWTH AND POVERTY

There is now a widespread consensus that economic growth is the best way to reduce poverty. But although economic growth clearly provides more resources for addressing poverty problems, it does not automatically do so. Poverty may not be affected much, for example, by a laissez-faire policy (not to be confused with the free play of competitive market forces), for laissez faire can simply mean giving oligopolistic forces free rein to exercise their economic and political power. Likewise, the poverty-alleviating potential of economic growth will be reduced by the kind of protectionist, import-substitution policies followed by many LAC countries in the 1960s and 1970s, under which the distribution of subsidies (including those provided by distorted exchange-rate, credit, and price-control policies) overwhelmingly favored middle- and upper-income groups. The very poorest groups in society don't benefit at all from electricity subsidies, for example, because they don't even have electricity! The vast bulk of electricity consumption, rather, is by households well above the poverty line. Free university tuition for all students is another highly inequitable subsidy whose benefits are captured overwhelmingly by middle- and upper-income groups. Economic growth thus needs to be accompanied by policies that:

- increase competition, thus reducing monopolistic and oligopolistic rents, including those from "crony capitalism";
- eliminate or sharply reduce global subsidies that largely benefit middle- and upper-income groups;
- target remaining subsidies specifically on low-income groups;
- promote investment in human capital, especially through widespread access to health services and to primary and secondary education;
- provide social safety nets to the most vulnerable groups of society, including those that may be affected adversely in the short run by economic adjustment measures;
- reward people on the basis of merit, thus stimulating creativity and increasing social mobility; and

• promote the rule of law as a means of leveling the playing field and reducing the importance of personal connections.

IV. STABILIZATION, STRUCTURAL ADJUSTMENT, AND POVERTY

If economic growth is the best way to obtain the resources needed to reduce poverty, what policies are needed for promoting growth? Policy reforms are commonly divided into those directed at economic stabilization and those aimed at structural adjustment.

Stabilization policies are designed to eliminate internal (fiscal) and external (foreign exchange) imbalances that result from policies producing unsustainable spurts of economic growth. Typically, internal and external imbalances go hand in hand, with fiscal deficits fuelling imports, discouraging exports, promoting capital flight, and eventually accelerating the pace of inflation, which usually affects lower-income groups negatively in a relative if not absolute sense during these growth spurts. Fiscal and balance-of-payments deficits can fuel growth and create jobs for a while; but once a country runs out of foreign exchange and has lost its international creditworthiness, the adjustment it will be forced to endure can be brutal.

Peru since 1985 provides a textbook case of this pattern. Economic growth in Peru averaged 8.8% in 1986-87; but then foreign exchange reserves ran out, and Peru's ability to borrow abroad largely disappeared because it was not servicing much of its existing debt. In the chaotic adjustment that was forced upon the country over the next three years, GDP fell by a cumulative 23% and per capita GDP by 29%. Inflation rose from the high two digits in 1986-87 to three digits in 1988 and four digits in 1989-90. Tax revenues fell sharply in real terms, and it was not lower-income groups who benefited most from the tax relief that hyperinflation always provides.

The stabilization program implemented by the new Peruvian government in 1990 stopped the decline in GDP and sharply reduced inflation. While it is true that some low-income groups were affected adversely in the short term by stabilization measures and other policy reforms, blaming stabilization ("austerity") for the plight of the poor is like killing the messenger bearing bad tidings. It is legitimate to debate whether adequate social safety net programs were put in place to accompany the stabilization measures. But the need for stabilization to restore confidence and lay the groundwork for renewed economic growth should be unquestioned. To put the issue another way, planned austerity is less harmful than the unplanned austerity inflicted on the Peruvian population during 1988-90.

Structural adjustment measures are designed to accelerate economic growth by increasing the efficiency of resource allocation. This includes an opening up of the economy to world markets in order to expand the geographic area over which market forces, and the principle of comparative advantage, are allowed to function. Structural adjustment measures may be broadly grouped into three categories:

1. <u>Price liberalization</u> measures that free or at least significantly adjust prices so that goods and services are valued closer to their true scarcity values, thus allowing productive inputs to gravitate to their most efficient uses. This includes market determination of exchange rates, interest rates, and wage rates; removal of price controls; and elimination or substantial reduction of taxes on foreign trade.

2. <u>Institutional reforms</u> that remove bureaucratic, legislative, and other non-price obstacles to the functioning of market forces. Key measures include deregulation, privatization, the clarification and fair protection of property rights, the lifting of restrictive barriers to foreign direct investment, the dismantling of quantitative restrictions on exports and imports, and the removal of barriers to labor mobility.

3. <u>Societal reforms</u> such as the removal of discriminatory barriers on the basis of sex, race, age, or other such variables (which are only partially remediable by direct government action), and a reallocation of government spending in favor of health, basic education, and other social services (thus contributing to both economic growth and equity objectives) and away from such areas as military expenditures (which tend to exceed legitimate national defense needs).

Much of what structural adjustment accomplishes is the elimination of subsidies that historically in the Latin American and Caribbean countries have tended to benefit middle- and upper-income groups much more than the poor. Low electricity prices and free university tuition have already been cited in this context. Other examples include:

- tariff and nontariff barriers to imports that protect inefficient domestic producers from external competition and saddle consumers with higher-than-market prices;

- subsidized interest rates that restrict the supply of savings and deny the poor access to the credit because they are at the end of a queue of credit demanders that is longer than the queue of credit suppliers;

- excessive regulatory requirements that make it difficult for low-income entrepreneurs to establish their own businesses, thus driving them into the informal sector, where their input costs (e.g. for borrowed funds) are often much higher than in formal markets; and

- price controls on basic grains (including subsidized imports) that restrict domestic supply and benefit politically powerful urban groups at the expense of the small farmers—among the poorest groups in society—who produce a large share (if not most) of the basic grains.

Removal of such subsidies—as well as impl mentation of societal reforms—should both improve resource allocation and promote a more equitable distribution of income. The more rapid rate of economic growth that structural reforms promote will also strengthen the demand for labor and push up wage rates once unemployment declines and labor shortages begin to appear. In the early stages of Taiwan's drive to export manufactures, nonmarket forces were not allowed artificially to inflate real wages, and thus threaten export competitiveness; real wages in manufacturing were virtually unchanged between 1954 and 1960. But Taiwan's policy of promoting market-clearing wages helped facilitate a rapid increase in manufactured exports, the virtual elimination of unemployment, and a tripling of real wages in manufacturing between 1960 and 1979. Similar income gains have been achieved in other East and South Asian countries, which have leapfrogged over many LAC countries in terms of poverty reduction. Since these Asian countries also invested heavily and broadly in their human resources, and generally avoided the kinds of inequitable subsidies prevalent in the LAC region, their distribution of income has become significantly more equitable than that of countries in the LAC region.

V. POLICY REFORM AND POVERTY: ASKING THE RIGHT QUESTIONS

The relationship between policy reform and poverty in Latin America has received a great deal of attention in the last decade or so. A common theme in the literature is that structural adjustment has had a negative impact on the poor, either absolutely or relatively. However, such assertions usually are not backed up with good empirical evidence. And even when evidence exists that the socioeconomic status of the poor has declined, this deterioration is often wrongly attributed to structural adjustment instead of the true causes, which might include unfavorable trends in the world economy, natural disasters, political instability, the legacies of prior policy shortcomings (e.g. inflation), or even structural adjustment programs that are implemented half-heartedly and therefore should not be called true reform efforts (the numerous failed plans in Argentina and Brazil come to mind here).

In addition, effects on the poor attributed to structural adjustment are sometimes more appropriately linked to the temporary effects of stabilization programs that are necessary to lay the groundwork for economic recovery. Stabilization programs begun in Bolivia in 1985 and Peru in 1990 had initial adverse effects on some groups of poor people; but it should be remembered that the poor suffered even more during the economic declines that these stabilization programs were designed to halt. In Costa Rica wage earners suffered (further) real income losses in the initial phases of that country's stabilization efforts in the early 1980s; but real wages began to recover quickly once the stabilization measures took effect and growth-promoting structural reforms were introduced.

Given the numerous forces other than stabilization and structural adjustment programs that affect the living standards of poor people, it is always extraordinarily difficult to establish linkages between policy reform measures and the status of the poor. Simply <u>identifying</u> these linkages—let alone trying to quantify them—is a difficult task, since there are important indirect as well as direct effects. Moreover, structural adjustment measures will affect economic performance (and therefore socioeconomic indicators) with different time lags, depending on the specific mix of measures and how they are implemented.

Just as we need to be clear about the definitions of stabilization and structural adjustment, it is important to clarify what we mean by "the poor" and to determine whether, and at what cost, the characteristics of this group (or groups) can be tracked over time—not an easy task given the data deficiencies in many countries. To the extent this can be done, a number of important questions then need to be addressed, although we should recognize that the answers will sometimes be only rough estimates:

- How many poor people have been affected adversely (absolutely and relative to the total population) since the onset of stabilization and/or structural adjustment?

- How many poor people have been affected <u>favorably</u> (absolutely, relatively)? (Perhaps many, if agricultural prices are decontrolled and small farmers and farm workers constitute a large percentage of the population.)

- Have the poor as a group been affected by structural adjustment more or less than the non-poor? In which direction have they been affected?

- If the (absolute or relative) effects have been negative (either for specific sub-groups of the poor or the poor as a whole), to what extent are they temporary?

- Have the negative effects been limited largely to politically vocal segments of the population (e.g. well-organized urban wage earners) that include non-poor as well as poor households (with the latter not being the poorest of the poor)?

- If structural adjustment has been successful from a macroeconomic standpoint, what is likely to happen to the absolute and relative socioeconomic status of the poor over the next 5-10 years?

- What would the status of the poor be (absolutely, relatively; short-term, medium-term) had structural adjustment not been undertaken?

We need to recognize that the search for clear causal linkages between policy reform and changes in poverty status may be fruitless, given the formidable methodological problems discussed above. Under these circumstances, a realistic objective is to make <u>plausible inferences</u> about the relationships between policy reform and poverty. In seeking to make such inferences, we should be guided by the following observations:

- It is better to look at <u>long-term trends</u> than year-to-year changes, since the latter are especially susceptible to being influenced by forces having nothing to do with policy reform.

- A <u>wide range of socioeconomic indicators</u> should be examined, especially if some of the data are of questionable quality. If we find that most or all indicators lead us to make similar inferences, we can have some confidence in the story they are telling.

- <u>Existing but neglected time series data</u> should be examined, with particular attention to disaggregation by sex, socioeconomic status, geographic location, and other types of breakdowns. It might be possible to determine, for example, whether a country's poorest geographic regions have experienced improvements/deterioration in educational, health, or nutritional status that are greater/less than the national average.

- For the medium term, <u>new data collection efforts</u>—including household surveys, anthropometric measurements of schoolchildren, and educational performance testing—may be desirable, although the benefits and costs of such efforts should be carefully weighed. In some cases it may take a number of years before good-quality data can be available. In El Salvador, for example, household labor force surveys that had been discontinued in 1980 were revived in 1985, but the data are still of only limited usefulness because of unresolved technical problems.

- A less expensive alternative to new survey work is to <u>add modules to existing survey instruments</u>. Opportunities to obtain data in this fashion should be explored.

VI. POLICY REFORM AND POVERTY: TRENDS SINCE THE EARLY 1980s

The 10% decline in per capita GDP experienced by the LAC region as a whole between 1980 and 1983 resulted in a sharp increase in the incidence of poverty. Very little of that increase, however, can be linked to economic policy reforms, since in most LAC countries major policy reforms had not yet been implemented. Ideally, we should examine trends in poverty since the onset of policy reforms in individual countries, and link these trends to reform efforts. This is difficult to do for the reasons discussed above, including problems of data availability and reliability. Moreover, it is not easy to decide when to date the onset of the policy reform period, and whether it is appropriate to consider aborted and/or feeble policy actions as true reform efforts. Finally, for the last few years, one must raise the possibility that the favorable effects of policy reform on poverty have been obscured/offset by the effects of recession or slow growth in the industrial countries.

Bearing in mind these considerations, we may note that the experience of selected LAC countries—summarized in the Appendix to this paper—is a mixed one. In some countries, the incidence of poverty has clearly fallen since the onset of reform; in others it seems to have increased.

The evidence for income distribution is also mixed. One recent study examining trends in 10 LAC countries for various time periods in the 1980s—not always coinciding with policy reform efforts—found that income inequality indicators widened in five countries (Argentina, Bolivia, Brazil, Panama, and Honduras), narrowed in four (Colombia, Costa Rica, Guatemala, and Uruguay), and showed mixed results in one (Venezuela).

However, among the five countries with widening income inequality, only one—Bolivia—can be considered to have had a major, sustained policy reform effort in place during the period for which income inequality trends have been calculated. Argentina and Brazil both announced several major reform efforts during the 1980s, with great fanfare; but all were quickly aborted. Argentina should not be put into the policy reform camp until 1991; Brazil is still not there. The major policy reforms in Honduras date from 1990, as do the (less comprehensive) reforms in Panama (which also went through an aborted reform phase in the mid-1980s). Thus, except for Bolivia, it is inappropriate to link widening inequality with policy reform. Moreover, another study of the Bolivian experience concludes that the relative position of the poor has improved, and there were significant real wage gains in the private sector between 1987 and 1991 (see the Appendix).

Among the four countries where income inequality appears to have narrowed, Costa Rica (1981-89) and Guatemala (1986/87-89) are appropriately considered reforming countries, although the Guatemalan case covers only a 2- or 3-year period. Colombia maintained its traditionally rather conservative, stable macroeconomic policies during most of the period under analysis (1980-89), although only in the last few years has it undertaken a major policy reform effort on a fairly broad front. Uruguay (1981-89) more closely resembles the Argentine and Brazilian cases, with policy reform efforts that were not sustained; but macroeconomic distortions were not as severe as in its two large neighbors.

VII. CONCLUDING OBSERVATIONS

Given the difficulties in establishing linkages between economic policy reform and poverty, the best way of examining such relationships is to conduct detailed country case studies that look at a wide range of socioeconomic indicators and emphasize long-term trends rather than annual variations. Such studies should distinguish between stabilization and structural adjustment policies, and identify factors other than policy reform that are likely to have significantly influenced poverty indicators (in either direction).

Case studies of this nature are unlikely to establish many clear causal relationships, especially in countries where the underlying data are poor and where there is disagreement about what should count as economic policy reform. For the most part, we will have to be content with making plausible inferences.

It is easy enough to find individual policy measures that affect some groups of poor people adversely, at least in the short run, just as it is easy to find individual measures that benefit the poor. But what we should really be looking at are the effects of comprehensive policy reform packages. It would be a mistake to assume that such packages will automatically address poverty concerns in the short run, although sound economic policies should alleviate poverty over the long run by raising GDP growth rates. Reducing poverty in the short run requires creative social safety nets, while establishment of a more equitable pattern of long-term economic growth depends to a large extent on major investments in human capital—something that is now widely recognized in the development literature. How to finance such investments will be a key challenge for LAC countries in the 1990s.

APPENDIX: SELECTED COUNTRY CASES

1. Argentina
2. Bolivia
3. Colombia
4. Costa Rica
5. Guatemala
6. Mexico

1. ARGENTINA

Argentina's experience in coping with the economic crisis of the early 1980s is one of repeated failures in stabilization and structural adjustment programs, due largely to inadequate efforts to reduce the fiscal deficit. Beginning in 1981, the economy fell into another stop-go pattern in which one to three years of economic decline alternated with two years of economic growth. Between 1980 and 1990 aggregate GDP fell by 12% and per capita GDP by 23%. The annual inflation rate over this decade exceeded 100% in every year except 1986 (when it was 90%), and in 1989 and 1990 it was in four figures. The fiscal deficit averaged 13.8% of GDP in 1981-84, fell to 5.6% in 1985-86, then rose to 7.9% in 1987-89.

Between 1980 and 1986 the proportion of the population living in poverty rose from 10% to 16%, with the great bulk of the deterioration occurring in urban areas. Real wages in manufacturing behaved erratically over this period, falling by a cumulative 20% between 1980 and 1982, rising by 49% from 1982 to 1984, and then dropping by 13% between 1984 and 1986. The combination of rising average real wages (4% higher in 1986 than in 1980) with an increase in the incidence of poverty suggests a widening inequality in the distribution of income, at least in urban areas, between 1980 and 1986.

In 1987 the economy continued the recovery begun in 1986, but GDP then declined for the next three years before performing strongly in 1991. Real wages in manufacturing, however, fell in each of the years from 1987 through 1991, stretching the period of decline to seven years. The cumulative loss in real wages between 1984 and 1991 was 34%.

Household survey data for metropolitan Buenos Aires (measuring income from all sources) show that the incidence of poverty rose from 6.3% of the population in 1980 to 21.5% in 1989. It rose more sharply for informal- than for formal-sector workers, but more for grade-school and high-school graduates than for illiterates. These data also show that the Gini coefficient for individual income distribution rose from 0.39 in 1980 to 0.46 in 1989—a significant increase in inequality. Other data, showing real <u>earnings</u> per worker, show a sharp rise in inequality between 1986 and 1989; this trend coincided with a jump in the inflation rate from 90% to 3,079%, lending credence to the widespread view that the poor are the least well equipped to defend themselves against accelerating price increases.

Rising inequality in Argentina during the 1980s was not associated with policy reform because there simply was not much policy reform during these years. Inflation continued to distort many relative prices, while subsidies in one form or another were estimated to account for about 8% of GDP in 1989.

The Menem government's first two stabilization programs, in 1989 and 1990, continued the pattern of failure that characterized its predecessors. Nevertheless, some progress was made on the fiscal deficit, which fell to 4.9% of the GDP in 1989. The 1991 stabilization and adjustment program, still under way, is a much more serious effort. The fiscal deficit was reduced in that year to 0.7% of GDP. Inflation fell sharply, and in 1992 it is likely to be in the very low two digits. Although new data on income distribution are not available, real wages fell in both 1990, when GDP declined slightly, and 1991, when it rose by 6%. What will happen to income distribution if the stabilization/adjustment program is sustained remains to be seen.

2. BOLIVIA

Bolivia's economy stagnated in the late 1970s and early 1980s, then declined by 10.1% between 1981 and 1985. Per capita GDP fell by 24.2% between 1978 and 1985 (based on initial 1992 population census estimates which showed less population growth than had been expected). The adverse effects on Bolivia of the world recession of 1980-82 were aggravated by internal political turmoil and economic mismanagement. The budget deficit soared, and so did inflation, reaching an annual rate of more than 24,000% in the 12 months ending in September 1985. Under intense pressure from internal forces, the government elected in 1982 agreed to leave office a year ahead of schedule.

The newly-elected government assuming office in mid-1985 moved quickly to stabilize the economy. It sharply reduced the fiscal deficit by controlling expenditures, increasing prices charged by public enterprises, and tightening monetary policy. Import tariffs were slashed to a uniform rate of 10% (5% for capital goods), nearly all quantitative restrictions were eliminated, and financial and labor markets were liberalized. The shock treatment administered to the economy quickly brought inflation under control. But GDP dropped by another 2.5% in 1986, and per capita GDP fell by 4.6%, partly because of unfavorable export price trends. Among those affected most adversely by the shock were thousands of public sector workers, including a high percentage of the tin miners, whose jobs were eliminated. An emergency employment program and other social safety net measures only partially compensated this group of workers—generally not the poorest of the poor—for their lost income.

Economic recovery began in 1987. Aggregate GDP rose by 3.0% a year, and per capita GDP by 0.9%, over the five years ending in 1991. Export earnings, after dropping from $942 million in 1980 to $519 million in 1987 (reflecting falling prices for natural gas, petroleum, and tin), recovered to $831 million in 1990 before slipping to $760 million in 1991. Nontraditional exports led the recovery, rising from $106 million in 1987 to $292 million in 1990 but then falling to $251 million in 1991.

Trends in social indicators during the process of structural adjustment have been mixed. Despite the large drop in output in the first half of the 1980s, urban open unemployment rose only from 5.6% in 1980 to 6.2% in 1985, while rural unemployment remained at 4.5%. (This reflected, perhaps, the largely unrecorded growth of coca/cocaine production, as well as efforts by many of the poor to earn income elsewhere in the informal economy.) Between 1985 and 1989, however, urban unemployment rose to 10.0%, although rural unemployment fell slightly to 4.4%. On the other hand, real wages in the private sector, which had fallen steeply in 1985 and 1986, rose by 26% between 1987 and 1991. Government spending for the social sectors, which had been cut sharply from 6.7% of GDP in 1980 to 3.7% in 1985, rose to 5.6% in 1990. Health indicators improved between 1987 and 1990; adult literacy was rising; and although the gross primary enrollment ratio was falling, this was at least partially due to lower repetition rates. A 1991 World Bank report on poverty in Bolivia concluded that the policy reforms of the mid-1980s had improved the relative position of the poor, especially by sharply reducing inflation and economic rents to privileged groups.

3. COLOMBIA

Colombia was an exception to the region-wide pattern of economic performance during the 1980s that gave rise to the term "lost decade." GDP grew in every year, rising at a modest average annual rate of 2.2% between 1980 and 1985 and by a healthier 4.5% between 1985 and 1990 following the adoption of a (gradual) trade liberalization program and other adjustment measures. Contrary to what is believed in some circles, this relatively good macroeconomic performance has more to do with policy than with exotic exports.

While Colombia did not implement a dramatic, wide-ranging, and rapid adjustment program during the 1980s, it needed such a program less than most other Latin American countries. Fiscal and monetary policies had been traditionally conservative, with only brief lapses, and a high degree of policy continuity helped establish a relatively favorable investment climate. The external debt was manageable, and scheduled debt servicing was maintained. The overall policy structure retained an import-substitution bias until very recently, but it never reached the extremes found elsewhere in Latin America, partly because the exchange rate kept exports competitive except for brief periods. Also, major export incentives helped offset other policy shortcomings and facilitated rapid export diversification. Nontraditional export earnings doubled from $1.06 billion in 1984 to $2.13 billion in 1989.

Between 1980 and 1986, when GDP grew only slightly faster than the population, the incidence of poverty among households fell from 39% to 38%, but the share of indigent households rose from 16% to 17%. For individuals, the percentage living in poverty was unchanged at 42%, while the indigent share rose from 17% to 19%. All of these changes are relatively small; slight deteriorations in the cities were offset by small improvements in rural areas, where the incidence of poverty is higher (although rural-urban differences are less pronounced in Colombia that in most other Latin American countries.)

Real wage data, which are for the industrial sector only, show an increase of 19% from 1980 to 1984. Although the economy was growing slowly during this period, labor productivity in manufacturing was rising rapidly (data on total factor productivity, however, revealed other inefficiencies). Productivity growth slowed toward the end of the decade, and real wages in industry rose by only 4% between 1984 and 1990.

Labor force surveys in major urban areas, providing data on income from all sources, permit a comparison between 1980 and 1989—a period that includes the more rapid growth of the economy following the adoption of structural adjustment measures in 1985. These data show a significant narrowing of income inequalities: the Gini coefficient fell from 0.58 to 0.52 and the Theil coefficient from 7.20 to 5.16. Approximately 6.5 percentage points of total income were transferred from the highest two deciles to the lower eight—the largest such transfer in Latin America during the 1980s.

The urban unemployment rate rose from 9.7% in 1980 to 14.0% in 1985 but then fell to 9.8% by 1989 as economic growth accelerated. Employment grew rapidly, as the labor force participation rate rose from 39% in 1981 to 44% in 1988. A higher percentage of households thus had multiple income earners.

Nutrition, health, and educational indicators all showed major improvements during the 1980s.

It is too early to determine the effects on medium-term growth and poverty of the trade liberalization and other adjustment measures begun by the Barco administration in February 1990 and continued under the Gaviria government. GDP grew by only 2.0% in 1991 and real wages in industry declined slightly. Economic growth was also slow in 1992, partly because of a further drop in coffee prices, temporary electricity-supply problems, and increased guerrilla activity. But the economy seems basically sound, and growth should soon accelerate as a major new oil and gas field comes into production.

4. COSTA RICA

The economy of Costa Rica hit bottom in 1982. Over the rest of the decade it made a solid recovery, facilitated by the stabilization program begun in 1982; a gradual process of structural adjustment; several debt reschedulings; and significant external resource inflows, especially from U.S. government loans and grants but also including private capital once economic policies improved. Between 1982 and 1990 GDP grew at an average annual rate of 4.3%, or 1.6% per capita, one of the best performances in the LAC region over this period. Although progress in policy reform was gradual, the cumulative change over the period was substantial, demonstrating that policy reforms do not always have to be implemented through a "shock treatment" approach.

During the recovery period, exchange-rate reforms and other liberalization measures improved resource allocation, especially into nontraditional exports, which grew at a compound annual rate of 24% between 1983 and 1990. The pattern of growth was more labor-intensive than in the past, with the labor force expanding rapidly and the unemployment rate falling from 9.4% in 1982 to an average of 4.2% during 1989-90. Formal-sector employment grew faster than informal-sector employment. Real wages recovered their 1980 level for private-sector workers by 1985 and for public-sector employees by 1990.

Per capita household earnings showed similar declines between 1980 and 1982 for all educational levels of the head of household. But earnings for households headed by persons with no education grew much more rapidly than average during the initial recovery years (1982-85) and equal to the average between 1985 and 1990. Similarly, real household earnings gains for the lowest three deciles were above-average during 1982-85; and although these gains were below-average during 1985-89, at the end of the period real earnings for the second and third deciles (but not the first, or lowest), exceeded their 1980 levels by more than the national average percentage gain. Of eight measures of the incidence of poverty, all but one show a reduction—usually significant—in the incidence of poverty during the structural adjustment period; the exception is due largely to a statistical quirk. Income distribution data—which are notoriously imperfect—are mixed, but on balance they show no widening of income inequality during the structural adjustment period.

Among the social indicators, health and nutritional status indicators show improvements during the 1980s, although trends in educational status are mixed.

In summary, both the burdens and the benefits of structural adjustment in Costa Rica have been distributed fairly widely. This was due to a large extent to conscious government policies, including social safety nets, some of which were in place before the economic crisis of the early 1980s.

5. GUATEMALA

Guatemala's aggregate GDP declined by 5% between 1980 and 1986, and its per capita GDP fell by 20%. Urban unemployment rose from a reported 2.2% (almost surely an underestimate) to 14.2%. Fiscal policy was uncharacteristically expansionary at the beginning of this period, with the deficit averaging 5.4% of GDP during 1980-82. The debt crisis, falling commodity prices, and other factors weakened the quetzal, which fluctuated wildly in the absence of a clear exchange-rate policy.

Despite these adverse developments, the incidence of poverty rose only modestly between 1980 and 1986, from 65% to 68% of the number of households and from 71% to 73% of the number of individuals. In rural areas the incidence of poverty actually declined, from 79% to 75% and from 84% to 80%, respectively. The modest increase in the overall incidence of poverty is due in large part to the fact that in 1980 the figure was already high and the distribution of income highly unequal. More revealing are the significant increases in the percentage of indigent households (from 33% to 43%) and individuals (from 40% to 49%). Moreover, indigence, unlike total poverty, rose not only in urban settings but also in rural areas (from 44% to 53% of households and from 52% to 57% of individuals). These trends suggest that income inequality may have widened between 1980 and 1986, a period characterized by the absence of major policy reforms.

The Cerezo government, which took office in early 1986, implemented a number of significant policy reforms in the first half of its five-year term, although there was some backsliding in the second half. The fiscal deficit was reduced to an average of only 1.4% of GDP during 1986-88. Consumer prices, which rose by an uncharacteristic 37% in 1986, increased at a moderate annual rate of 11.5% over the next three years. Exchange-rate policy improved, and real interest rates became positive. GDP growth averaged 3.8% a year during 1987-89 (and 3.6% during 1990-92). Nontraditional exports to markets outside Central America doubled between 1986 and 1990, from $128 million to $237 million.

Two national socio-demographic household surveys, in 1986/87 and 1989, roughly coincide with the beginning and end of the Cerezo government's policy reform efforts. (Although policy has been erratic since mid-1988, it has remained much better than during 1980-85, and a number of major reforms were adopted in 1992.) The Gini coefficient was roughly unchanged from the first survey to the second, falling from 0.532 to 0.528, not a significant movement toward greater income equality given the quality of the data. Such a movement is more evident in the decline of the Theil index, from 6.55 to 6.19. The income share of the lowest 40% of the population was unchanged at 10.9%. Indeed, the only income-share change of any consequence was a shift of about half a percentage point from the tenth (highest) to the eighth decile.

Poverty indicators from the 1986/87 and 1989 socio-demographic surveys show that, although the overall incidence of poverty rose slightly, from 55.9% to 56.9%, the poverty gap—the difference between the average income of poor households and the poverty line—fell from 47.4% to 44.7%. The greatest improvements occurred in Guatemala City and in those rural areas where the expansion of nontraditional agricultural exports by small farmers has been concentrated. On the other hand, both the incidence of poverty and the poverty gap increased in the isolated and politically troubled north and northwest departments, the poorest in the country.

In summary, structural adjustment in the late 1980s did not have an adverse relative or absolute effect on the poor as a whole in the short run. The status of some poor groups deteriorated, but that of others significantly improved. The outcome over the longer run is less clear. While the economy now has fewer of the price distortions that traditionally have favored the well-to-do, spending on education, health care, and other social services remains very low, thus limiting future income gains for many poor Guatemalans.

6. MEXICO

Mexico's economy experienced a petroleum boom in the late 1970s and early 1980s, and annual GDP growth during 1978-81 averaged 8.7%. But this growth was accompanied by heavy external borrowing, and the debt service burden increased sharply as world interest rates rose. In August 1982 Mexico suspended payment on its debt to commercial banks. GDP fell by an average of 2.4% in 1982-83 before recovering at an annual rate of 3.2% in 1984-85. Major policy reforms adopted in 1983 included a sharp real devaluation of the peso and a sharp (and sustained) reduction in the fiscal deficit.

The 1984-85 recovery was halted by a severe earthquake in September 1985 and then by a sharp drop in oil prices in 1986, when GDP fell by 3.9%. A new adjustment program, responding to this downturn, featured another sharp currency depreciation and major trade liberalization. But quarterly wage indexation and frequent exchange-rate changes to maintain competitiveness kept inflation high. The Government responded in 1987 with an Economic Solidarity Pact with business and labor that featured a tight fiscal policy, further structural reforms, and temporary controls on wages and some prices. Inflation subsided, but annual GDP growth in 1987-88 averaged only 1.7%. Further structural adjustment reforms undertaken by the Salinas administration which assumed office in December 1988, debt relief in 1989, and a continuation of the successful Pact helped raise annual GDP growth to 3.7% in 1989-91.

One feature of the Pact was that minimum-wage adjustments lagged behind inflation, so that real minimum wages continued the decline begun in 1982. However, more than 90% of the labor force now earns more than the minimum wage, and during 1989-91 real wages in manufacturing rose by 4.8% a year. Still, these gains do not make up for the cumulative decline in manufacturing real wages of 36% between 1982 and 1988--significantly more than the 13% decline in real per capita GDP over this period. At least some poor and moderate-income segments of the population, then, would appear to have suffered more than proportionately during the first six years of the adjustment process. What happened to rural earnings over these years is less clear, but rural residents may have fared relatively better than urban workers, especially if one takes remittance income into account.

Data on real wages, of course, are misleading because they do not reflect all sources of household income; for many families non-wage income either increased or fell less rapidly than wages. Moreover, the urban open unemployment rate fell from 6.3% to 3.5% between 1982 and 1988—and annual labor force growth (3.2%) exceeded population growth (2.0%) during 1980-91—suggesting that for many households the number of wage earners increased.

Poverty indicators, available only for 1977 and 1984 (mainly prior to adjustment), show the incidence of individual poverty falling from 40% to 37% and indigence from 14% to 13%. The very rapid GDP growth between 1977 and 1981 apparently did not reduce poverty dramatically.

Trends in social indicators were mixed. Nutritional status increased for most of the poor during adjustment, but worsened for a minority. Although food subsidies were slashed, targeting of the poor improved, especially in urban areas. Health programs were cut less than overall government spending, and many health indicators continued to improve. On the other hand, there were relatively sharp cuts in spending on primary education and on rural and community development programs targeted on the poor.

In summary, the poor suffered significant declines in real incomes during the first six years of the structural adjustment process, although it is not clear whether their total incomes fell more than those of the non-poor. Job preservation offset some of the negative impacts of falling real wages, and some social indicators continued to improve. Real wages increased after 1988, and the unemployment rate continued to decline.