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ECONOMIC CHANGE AND THE POOR: AN HISTORICAL PERSPECTIVE

by

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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 (with occasional limited exceptions) 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.

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EXECUTIVE SUMMARY

Historical evidence shows that economic change—whether caused by structural adjustment or by any other force—virtually always hurts **some** groups of poor people **in the short run**, and often for longer periods. But it also provides immediate new opportunities for others, including poor people.

The appropriate response to such change is not to resist it, but to find cost-effective ways of (1) cushioning, in the short run, the negative effects of change on poor people and (2) providing them, over the medium and long terms, the means to take advantage of new economic opportunities. The distinction between these two responses is that between **consumption** and **investment.** Both are needed, but the **long-term (investment) responses should receive priority.**

Long-run solutions should emphasize, first, the adoption of appropriate macroeconomic and microeconomic policies that increase a country's overall GDP growth rate. Rapid and sustained growth over the long run is the best way to relieve poverty. The scope for redistributing income, at least in the short and medium terms, is modest, since evolutionary social change is the historical norm. **Economic growth, of course, is not enough**, for the pattern of overall growth can distribute benefits very unequally.

A second, complementary long-run solution to poverty problems is therefore needed: investment in human resources. This requires (1) an expansion of education and health services, and an improvement in their quality; and (2) increased access to productive inputs. Investments in human resources need to be made within a framework of growth-inducing economic policies; otherwise, they will produce low returns.

Access to land, credit, and other productive inputs is less important than investment in health and education, partly because radical changes in access are difficult to accomplish politically and partly because increased access will occur to a large extent automatically as better education and health get translated into higher incomes and wealth and therefore a greater capacity to acquire productive inputs. Since support for major agrarian reforms has weakened in the LAC region, the focus should be on programs to facilitate land titling and to give individual members of cooperatives or communes more freedom to buy, sell, or rent land. With respect to credit, it is now widely recognized that subsidized and directed credit programs have been counterproductive in addressing inequalities of income and wealth. The poor are much better served by programs emphasizing deposit mobilization, informal finance, and prudential regulation and supervision.

Poverty alleviation through rapid, sustainable economic growth and investment in human resources may be slow in the short run; but over two or three decades the changes can be dramatic, as the East Asian "baby tigers" have demonstrated. **It is important for policy-makers and the general public to have the patience to wait for these changes**. There are no quick-fix, magic keys to poverty alleviation, such as political independence or petroleum revenues. If anything comes close to being a magic key, it is savings and investment. Even the poor have some capacity to save; all they need are the incentives to save and invest (including in their own human capital formation) that sound economic management can provide.

In looking at the relationship between type of political regime and the proclivity of political leaders to exercise patience by putting long-term interests ahead of short-term expediency, it is encouraging to note some recent research suggesting a positive correlation between degree of democracy, on the one hand, and commitment to sound economic policies and to social development, on the other.

I

Economic change at the societal level—whether caused by Arnold Toynbee's challenges and responses, Adam Smith's invisible hand, Joseph Schumpeter's entrepreneurial innovators, Frederick Jackson Turner's frontiersmen (and -women), Mao Zedong's cultural revolutionaries, or the World Bank's structural adjusters—virtually always hurts **some** groups of poor people in **the short run**, and often for longer periods. At the same time, it provides immediate new opportunities for others, including poor people.

This historical pattern is documented in a study by Irma Adelman and Cynthia Taft Morris in the Supplement to Volume 25 (1977) of **Economic Development and Cultural Change**, which examines the experience of 23 countries (some currently developed, some still developing) in the first half of the nineteenth century. The authors found that the very poorest groups in society tended to be affected most adversely by **any** type of structural economic change. All of this occurred, of course, **before** the days of modern "structural adjustment."

The historical record thus suggests that temporary reductions in living standards are inevitable for some groups when major societal changes occur. For Schumpeter, this regular pattern was part of the process of "creative destruction." The familiar proverb about omelettes and eggs comes to mind here, too.

The appropriate response to these historical regularities is not to do battle against **any** change, à la Ned Ludd[1] and his present-day successors who have sought to conserve their present world and their place in it, but rather to find cost-effective ways of (1) cushioning, in the short run, the negative effects of change on poor people who are adversely affected and (2) providing them, over the medium and long terms, the means to take advantage of new economic opportunities.

The distinction between these two responses to change-induced impoverishment is basically that between consumption and investment. Some consumption is always necessary in the short run just to stay alive; but too much attention to consumption at the expense of investment means that the future will not get better. That is why **long-term** solutions to poverty should have a higher priority than stopgap measures, which will never be able to target effectively **all** those adversely affected by change in the short run, partly because the costs of identifying all such persons are prohibitively high and partly because some effects will not be foreseen.

Long-run solutions should emphasize, first, the adoption of appropriate macroeconomic and microeconomic policies that increase a country's overall GDP growth rate. That was the clear

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[1] Ned Ludd was one of those colorful English characters, like Robin Hood, whose historical authenticity is in some doubt. He is alleged to have destroyed weaving machinery in about 1779 to protest its job-displacement effects. Between 1811 and 1816 a wave of similar destructive activity hit the British textile industry, and its perpetrators came to be known as Luddites.

message of the background research for the World Bank's **World Development Report 1990**, which focused on poverty. It is helpful to bear in mind here that income and production are two sides of the same coin. If production is not increasing, neither is total income (in cash or in kind), and one group's income gain can only occur at the expense of another's income loss.[2] History teaches us that in the absence of profound social revolutions, the scope for **redistributing** income, at least in the short and medium terms, is modest. History also reveals that examples of profound social revolutions are few and far between, and that often their initial effects are adverse for nearly everyone. Evolutionary social change is the historical norm, and it is in this context that sustained income growth over time should be viewed as the major vehicle for poverty alleviation.

Economic growth, of course, is not enough. Those familiar with the history of Central America between 1950 and 1980 know that, with the exception of Costa Rica, rapid economic growth was accompanied by a deterioration of living standards for large groups of people over periods of time that went well beyond the short run. This distorted pattern of growth occurred partly because of tariff protection, cheap credit, and other subsidies

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[2] This statement ignores international flows, such as remittances and foreign assistance, that can allow income to exceed the value of domestic production. However, when production is stagnant, it is only the **increase** in such flows that adds to income over time, and continual increases of this nature are unsustainable. Thus the basic closed-economy principle of income = production is a reasonable assumption for open economies over the long run.

to higher-income groups, and partly because Central American countries other than Costa Rica failed to invest adequately in their human resources. The result was an attempt to overthrow the existing social order in three countries: El Salvador, Guatemala, and Nicaragua. (Honduras was spared largely because it gave base-level organizations much more freedom to sprout up and grow than did the three countries facing insurgencies.) In only one of the three countries—Nicaragua—were the insurgents successful in overthrowing the social order. But the Sandinista revolution failed, thus illustrating the comments made above about the frequency and initial effects of social revolutions.

The second long-run solution to poverty problems, then, is investment in human resources. This requires two types of actions. **First**, and most important, is **an expansion of education and health services, and an improvement in the quality** of these services. The payoffs to such investments will not be evident in the short run, but over the long run they can be huge, as the example of the East Asian "baby tigers" demonstrates. In education, for most developing countries the greatest payoff will come from investment at the primary level (the largest contributor to East Asian economic growth, according to one World Bank model), and will be higher for girls than for boys. In health, investments in preventive measures and primary care facilities will be the most productive.

Investment in human resources tends to be positively correlated not only with economic growth but also with reductions

in income inequality, an improvement in the social as well as economic status of women, and lower population growth rates. A recent World Bank study, for example, found that differences in educational attainment constituted the dominant source of income inequality in the LAC region, accounting for about a quarter of all the observed income inequality. But if major investments in human capital occur in the context of poor economic policies that produce low or negative rates of economic growth, the result can be large-scale external migration of a country's more skilled human resources, with negative consequences for its long-run economic growth. In the LAC region, this phenomenon was particularly severe in Guyana and Jamaica during the 1960s and 1970s. Another possible outcome is the widespread unemployment or underemployment of human resources that now characterizes much of the former Soviet Union. In both of these situations, economic policy shortcomings sharply reduced the realized rate of return to investment in human capital.

During the economic downturn of the 1980s, many LAC governments reduced real expenditures on education and health as part of their efforts to achieve economic stabilization. Real delivery of educational and health services, however, generally declined by less than real spending (if at all) because the vast majority of the cuts in real spending consisted of lower real salaries for basically the same number of educational and health professionals. Nevertheless, the **quality** of educational and health services probably declined in many countries, because of

both lower real expenditures on supplies and lower morale among teachers and health professionals.

LAC countries have a great deal of scope for improving both the quantity and quality of educational and health services. Much could be accomplished simply by improving resource allocation, even if real spending were unchanged. The familiar litany of problems includes bloated ministerial bureaucracies; excessive spending on university-level education (fuelled by free or highly-subsidized tuition that overwhelmingly benefits middle- and upper-income groups), at the expense of primary education; and too much attention to curative health care relative to preventive care. The solutions are clear enough, and not just to economists. But how to achieve a consensus for implementing them—whether by decentralizing service delivery or by reforming decentralized systems—is fundamentally a political problem.

The **second** type of investment in human resources that can contribute to economic growth and poverty reduction is more indirect. It consists of providing more people **access to productive inputs**, particularly land and credit. It is less important as a tool for alleviating poverty than investment in health and education because (1) radical changes in access to productive inputs are difficult to accomplish politically and (2) increased access will occur to a large extent automatically as better education and health get translated into higher incomes and wealth and therefore a greater capacity to acquire productive

inputs. Nevertheless, nearly all societies have some scope for significant actions in these areas.

Let us look first at access to land. Recent historical examples of agrarian reform that has contributed successfully to both economic growth and greater income equality include the post-World War II reforms in Japan, South Korea, and Taiwan. In the Latin American and Caribbean (LAC) region, the Alliance for Progress sought in the early 1960s to promote agrarian reform throughout the hemisphere. At that time the U.S. foreign-policy community tended to view a reduction in the incidence of poverty—through both economic growth and redistributive social programs—as essential for countering the appeal of Fidel Castro and those who sought to emulate his Cuban Revolution. While almost all LAC countries passed some form of agrarian reform legislation, actual redistributions of land in the 1960s were modest. The only really significant transfer occurred in Peru, toward the end of the decade and outside the context of the Alliance for Progress. Elsewhere, large landowners and their politically powerful allies successfully resisted major land redistributions, especially those that would have involved the confiscation of private land. To the extent that poor farmers did receive land of their own, it was usually through colonization (either planned or spontaneous) of government-owned land on the frontier, or through the parcelization of government-owned haciendas such as those in Ecuador expropriated from the Church in the early twentieth century. Few beneficiaries

received supporting services such as agricultural extension or access to credit.

By the time of the "lost decade" of the 1980s, political support for agrarian reform in the LAC region had diminished from its already restricted level in the 1960s. Agricultural production trends were disappointing in the major reforming countries[3] (joined in the late 1970s by Nicaragua and in the early 1980s by El Salvador), and these poor performances were often attributed—usually incorrectly—to agrarian reform **per se** rather than to price and marketing controls and other misguided agricultural-sector and macroeconomic policies, including overvalued exchange rates. In addition, the rapid urbanization of the LAC region—from 49% of the population in 1960 to 65% in 1980—significantly reduced the relative importance of poor farmers and farm workers in the total population.[4]

Meanwhile, a modest number of small farmers in the region had acquired land of their own through voluntary land transactions. Unfortunately, many of these transfers occurred outside the formal land market (i.e. without land registration and legal titling), usually preventing the new landowners from obtaining credit from the formal financial system. In addition, many agrarian reform beneficiaries (whether as individuals or cooperatives) had never received definitive titles to their land.

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[3] Bolivia, Cuba, Mexico, and Peru.

[4] The LAC region is now about 73% urban.

In this recent historical context, where political openings for major agrarian reforms have been few, external donors wishing to support improved access to land have been focusing on programs to facilitate the granting of legal, definitive titles to small landholders. El Salvador, Honduras, and Mexico have eased restrictions on the sale of communally- or cooperatively-owned land and on the ability of members of these groups to convert to individual ownership or to "cash in" their shares and take advantage of other opportunities, often outside the agricultural sector. The work of Hernando de Soto on the informal economy in Peru has stimulated interest in establishing faster, simpler procedures for titling both urban and rural land. (The high cost of transferring land under traditional titling and registry systems has been a major obstacle to land purchases by small farmers in many LAC countries.) New and expanded programs along these lines merit donor support, although under some circumstances—e.g. where judicial systems are especially weak—formal titling may not be in small farmers' best interests.

We turn now to access to credit. The shortcomings of subsidized and directed credit programs, which had many adherents in the 1960s and 1970s, are well known. Subsidized interest rates made the demand for credit exceed the supply at these rates, and since the poor were at the end of the queue they received only a small share of total credit—even from government banks ostensibly set up to serve them. Wealthy borrowers often used their loans for consumption purposes. Their repayment rates

were less than exemplary, and foreclosure was an empty threat. The combination of subsidized interest rates and poor loan recovery led to the decapitalization of state-owned development banks, which were periodically bailed out by their governments, often with funds provided by external donors. Savings mobilization as a source of loanable funds was neglected. The economic crisis of the 1980s brought donors and governments to their senses, and some public development banks were allowed to go bust. The poor did not suffer much from such closings, since they never had much access to credit from these institutions.

While disillusionment with subsidized and directed credit programs was growing, the importance of deposit mobilization, informal finance, and prudential regulation and supervision was increasingly recognized. Banks and other financial institutions that rely on **deposit mobilization** for most of their resources are much more likely to grow in a sustainable way than those relying on government-guaranteed external loans. They also have the potential to raise far more resources and thus to do a better job of expanding the base of their clientele, especially among relatively poor groups in the population (although they are unlikely to reach the very poorest). To succeed in their deposit-mobilization role, these institutions need to be able to set their own deposit and lending rates free of (or with only minimal) government controls.

The formal financial system in developing and developed countries alike is supplemented by various **informal financial**

networks. These include input suppliers; rotating savings and credit associations (ROSCAs) among small groups of poor people; lending programs for the poor run by NGOs; and the traditional "evil" moneylenders. Credit unions and cooperatives are sometimes treated as part of the informal financial sector, but whether this designation is merited depends on the extent of their legalization and their range of financial functions. Considerable scope exists for expanding the operations of informal financial networks, improving their efficiency, and eventually bringing some of them into the formal financial system.

Some credit programs operated by NGOs, although clearly focused on the poor, suffer from the same problems as the state-owned development banks[5]: interest rates are subsidized; repayment records are poor; little if any attention is paid to deposit mobilization; continued infusions of external resources (unlikely to be available forever) are necessary just to maintain the programs at their existing levels; and operating procedures tend to be paternalistic rather than participatory. This is not a recipe for sustainability.

Nor is it characteristic of all NGOs. Others have found ways of delivering credit to the poor in ways that promise to be self-sufficient and sustainable. This successful technology—to quote from an article by Elizabeth Rhyne and María Otero in the

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[5] These NGOs might be appalled by such a comparison, but it is a valid one.

November 1992 issue of **World Development**, focusing on lending to microenterprises—"utilizes sound financial principles as its basis, that is: understanding the needs of the client; increasing efficiency by cutting administrative costs; and using various techniques to motivate repayment. Savings receives equal emphasis as a financial service. . . ." These principles have been applied successfully in the last few years in a USAID-supported program to revitalize credit unions in Guatemala.

Prudential regulation and supervision differ in fundamental ways from other, less desirable controls on financial systems, such as ceilings on interest rates and targeted credit. Briefly, the objectives of prudential regulation and supervision include protection of depositors, borrowers, and taxpayers; openness and transparency in the operations of financial institutions; and market discipline. The idea is to strengthen the financial system, not to hobble it. If extended to credit unions, cooperatives, and other institutions now considered informal, these institutions can eventually become part of the formal financial system and increase their access to financial resources. Bolivia's BancoSol, a financial institution serving microenterprises, is now experiencing this kind of transition.

Poverty alleviation through rapid, sustainable economic growth and investment in human resources may be slow in the short run, but over two or three decades the changes can be dramatic,

as the East Asian "baby tigers" have demonstrated (see Gary Fields' article in the March 1984 issue of the **Economic Journal**).

It is important for policy-makers and the general public to have the patience to wait for these changes. Unfortunately, patience is in short supply, and messianism/millenarianism is alive and well in many societies. A half century ago, many Indonesians held millenarian expectations that living standards would rise dramatically after the colonial yoke was thrown off in 1949. Alas, these hopes were dashed; political independence did not prove to be a magic key. Similar millenarian views are evident today among segments of the newly-empowered majority in South Africa, where President Mandela is trying hard to create more realistic expectations.

Some developing countries thought they had found a "magic key" to poverty alleviation in the form of petroleum; but that has sometimes proved to be a mixed and temporary blessing. When the benefits of petroleum were combined with major economic policy reforms, as in Indonesia, a dramatic reduction in the incidence of poverty occurred—from 65% in 1965 to 15% today. When they were not accompanied by policy reforms and sound macroeconomic management, as in Nigeria, high rates of poverty persisted.

If anything comes close to being a magic key to economic growth, it is **savings and investment**, as Sir Arthur Lewis emphasized in his classic 1955 book, **The Theory of Economic Growth**. Saving implies a sacrifice of consumption in the short

run, but by definition it is necessary to finance investment—in both physical and human capital. Contrary to the conventional wisdom, **even the poor have some capacity to save.** Haiti's poor families tend to keep their savings in four-legged banks—pigs. They draw on their savings to finance large expenditures on funerals, and on desperate, often fatal efforts to reach the United States in flimsy vessels. What they need are incentives for investing in life rather than death.

In concluding, we might briefly address the relationship between type of political regime and the proclivity of political leaders to exercise patience by putting long-term interests ahead of short-term expediency. Two recent studies shed some light on this issue. Karen Remmer, using regression analysis to examine the relationship between elections and macroeconomic performance (**American Political Science Review**, June 1993), found that "contrary to . . . the conventional wisdom about Latin America, competitive elections have enhanced, rather than undermined, the capacity of political leaders to address outstanding problems of macroeconomic management." Similarly, Marc Lindenberg (**The Human Development Race**, 1993) found that democratic regimes, or authoritarian regimes providing some space for civil society to function, had a better record in improving social development indicators than totalitarian states or authoritarian regimes that provided little space for civil society. These are encouraging results for those who believe that democracy is an important component of sustainable development.