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## SOCIAL SECTOR INVESTMENT AND SOCIAL EQUITY

by

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# SOCIAL SECTOR INVESTMENT AND SOCIAL EQUITY


## SUMMARY

**This concept paper considers how donor-funded social sector investment can be best structured to maximize impact on poverty reduction and social equity in Latin America. A case is made that social sector projects are unlikely to achieve their desired impact if they are not preceded and accompanied by policy improvements related to public sector allocation of resources, strengthening of the institutional setting, and greater efficiency and targeting in the delivery of services.**


## I. THE SETTING

The eighties were devastating years for Latin America. In the early part of the decade, the region lost approximately 10 percent of its per capita GDP due to adverse commodity prices, the debt crisis, and inappropriate domestic policies. Stabilization programs to rein in demand and bring down inflation also constrained income growth in the short run. Public sector austerity reduced the proportion of GDP spent on social programs, primarily through reductions in the real wage of public sector employees, postponement of investment and curtailment of nonsalary expenditures.

Most Latin American countries have begun to emerge from recession. This progress is in no small part due to their commitment to stabilization programs, and to improvements in economic efficiency resulting from adoption of structural adjustment measures such as privatization, trade reform and financial sector liberalization. That we are no longer debating whether the Latin American economies should liberalize trade or privatize public enterprises is a tribute to the region's broad endorsement that sound economic policy is fundamental to growth and development. The debate of the nineties goes to a more basic question: what can be done to reduce poverty and income disparities in Latin America?

Latin America is not the poorest region of the world, but it is characterized by a relatively unequal distribution of income. This characteristic has complicated the design of strategies to reduce poverty in the region. The reasons for such wide income disparities in Latin America are not perfectly understood.

Income distribution reflects, among other factors, individual endowments of physical and human capital and land, public sector tax and expenditure policies, the legacies of the colonial period, and the dynamics of the political system.

Public policy (along with endowments, most of which arguably are products of past public policy) is a strong influence on income distribution. For this reason, investing toward sustainable development in a given country without seeking policy change to promote equity is analogous to pouring water into a bathtub that is tilted. No matter how much water flows in, no matter which spigot is used, no matter how many leaky spots you plug, the water will always collect in one end. In this regard, a strategy for poverty reduction must not limit itself to looking for new spigots or additional sources of water. Rather, the strategy must at the same time seek to "retilt the bathtub" so that the benefits of growth and social expenditures flow to the neediest groups. Changing public policy is the key.

## II. POVERTY, INCOME AND SOCIAL SERVICES

The pervasiveness of poverty and the wide disparities in income in Latin America have long troubled those who live and work in the region. The decline in national income that occurred in the early eighties increased the proportion of the population whose income did not cover basic needs.

National governments are pursuing poverty reduction along two parallel tracks. The first track recognizes that the economic reforms now being implemented hold many of the keys to expanding incomes for the poor, especially over the long term. It remains true that economic growth is the most direct and effective way to raise people out of poverty. Sound economic management makes the local business environment more attractive for savings, investment and entrepreneurial risk-taking. Hence, policy reform offers great potential for job creation and expanded incomes for lower-income households. Moreover, in Latin America structural reforms have tended to shift incentives toward greater use of labor. Since the major asset of the poor is their contribution to the work force, such policy reforms are a step not only toward growth, but also toward greater equity.

The second track, which complements the first, notes that increases in household income alone (for example, by mobilizing national resources more efficiently and creating jobs) do not constitute a "full-court press" against poverty. Not only do poor households need more income, but their quality of life also depends on access to what, for lack of a better term, may be called **social services** that enhance both well-being and productivity in the work force.

Exactly what to include in the category called "social services" defies precise definition. Most authors define by example; education, health, family planning and sanitation seem to make everyone's list, while other areas such as modernizing the state, rural development and housing are less universally agreed upon. Social services might be considered to be those interventions which benefit the household in ways other than immediate income.

Reform efforts to date in Latin America have emphasized renewed economic growth. Reform has been characterized by a shared set of objectives; these include increased competition and reliance on markets, reduction and better targeting of subsidies, realignment of the role of the state within the economy, more emphasis on accountability within public finance, and greater encouragement of innovation and technological advancement. Applying the same objectives to social sector policy and expenditures would contribute to greater social equity and better use of scarce financial resources. Unfortunately, however, these reform objectives have not been extensively pursued in the social sectors.

The reasons for this are many. It was widely believed that "efficiency improvements would come naturally" as budget cuts were engineered. This belief in retrospect was probably misplaced. The technical demands of implementing reform forced governments to prioritize -- benign neglect of social sector reform issues seemed less costly in the near term than postponing measures aimed at reactivating economic growth. The political constraints to action in social sectors tend to be larger (consider the potential controversy raised by changing the Central Bank's approach to open market operations as opposed to changing the administration of primary schools or hospitals). Whatever the explanation, in most countries the sweep of reform has hardly reached social service delivery systems. Perhaps the more valid criticism of structural adjustment is not that it has hurt the poor, but rather that the social sectors were left out.

## III. CONSTRAINTS TO SOCIAL SERVICE DELIVERY

Achieving efficient and well-targeted social service delivery is enormously complicated. The most fundamental constraint in developing countries is the resource gap -- a problem made more acute due to the recent imperative for austerity. There are additional problems, however, that cause the scarce resources (local and foreign) mobilized by the Latin American countries to be inefficiently used or regressively allocated among the population.

Practitioners who work in Latin America note a long list of obstacles (books could be written about any one of these, so the reader is asked to pardon both the brevity and generalization which follow) to better social service delivery, the most important of which are:

- **Institutional Weakness:** Social sector ministries tend to be the least modern and the weakest politically. They often have antiquated and inefficient management, budgetary and project implementation systems. These problems impede rational allocation and coordination of resources, made all the more difficult because the social ministries tend to operate programs and execute investments throughout the country.

- **Excessive Centralization:** Social service delivery systems tend to be self-contained and typically have had little incentive to respond to the demands of user groups or the public at large. Part of the problem relates to the strong role taken by Latin American central governments in the social sectors, both in financing and managing social service delivery -- a reflection of past belief that a strong central government needed to serve as the motor of growth in a developing country. There is little tradition in most Latin American countries of using the private sector and PVOs as mechanisms for social service delivery. Moreover, municipal and provincial governments are usually weak and lack authority to raise significant amounts of their own revenues.

- **Lack of Responsiveness:** There are no well-formed "outside" constituencies demanding access to quality social services. For example, while teachers' and medical professions' unions (examples of "inside" constituencies) are able to mobilize effectively and lobby their concerns before the government, parents and patients generally are not organized to press their demands. Part of the problem lies in the centralization of service delivery. If powerful interest groups are centered in the capital, those without access (who tend to be geographically dispersed) have difficulty in making their demands forcefully known. The private sector has not lobbied government for better basic education, health care and governance, despite their importance to productivity. Finally, there is no strong tradition of citizen participation in, and organization of, voluntary civic organizations.

- **Inadequate National Budget System:** Most Latin American countries have weak national budgetary systems. Even when the government in power has a strong vision for social development, national leaders have found it difficult to translate this vision into budget priorities and programs on the ground. Examples of specific weaknesses that occur at the national (rather than ministry) level are arbitrary decisions (rather than analysis) mediating between budget requests from individual ministries and the consolidated national budget, inadequate systems of revenue projections (and in some countries, inadequate revenue raising), onerous procedures for transferring financial resources from the central treasury to ministries, complex procurement and contracting rules, and budgetary rigidities such as constitutional earmarks and the inability to borrow short term during seasonal lows in revenue collection.

How do these weaknesses conspire to deny many of Latin America's poor access to basic social services? The following sections elaborate examples to illustrate the dynamics and complexity of the obstacles to greater equity in social service delivery. Two examples are public university education and community-based water supply systems. A third example relates to the psychology of donors, which also may impede achievement of social equity concerns.

## IV. Examples of Social Service Delivery Constrained by Inappropriate Policy

**University education** is the most commonly cited example of poor resource allocation in Latin American countries. Typically, the national university is free or inexpensive (and open to all secondary graduates). Secondary education is not universally available, on the other hand, and both primary and secondary schooling suffer quality deficiencies due to inadequate funding for books and other inputs. Because of weaknesses in the primary and secondary education systems, few students make it through to the university level. Those who do tend to be from wealthier families -- with the result that free tuition subsidizes groups within the country who could afford to pay part or all of the cost of a university education.

Moreover, this resource allocation choice usually has been codified, institutionalized and politicized. The proportion of the budget devoted to the national university in some countries is written into the constitution. University students and faculty are a potent political force that can effectively lobby for their share of the national budget. And the national university is a source of national technology, an opinion leader, and a symbol of national pride.

This presents a problem if a donor agency is asked to provide funding for primary education. What if a country has chronically failed to finance the recurrent costs of primary education, and at the same time devotes increasingly more of its scarce resources to university education? Should a donor identify basic education as an area into which its resources should be programmed? Or does providing financial support for primary schools merely facilitate a lack of commitment that contributes to inequity?

It is instructive to consider how the pattern of resource allocation in the education sector has evolved in some countries. Funding a public university is a reasonable policy choice for all but perhaps the very smallest and lowest-income countries. How this national choice was executed has resulted in some probably unintended outcomes.

Typically, Latin American countries have funded one large campus in the national capital, with branches or secondary campuses in other major cities. In larger countries, there are provincial public universities as well. Tuition is low or nonexistent, to encourage enrollment and human capital deepening. Labor market rigidities (e.g., minimum wage laws) contribute to relatively high rates of youth unemployment.

Moreover, the nature of the secondary school curriculum (which tends to neglect vocational education, scientific disciplines and technological applications) also limits options for secondary school leavers. The ability to live at home (or with relatives) makes attending the university affordable to a broad spectrum of the secondary school graduate population. The absence of entrance standards, and the ability to maintain matriculation even if the student has difficulty passing courses (a policy that ironically was adopted for equity purposes) assures a large population of university students.

This set of policies may have made it easy for Latin American public universities, particularly in the smaller countries, to evolve into strong centers of political power. The capture of a large population of 18 to 25 year-olds (who, like the American Association of Retired Persons in the United States, have very focused political concerns and the spare time to pursue them) in the capital and major cities has -- no surprise here -- enabled public universities to demand and receive a disproportionate share of the national education budget.

For donors (and national governments) interested in retilting the balance toward basic education, policy measures may help. In addition to asking for commitment that countries devote adequate resources for basic education, other policy changes can help free up resources now allocated to the university:

(1) Providing more and better options for secondary school leavers. These might include making labor laws more flexible so that firms have more incentive to hire inexperienced young workers, and looking at reform of the secondary school curriculum.

(2) Introducing income-based fees at public universities and a student loan program for individuals without sufficient income.

(3) Encouraging establishment of private universities, and offering public funds for student loans and scholarships for qualifying students who cannot afford private university tuition.

(4) Introducing minimum standards in public universities aimed at reducing course repetition, "seventh-year seniors" and other inefficiencies.

(5) Using social marketing to make the public aware of the trade-offs between devoting a major portion of education resources to the national university, and other options.

It would not be realistic to condition provision of a loan for basic education on, for example, elimination of the constitutional earmark for the national university. It **would** be feasible to discuss commitment to basic education with host country governments, and ask for indications that expenditures in this area are a priority. Commitment to measures that guide resources out of university subsidies as listed above would also be appropriate for discussion. Such measures may be a worthy complement to reform efforts in basic education, when the drain of an over-financed public university is an impediment to improving basic education. The important point is that allocation of resources within the sector should be looked at as a whole.

**Rural Water Systems** have tended to suffer neglect from national governments, which have focused scarce resources on urban infrastructure. Donors and private voluntary organizations have commonly augmented national spending on rural water systems, relying on community involvement to defray investment costs and assure future maintenance. Typically, local communities have been mobilized to provide labor during the construction phase, and to supply labor and sometimes a monetary assessment to maintain simple gravity or pump water systems. Such programs have been viewed as models of "successful" sustainable development, and indeed represent a practical approach to using scarce donor resources in a way that brings tangible benefits and decision power to poor communities.

Nonetheless, some social equity questions can be raised when these kinds of programs are considered within the context of the overall system. Community residents are in essence being taxed twice to have access to safe water. They are taxed once by a national budgetary system that provides them with no service. (In fact, in countries where most revenues come from taxes on commodities rather than income, the poor may pay a disproportionate share of the tax burden.) They are then taxed again as a contribution to the community development program.

Meanwhile, back in the capital, public revenues are transferred to the water utility's capital budget to finance renovation of the pumping station that serves the middle-class part of town. The water utility relies on the central government for capital expenditures, as its rate structure and faulty metering system do not generate sufficient income.

The policy recommendations appropriate to this example, if our interest is in retilting resource allocation toward poor communities, would center on charging appropriate fees to urban water customers and on integrating the community-based water system programs into the national resource allocation process. Some possible policy changes might be:

(1) Acknowledge the success of the PVO programs, and find a mechanism to channel national budgetary resources into such programs (rather than having the Ministry of Works try to implement such programs itself). In many Latin American countries, there is no tradition of providing government matching grants to PVOs or of using PVOs or the private sector as contracted service providers.

(2) Insist on cost recovery for middle- and upper-class water customers, and strengthen water metering. Cost recovery should aim to cover both operating and investment costs.

Analogous to the example of university education, it is difficult to assure that a donor's contribution to rural water system development is truly contributing to social equity without looking at the overall pattern of resource allocation. Donors should look at how funds are raised and spent within the sector, and if the system tends to ignore or excessively charge lower-income customers, programs should seek commitment to more equitable burden-sharing.

**Donor Psychology** influences how resources are allocated by Latin American governments, especially those which still rely on bilateral aid agencies and multilateral lenders for much of their public sector investment finance. Donor countries provide funds to developing countries for a variety of reasons, but the political acceptance of foreign assistance by the tax-paying public depends in large part on perception that funds improve the well-being of the poor. Hence, donors choose to assist developing countries with their resource constraint by financing those projects that provide direct benefits to identifiable groups of poor people. Multilateral lenders, who receive resources from and respond to the interests of member countries, feel somewhat the same pressure.

As a result, in many countries in Latin America, any investment activity directed at social service provision to poor populations is likely to be funded with external resources, and any activity related to some other objective is likely to be funded with domestic resources. While this situation is not bad in itself, it does raise some questions.

- Has a culture been created that social service delivery to the poor is the responsibility of international development agencies?

- Are donors being short-sighted in preferring projects that provide direct benefits to identifiable target groups, if in so doing opportunities are missed to assist Latin American countries improve efficiency, change resource allocation policies, and strengthen management of public sector expenditures and revenue raising? Often there is pressure to avoid policy lending and public administration projects because the money "goes to a bloated bureaucracy" and "doesn't help people." How can donors sell this type of activity to skeptical taxpayers who must provide the funding for foreign assistance programs?

- Why are recipient countries so often unable to finance the recurrent costs of priority investments? How can donors determine if inability to meet recurrent costs stems from the financial constraints that Latin American countries face or from possible lack of commitment that results in such costs being seen as low priority?

- Given that externally-financed projects impose their own procurement, contracting and other norms, do externally financed projects prepare countries to assume more of the burden of social service delivery as their financial capacity expands?

- And finally, do donor contributions to social investment supplement host country financing, or do they substitute for national funds, and permit the budget to be expanded elsewhere?

Such questions are enormously difficult to answer. A better understanding of these issues, however, is possible if project proposals are considered within a broader context of the overall priorities of the recipient country's budget. Donors should look for commitment to efficiency, equitable allocation of national resources, and attention to disadvantaged groups as a condition for financing any project, so that our contributions to social investments can help create an overall public expenditure pattern more conducive to equity.

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There is no doubt that incorporating a broader notion of how projects contribute to poverty reduction and equity is a complex undertaking. It is challenging enough to design and implement a project that works. Further burdening the process with the analysis and policy discussion that this strategy suggests represents a sacrifice. **Nevertheless, our foreign assistance monies may not fully contribute to a better distribution of income and opportunity in Latin America, if we do not take a broader view of how projects fit into the overall pattern of resource allocation.**

## V. Elements of a Strategy for Social Investment

Several recent developments in the foreign assistance business suggest a growing awareness of the need to look broadly at social service delivery.

- Both bilateral and multilateral agencies have begun to look at the proportion of national budgets spent on military expenditures, and are raising the issue with countries where the military budget crowds out social expenditures.

- The World Bank has initiated Poverty Assessments for some Latin American countries, which will look at how conducive the overall policy climate is to addressing poverty.

- The concept of policy dialogue, once reserved for policy-based cash transfers, is now more commonly extended into issues of social sector public finance, budget reform and related questions. There is some concern that this development might "overload the system" by putting too many conditions on aid. Nonetheless, without national commitment to change policy, it may be difficult to assure that project finance contributes to social equity.

There are other approaches that might be tried. Greater use of program rather than project loans in social sectors, or hybrids (a mix of program and project money) might enable international development agencies to help Latin American countries undertake reforms and meet the short-term recurrent costs of a deeper emphasis on social service delivery. Better use of the country programming process to focus attention on policy issues is also warranted. An additional tool is withholding project finance in countries where the public policy is clearly tilted away from the needs of the poor, and where there is no commitment to change. In such circumstances, social sector projects achieve little.

This paper hardly scratches the surface of a very complex topic. The stylized examples given may not fit all Latin American countries, nor may the solutions proposed be feasible in all settings. The essential point is that the most important element in a strategy to reduce poverty and achieve greater equity in Latin America is national commitment.

The democratic governments in the region have voiced concern about political instability arising from frustration among lower income groups. National commitment to poverty reduction and social equity in the region may well be gaining momentum.

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