Economists' Training Workshop

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Acknowledgement

The 1995 Economists' Training Workshop brought together over 100 USAID economists and others to help update their knowledge on the current thinking and trends in development economics, and to explore the uses of new analytical tools to analyze economic growth issues and poverty-reduction measures in developing and transition countries. The Office of Economic and Institutional Reform of USAID's Economic Growth Center is especially appreciative of the efforts of three colleagues, Janet Ballantyne, Senior Deputy Assistant to the Administrator, Office of Policy and Program Coordination; Ann Van Dusen, Deputy Assistant Administrator of the Global Bureau, and John Wilkinson, Associate Assistant Administrator of the Economic Growth Center, for making the workshop possible.

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Chapter 1
Policy, Growth and Poverty
The Economists Training Workshop
Introduction and Summary

The Office of Economic and Institutional Reform of USAID's Economic Growth Center, Bureau for Global Programs, Field Support and Research (G/EG/EIR) sponsored the worldwide Economists' Training Workshop in Annapolis, Maryland on September 13-15, 1995. The workshop brought together over 100 participants, including USAID economists; USAID officers in other technical areas such as agribusiness, private sector development, general development, and program and project development; developing and transition country economists; and leading economists from the U.S. academic and private sectors.

This report documents the important ideas presented at the workshop. It includes written summations of the speakers' remarks (Part I) and selected papers (Part II). G/EG/EIR is distributing the report to inform invitees unable to attend, and to provide a reference source that USAID economists and their counterparts will find helpful in promoting economic policy reform.

Workshop goals were to:

- update USAID economists and their host-country counterparts on current thinking and current trends in each of the subject areas on the agenda;
- explore the uses of economists' conceptual and analytical tools to analyze growth issues and poverty-reduction measures in developing countries;
- increase the options for year-around on-going communication among USAID economists and their counterparts about the use of economic concepts and analysis to assist policy reform and to attack other development problems in host countries; and
- document and disseminate workshop findings to USAID economists and their counterparts, including those of both groups unable to attend.

Part I summarizes the presentations much in the order the subject areas appeared on the agenda. G/EG/EIR chose agenda topics on the basis of its perception of the critical issues facing USAID economists, taking into account expressions of interests of USAID economists in the field to assure the workshop responded to their needs. This approach produced an agenda reflecting a wide range of topics across several sectors.

Having completed 50 years of experience in economic development in the post World War II world, the workshop offered a combination of retrospective views on the evolution of thinking on economic development and foreign assistance over the period, and current issues and concepts that are influential in understanding economic development. Topics addressing the issues and concepts were categorized broadly under three majr subject areas:

- Poverty and Economic Growth;
- Reforming the State and Transitioning to a Competitive Economy; and
- Economic Policy Reform in Post-War and Transition Economies.

Part II of the report includes selected papers prepared in conjunction with the workshop. A bibliography is also included which lists helpful references. The following paragraphs highlight several of the key ideas presented.

Evolution of Economic Development Thinking and Foreign Assistance

Several participants discussed new ideas in the theory and practice of economic development, what economists have to say about economic growth, poverty and policy reform, and USAID's experiences with economic policy reform. These presentations and discussions began with a review of the 1960s characterized by strong USAID leadership in inducing several countries to undertake economic reforms, encouraging them to adopt "self-help measures" to increase savings and foreign exchange earnings.

The 1970s witnessed "New Directions" that stressed policies and programs aimed at satisfying basic human needs. Economic assistance was targeted directly to the poor to inoculate children, distribute oral rehydration materials, provide disaster relief, etc. Food production and food security received strong emphasis in response to the world food crisis of 1972-74.

The 1980s saw more attention being given to macroeconomic stability, this being prompted by several dramatic economic developments in the 1970s; namely, the rise in petroleum prices, growing external debt and balance of payments crises which prompted more attention to macroeconomic stability in the 1980s. The prescription for economic policy reform included macroeconomic stability and structural adjustment, the promotion of exports, the deregulation of markets, the reduction in the size of government, and the promotion of private sector activity.

In the more recent years of the post World War II period, we have seen an evolution towards acceptance of the central role of markets in economic development, and subsequent reform programs in trade, privatization and financial markets. New theoretical concepts appeared such as the application of asymmetric information to factor markets to explain the rationale for unanticipated behavior of prices in labor and credit markets. Other ideas gaining prominence included property rights, the informal sector, macro-economic management in an open economy, the monetary approach to the balance of payments, and international financial markets.

As development economists contemplate strategic approaches for the 1990s, there is general agreement that some degree of macroeconomic stability is essential for economic development, that severe price distortions are costly, that viable markets are essential, and that more attention needs to be paid to gender issues and environmental sustainability. Questions that USAID economists will likely continue to address in the 1990s include: What are the political conditions for reform? How do we measure the capacity of government to undertake reform? And what choice should be made between shock treatment and gradualism?

Poverty and Economic Growth

Massive reductions in poverty have always been a major goal of economic development, and economic growth is by far the most powerful mechanism to achieve poverty reduction on a large scale.

Achieving poverty-reducing growth is the principal aim of economic reform. However many have questioned whether the emphasis on structural adjustment and policy reform has not diminished interest in reducing poverty. It was therefore the first and foremost subject area on the workshop agenda. Development professionals in the eighties have emphasized the importance for economic growth of policy reform in trade, labor markets, and financial markets. Presenters were asked to discuss linkages between each of these markets and poverty reduction, and to discuss advances in poverty measurements that facilitate making cross-country comparisons.

With respect to poverty measures, the presenters discussed the kinds of indicators that are useful in assessing the socio-economic situation in a country, while recognizing the many issues involved in measuring poverty. The conceptual issues are not new but there has been increased focus on the robustness of results and the sensitivity of measures to alternative formulations. The presenters discussed the kinds of analyses that are most useful for assessing the impacts of policy on poverty reduction.

Regarding labor markets, two topics were discussed: employment generating policies and factors influencing a person's decision to invest in human capital. The session cautioned that basic labor market institutions - minimum wages, trade unions, public sector pay policy, high wage rates required of multinational corporations by host country governments, and labor codes - are well-meaning but can sometimes produce adverse employment, income, and efficiency effects. Empirical evidence suggests that labor can benefit from today's global economy, despite intense competition from labor surplus countries that do not set minimum wage standards.

Turning to capital markets, the participants recognized that the empirical literature on financial sector reform and poverty reduction is scarce. However much of what exists points to favorable effects on poverty. (Fry 1995). One presenter argued that developing countries depend more on securities markets for investment financing than OECD corporations, and that stock market development is positively related to economic growth and poverty reduction.

Trade liberalization is usually at the top of the economists' list of structural reforms to foster economic growth. However, it is less enthusiastically welcomed by its' critics because of the risks associated with the possible loss of jobs and domestic production. The presenters were asked to discuss the impact of trade on poverty reduction and alternative views arguing that free trade does not necessarily reduce poverty.

Reforming the State and Transitioning to a Competitive Economy

The second major theme that permeates development economics is structural economic reform, which in practice often leads to a discussion of reform of the state, and transition to a competitive economy. Both issues have widespread implications for practitioners in developing and transition economies. For this reason the second day of presentations focussed on this topic.

Many countries have embarked on the restructuring of their economies, whether through stabilization and structural adjustment programs with the IFIs or on their own, only to face new sets of problems posed by the restructuring. Fiscal reform, integral to stabilization programs, usually implies the restructuring of budget allocations, and re-thinking about which government services will be delivered to whom and how. Everyone favors the government providing health, education, safety nets, unemployment benefits, welfare, and pension benefits to improve the human capital of the poor. But when revenues are not sufficient to pay for the services, adjustments have to be made. One approach is to consider when and how the private sector can provide some of these services, and when is it essential for the government to retain its primary role. Reform of government's delivery of social sector services, and the extent to which the private market can shoulder some of the responsibility, underlies the presentations on health, social safety nets, governance, and measuring effectiveness between sector activities.

Spending more on social services doesn't necessarily increase the human capital of the poor. A number of countries with a high share of government spending for social sectors have provided low quality social sector services to the poor. Re-orienting spending and allowing the private sector to provide services for which there is a middle income market can greatly improve the efficiency and effectiveness of services.

The sessions on the health sector cautioned that efficiency and equity problems can result if the sector does not possess the characteristics of a competitive market. Two constraints to be wary of are (1) imperfect information which can lead to escalating costs and inappropriate incentives, and (2) market power captured by groups that can practice price discrimination and limit the availability of health care services. A strategy that calls for shifting the financing of health care from the government to households, as is being done in Indonesia, eliminates the need for non-sustainable subsidies and makes funding available for the very poor.

In introducing the discussion of social safety net activities, it was argued that despite the debate about reform being bad for the poor, non-reform is worse for the poor. If a system of social safety nets is implemented well and if it is linked to broader economic and sectoral reforms, it can have a positive effect on poverty reduction and can help sustain economic reforms until longer-term growth sets in.

Another important dimension of reforming the state is the assignment of fiscal responsibilities at the various levels of government for providing social services. In many cases, the provision of social services is overly centralized, and efficiency could be greatly improved if service delivery was closer to the customer. For this reason decentralization was discussed as an approach to improved service delivery and governance. Participants considered the role of inter-governmental finance, fiscal federalism and local government as a means of improving fiscal performance and promoting participatory development. Key features of a decentralized fiscal system were recognized.

Reform of the state is not complete without the complementary development of a competitive private sector functioning as the producer of most goods and services. The public sector is still a major producer of goods and services in many countries although the private sector could often produce them more efficiently. Successful privatization rests on a market incentive structure based on full information, free entry and exit, and an enabling environment that promotes private property, rewards risk and honors contracts. Presenters discussed a number of issues on how one initiates, recognizes, and measures competitive markets, and what we know about corruption and economic growth in building competitive markets.

The public sector's involvement in the production of some services plays a major role in competitiveness (or lack of) in the private sector. Examples are electricity, ports, and telecommunications. Inefficiency in the public sector represents a major constraint to growth. In some cases the state can not manage the company efficiently to bring a high enough level of services at competitive prices, and they don't have funds for investments required to update the firm. In other cases, the state needs the revenues from the sale of the company to improve the fiscal balance. Rethinking which services and how they are provided is a key element in reforming the state.

Looking to country experiences on ways to create a competitive economy, the workshop drew lessons from USAID efforts in East and Southern Africa and from Mongolia. USAID private sector activities in East and Southern Africa offer some insights into the constraints and possible solutions. The presenter identified three main barriers to private sector growth in the region: (1) a lack of entrepreneurship, (2) a perception of a lack of credit, and (3) government policy permitting excessive government involvement in private sector activity. Turning to the Mongolian experience, participants examined how a government, with the aid of long-term advisors, approaches the drafting and implementation of anti-trust law, an essential component of a competitive economy.

Efforts to reform the state must also take into account measures to counter corruption, a problem often identified with the "incentive" structures of former command economies. Corruption was explained in the workshop not by differences among countries in morality, but by the lack of private sector incentives for law-abiding behavior. Richer countries tend to provide incentives in the form of laws to promote competition and protect property rights, whereas poorer countries use price and quantity controls which create opportunities for rent-seeking.

Reforming the state entails decision-making on the allocation of resources among competing sectors in the economy. Workshop presenters were asked to address the issue of measuring the effectiveness of programs between sectors to better inform this decision-making. Participants agreed that measuring the cost-effectiveness of USAID activities in one sector relative to others in the same country is difficult, and that USAID lacks good tools to assess the trade-offs between sectors. One presenter described the usefulness of contingent valuation, a technique that relies on surveys to estimate the value of non-market goods and services. Cost-benefit methods can then be used to measure trade-offs between the provision of these and other goods and services.

Economic Reform in Post-War and Transition Economies

The third theme prevalent in the development profession today is economic reform in transition countries. USAID is increasingly involved in countries that differ dramatically from the traditional profile of developing countries; namely, the former Soviet Union and East and Central Europe; former satellites of the Soviet Union; war-torn countries; and middle-income countries.

Some people have difficulty referring to countries outside of the former Soviet Union and East and Central Europe as *transition* economies. Yet several developing countries face many transition economy issues that offer lessons for the former Soviet Union and East and Central European countries. For this reason, one should not lose sight of economic issues because of previous or existing political distinctions.

Post-conflict countries also deal with many of the issues confronting transition economies. Ironically many of these countries were "clients" of the two Cold War protagonists, and their conflict in some instances may be said to result from the withdrawal of their patrons.

These groups of countries challenge USAID economists to think in new ways about how to best respond to their needs. Some of the traditional ways of posing economic problems may not be as effective in the policy environment of transition and post-war economies. For example, asking whether privatization should be pushed now or later may miss the point. Waiting allows opposition to develop. Instead, one should proceed with privatization, paying particular attention to measures that help create positive economic activity and job growth at the level of the firm.

USAID's 1991 experience in establishing private banking in Nicaragua illustrates these points further. The Agency pushed for private banking in spite of other donors claims that the country was not ready. The lack of an adequate regulatory system was cited among other constraints. Nonetheless, the government pursued the reforms and this created pressure to establish the regulatory system as well as address other constraints. This would not have happened a year later owing to a deteriorating political climate.

The presentation summaries in Part I and the selected papers in Part II offer more detailed elaborations on the above themes and subject areas which USAID economists should find helpful in their on-going efforts to encourage the adoption of economic policies that promote economic growth and poverty reduction.

Elaine Grigsby
Forest Duncan

Chapter 2
Summary of Workshop Presentations

POLICY, GROWTH AND POVERTY: 40 YEARS OF THOUGHT AND EXPERIENCE

Presenters:

Lester Gordon
HIID

Michael Roemer
HIID

Gustav Ranis
Yale University

Michael Pillsbury
Atlantic Council

The presentations of Lester Gordon, Michael Pillsbury, Gustav Ranis, and Michael Roemer provided an overview of forty years of economists' thinking about the connections between economic policies, economic growth, and poverty reduction in LDCs. The four provided a similar overview of changes in the thinking and the role of USAID.

Commenting on the connection between economic growth and poverty reduction, Michael Roemer asserted:

> I confess to being astounded that we even have to debate the question of whether economic growth reduces poverty, but in fact this has been a contested issue since the beginning of development economics....Thirty years of development have taught us....The most important reason why people are poor is that they live in poor countries. Raising national income, whatever happens to income distribution, reduces poverty.... there are an increasing number of cases in which rapid income growth has reduced the incidence of poverty. My favorite is Indonesia, one of the world's largest and poorest countries in the 1970s, where income growth of 4 percent per capita has reduced the incidence of poverty from 60 percent to 15 percent of the population in 25 years.

Having agreed on this, the four speakers considered the changes since the 1950s in economists' views of the "need" for policy reform to achieve growth and the changes, since its origin, in USAID's role in policy reform.

Both Gordon and Roemer noted the policy areas that many development economists were inclined to ignore during particular time periods:

- During the 1950s and 1960s, most economists viewed capital accumulation and foreign exchange availability as the critical variables determining growth rates, with the latter determined by internal structural rigidities and world markets, with emphasis between the two varying within the profession. In the face of such barriers, prices were not thought to be a pivotal factor in the growth process.

- Concentrating on capital accumulation and the long view, many development economists were inclined, until well into the 1970s, to ignore the importance of the principal instruments of macroeconomic control, the money supply and the fiscal balance, as well as the exchange rate.
- Throughout the 1960s, economists assumed that growth would reduce poverty fairly regardless of government policies in education, health, licensing, property registration, tariffs and all the other areas of government intervention now stressed by economists as affecting the income achievements of the poor.
- Until the 1980s, economists usually assumed that externalities involving environmental damage during growth were either too unimportant to worry about or were, somehow, being offset.
- For decades, many economists assumed that wherever negative externalities or other market failures occurred, government interventions could be trusted to compensate.

Contrary to the conventional wisdom in the assumptions cited and in the interest of faster growth, USAID practitioners, the speakers noted, often engaged in reforms in the policy areas described as neglected in theory. Gordon cited the USAID mission that took Arnold Harberger to Chile in the early sixties to promote stabilization reforms. Pillsbury cited the deep involvement of USAID staff in the policy and institutional reforms that brought rapid growth to Taiwan and Korea.

As a member of the Task Force on Foreign Aid that designed the new Agency in 1961, Gordon recalled the six "self-help" measures the Kennedy Administration specified as evidence that a nation deserved U.S. economic assistance:

- policies supporting export diversification and expansion,
- realistic exchange rates,
- elimination of subsidies and price controls,
- reform of public "enterprises,"
- appropriate tax reforms, and
- policies fostering private savings, innovation, and enterprise.

From these origins of USAID policy activism and of academicians' theoretical neglect, the speakers traced the evolution of economic theory and fashion and of USAID practice over the following 30 years.

The 1960s: The Golden Age of Economic Reform

Michael Pillsbury referred to the 1960s as the "golden age of economic reform." During this period, USAID demonstrated strong leadership in inducing a number of countries to reform economic policies. This accomplishment occurred, despite the neglect of many economic policies in most contemporary growth theories, because USAID's founders defined self-help as a policy environment nourishing free markets and private enterprise.

Referring to USAID's origins, both Gordon and Roemer emphasized the importance of the thinking of such scholars as Max Millikan and Walter Rostow who viewed the rate of economic growth as a function of the savings rate and the inflow of foreign exchange. In giving USAID the rule of helping only those helping themselves, they saw the connection between their five self-help criteria and the savings rate and ability to export.

In that decade, USAID policy assumed that growth would assure equitable poverty reduction. Simon Kuznets and W. Arthur Lewis had led growth practitioners to expect growth to bring, first, increased income inequality and, later, less inequality. The system would "naturally" be fair in the long run. Poverty, therefore, was not a separate item on the USAID agenda.

In economic theory, the "structuralists" were prominent at that time. Paul Rosenstein-

Rodan, Albert Hirschman and others argued for increased government interventions to offset LDC market failures and direct resources to accelerate growth. This view called for more government economic planning and public investment. While the World Bank seems to have been strongly influenced by that view, USAID took a more policy-oriented approach, which closely resembled many of the reforms being advocated today.

Pillsbury argued that USAID successes during this period were primarily due to interventions designed and undertaken by field Mission staff. He reported on five of these cases from the 1960s:

- USAID's participation in the Taiwanese policy changes that reined in the parastatals, nourished a growing private sector, and facilitated exporting.
- USAID participation in designing and implementing policy and institutional changes facilitating the success of Korean exporters.
- USAID's analysis of the agricultural sector's needs that supported PL-480 conditionality that led the Indian government to allow private investment in fertilizer production and to decrease the overvaluation of the rupee.
- USAID's informal but effective alliance supporting the policy reform initiatives of the Indonesian economists known as the Berkeley mafia.
- USAID financing and technical assistance for creation of the Dominican Republic's first investment- and employment-friendly free trade zone, now expanded to 15 FTZs supporting some one-fifth of the nation's families.

Despite these successes, there were a number of problems that emerged by the end of the 1960s. First, USAID's emphasis on conditional assistance to "good performers" became overshadowed by the political imperatives of the Cold War. This ultimately led to aid sometimes being provided to political allies regardless of their economic performance. USAID's extensive involvement in Vietnam is a good example of how this damaged USAID's reputation.

Second, U.S. foreign assistance was perceived to have failed to adequately address the problems of the poor. Gordon pointed to the fact that, for example, the only self-help measure advocated by USAID in the 1960s that would have had a significant impact on poverty directly was land reform. While land reform was an important component of Kennedy's Alliance for Progress in Latin America, however, it came slowly and its benefits were difficult to measure. Ultimately, a Democratic Congress passed the "New Directions" mandate to aid the poor in 1971. This ushered in a new era in U.S. assistance characterized to a large extent by greater congressional oversight in USAID programming.

The 1970s: The Golden Age of Basic Human Needs

The New Directions mandate emphasized measures designed to deal with basic human needs such as inoculating children, distributing oral rehydration materials and providing disaster relief. It also placed more emphasis on food production and assuring food security, especially after the world food crisis of 1972-74. In short, it made an effort to target aid directly to the poor.

In 1973, Robert McNamara delivered a speech in Nairobi which emphasized the need to deal more effectively with the poorest 40 percent of the world's population. Thereafter, the World Bank began to combine investment in agriculture with an effort to satisfy basic human needs through its integrated rural development (IRD) projects. Yet reaching the poor directly turned out to be more difficult than anyone realized. Targeted programs and IRD projects proved to be very intensive in management and administrative skills — both scarce in developing countries — and difficulties in paying their recurrent costs led to the collapse of these programs and projects once donor support was removed. That many of the benefits of these programs went to the non-poor also revealed the considerable inefficiency with which they were administered. Finally, Hollis Chenery and others demonstrated that poverty reduction would be greatly affected by who owned how much land and by the effectiveness and extent of publicly provided elementary education.

With this experience, economists made substantial advances in their understanding of the process of economic development. Roemer pointed to many of these. First, the dissenters from the structural approach to development, such as Theodore Schultz, demonstrated the effectiveness of Third World markets by documenting the rationality of small farmers in the face of market incentives. Schultz also emphasized the importance of human as well as physical capital and so complemented the research of Robert Solow who showed the importance of "the residual" in explaining economic growth.

Second, trade economists such as Anne Krueger, Ian Little, Tibor Schitovsky and Maurice Scott began to demonstrate the high costs imposed by import substitution as a strategy for economic growth, a strategy that had been pursued by many countries during the 1950s and 1960s.

Finally, Joseph Stiglitz showed how factor market distortions could be explained by such practices as the "efficiency wage," paid by employers to provide them with labor pools from which they could "cream" the better qualified. Later, Stiglitz applied the concept of "asymmetric information" that was behind the efficiency wage to explain why bankers would keep lending rates below market-clearing levels.

The 1980s: A Decade of Economic Reform

With the economic shocks that shook the economies of the world following the rise of petroleum prices in 1973, economists began to pay much more attention to macroeconomic stability as a prerequisite for economic growth. The external debt and balance of payments crises provoked by these shocks and by the subsequent increase in foreign borrowing by LDCs during the 1970s resulted in many of these countries seeking financial assistance from the major donors, principally from the IMF and the World Bank. While this assistance was forthcoming, it came with strings attached in the form of conditionality.

Thus the 1980s witnessed a return to the pattern of program lending based on conditionality that had originated in the 1960s. Yet, by the early 1980s, economists understood much more about the process of economic development than they had at the beginning of the 1960s. Armed with the benefit of more than two decades of empirical research as well as the evidence from East Asia's success stories, their prescription for economic policy reform could be much more clearly formulated:

- Promotion of exports through devaluation, the establishment of more flexible exchange rates, the dismantling of quantitative restrictions on imports, the lowering and harmonization of import tariffs, the reduction in or elimination of taxes on exports, and the establishment of preferential regimes regarding credit, taxation of imported inputs, etc.
- Macroeconomic stability through a reduction in government expenditures, tax reform, and monetary restraint.
- Deregulation of markets for goods, labor, and capital and the elimination of subsidies in these markets.
- Reduction in the size of government and parastatals and promotion of private sector activity.

Despite a more sophisticated substantiation of the reforms considered necessary for economic growth, the implementation of such reforms has not gone uncriticized. Gordon noted that structural adjustment has been attacked on the grounds that it hurts the poor and undermines the natural environment. Programs of economic stabilization and structural adjustment have also been criticized for being too short-term in nature.

What does the record show? Gordon noted that economic growth and structural adjustment have occurred more rapidly in the developing countries during the 1960s and 1970s than they did in the industrial countries at any stage of their history. The 1980s did not reverse this trend, although the decade did see wide regional variations — Latin America and especially Africa did much more poorly than the rest of the developing world. Nevertheless, Elliott Berg argued that the quality of life even in these areas has improved. He cites three findings:

- The data on life expectancy, infant mortality, school enrollment, literacy rates, and other variables do not show a general decline in living conditions.
- The evidence shows that, in general, the poor do not fare worse in adjusting countries than they do in non-adjusting countries.
- There is no evidence that the burden of adjustment has fallen disproportionately on the poor within individual countries.

Yet there remains concern that adjusting countries have not implemented an adequate system of safety nets to protect the poorest of the poor and that, in many African countries, the safety nets that have been implemented have not achieved their objectives.

Lessons for the 1990s

What are the lessons for the 1990s? There is general agreement that some degree of macroeconomic stability is essential for economic development. It is also widely accepted that severe price distortions are costly in terms of reduced efficiency, lost consumer welfare and wasteful, rent-seeking behavior. There is also little argument, given the collapse of communism, that viable markets are essential. Most people also agree that more attention needs to be paid to gender issues and environmental sustainability. Beyond this, there is less agreement.

Lester Gordon observed that while we now know what policies are necessary for economic growth, we do not necessarily know how best to implement them. For example, Gus Ranis cited the distinction between export substitution and export promotion. Should developing countries emulate Latin America, which has put more emphasis on subsidizing exports, or Asia, which has emphasized reducing price distortions and expanding labor-intensive exports? Even in Asia, policies to protect the import-competing sector have been preserved by positively promoting exports through duty-free access to imported inputs, export processing zones, directed credit schemes, and other measures. So, one might ask, where and when should the government intervene to distort prices?

Ranis also emphasized the importance of investment in human capital to sustain export growth. Once surplus labor is absorbed and there is upward pressure on real wages so that labor-intensive exports become less competitive, secondary education becomes increasingly important. Local R & D is also vital to promote adaptive technological change. This is evidenced by the experience of Korea and Taiwan.

Finally, Ranis drew attention to the need to treat countries differently according to their stage in the development process. For example, development is normally accompanied by increased autonomy of the central bank in managing the money supply and in intervening in foreign exchange markets. It is also characterized by greater transparency and open debate about development issues. Donors, he argued, should therefore be more passive in countries that are further along this path. They should also be more flexible in providing support at the right time. Too much capital at the wrong time can actually impede policy reform.

Despite these and many other advances in our thinking about economic policy reform and growth, many questions remain. For example, where are the "political windows" to which Mike Roemer referred? What are the political preconditions for reform? How do we measure the capacity of government to undertake reform? And what of the choice between shock treatment and gradualism? These are all questions USAID economists and the larger development community must address in the coming decade, as is the question of how to contribute to the reform process with increasingly limited resources.

Chapter 3

POVERTY AND ECONOMIC GROWTH

Measurement of Poverty and its Impact

Presenters:

Peter Lanjouw and Guarav Datt
World Bank

Orest Koropecky
Global Bureau
Economic Growth Center

PETER LANJOUW AND GUARAV DATT

Lanjouw and Datt discussed their use of household level data to monitor, measure and evaluate levels of and changes in poverty.

I. The concept

Poverty is a state of depravation. The question is, depravation in terms of what? There are two principal dimensions along which we can think about depravation and well-being: income and non-income.

- The income/consumption dimension is a summary measure of a generalized command over goods and services.
- The non-income dimension includes other measures like education, infant mortality rates, life expectancy, health status, etc.

Each of these by itself is inadequate. People with similar levels of income may have varying levels of access to items along the non-income dimension because of the unequal public provision of non-income benefits.

For this reason, it is better to keep the income and non-income dimensions of poverty separate so that discrepancies between the two are clearer. It is better not to aggregate a lot of different things into a single measure. Rather, the two dimensions should be seen as complementary.

The Physical Quality of Life Index and the Human Development Index are examples of poverty indices. These are inherently problematic in that what is included and the relative weights given to what is included tend to be arbitrary.

A. Absolute versus relative poverty.

Poverty measures for the United States and Indonesia indicate that approximately 15% of the population in both countries is poor. What does this mean? Is the magnitude of poverty in both countries the same or is it that different standards are used to measure poverty?

In general, the perception of what constitutes a minimum level of poverty varies. Minimum standards are different in richer and poorer countries. Real standards of living tend to be higher in richer countries.

Relative poverty refers to the fact that standards of living vary over time or between countries, whereas *absolute poverty* refers to a fixed poverty line that does not vary over time or between countries.

B. Subjective poverty

The determination of a poverty line involves value judgments. Most poverty measures are based on household-level data. These are inherently subjective in that they are established on the basis of information gathered from respondents who are asked about what they consider to be a minimum standard.

There is really no substitute for *absolute poverty* measures if the purpose of the measure is comparability over space and time.

II. Constructing poverty measures

There are three steps to constructing a poverty measure. First, define well-being. Second, establish a line that constitutes a minimum level of well-being. Third, construct a measure that can aggregate the poverty line across individuals.

A. Constructing a standard of living indicator

Some kind of standard of living indicator is needed to distinguish between the poor and the non-poor.

Along the income dimension, we can measure income directly or we can measure consumption. Both are important aspects of living standards that are easily measured systematically in surveys. Both are widely used. Latin America uses income; Africa and SE Asia use consumption; countries in East Asia use a mix. Income is more frequently used in richer countries.

There is a philosophical argument that can be made concerning which is more appropriate:

Income is thought of as the opportunity households have to achieve a certain standard of living. It represents purchasing power they can use any way they choose. However, it usually only works as a measure of poverty in the presence of well-functioning markets. In Eastern Europe, for example, it breaks down in the presence of rationing basic goods and services.

Consumption is viewed as an indicator of what individuals and households actually choose or achieve.

In practice, income is more difficult to measure in developing countries so consumption tends to be preferred. The problems of measuring income and consumption and the advantages of measuring consumption over income are presented below.

Problems with measuring income:

1. Households tend to have multiple sources of income. Any measure of total income would have to aggregate these.
2. Agricultural income tends to be seasonal and therefore fluctuates over time.
3. Many individuals are self-employed or employed in a variety of informal sector activities. These are notoriously difficult to enumerate.

Advantages of measuring consumption:

1. It tends to be smoother over time. Seasonal and geographic differences are accounted for.
2. By concentrating on a small (minimum) basket of goods, it tends to be more easily comparable.
3. It overcomes the problem of having to aggregate numerous sources of income/transfers and so is more easily comparable.

Problems with measuring consumption:

1. Choosing which goods to include in the minimum basket is subjective.
2. It's difficult to control for quality differences.
3. In transitioning economies, the composition of the minimum basket is changing: pre-reform/post-reform.
4. It is measured in terms of value (money), not quantities - although sometimes we can measure calories.
5. A distinction needs to be made between final and intermediate consumption. Some consumption is merely inputs to production.
6. It must be comprehensive so that rural consumption can be compared with that of urban net purchasers.

While the debate over whether to use income or consumption to measure standards of living is on-going, Lanjouw and Datt prefer consumption. If an effort is made to ensure that it is a comprehensive measure, it tends to be a more convincing measure and is more easily comparable. While they prefer consumption because it is more easily measured, however, they recommend viewing it as one of many dimensions of well-being, along with infant mortality, life expectancy and education.

B. Adjusting for family size and composition

To supplement consumption as a measure, we can also develop *poverty profiles* (descriptive profiles of each household) which can flesh out the picture. These can illustrate discrepancies between consumption within households in which some members consume more than others. Adult males, lactating women, and children all have different consumption needs.

Lanjouw and Datt also use *equivalence scales*. These are rules by which to convert household members into adult equivalents. For example, a child may consume as much as one quarter of what an adult consumes and therefore is counted as a quarter adult.

However, these scales can be subjective and can vary widely. Lanjouw and Datt recommend doing sensitivity analyses when evaluating them.

C. Cost of Living Adjustments

The same level of income will represent very different standards of living in rural areas than in urban areas because of cost of living differences. This can be remedied by calculating different poverty lines in different parts of the country or by converting all expenditures to some comparable basis.

D. Developing a poverty line

There are four principal reasons to use a poverty line:

- We need a standard-of-living threshold that establishes a minimum.
- It is useful in distinguishing the poor from the non-poor, in identifying that part of the population that is poor and in determining why they are poor.
- The line can be used by governments to set transfer levels and determine eligibility for participation in programs.
- It is useful in monitoring poverty, assessing changes in poverty, and educating the debate. A poverty line helps keep poverty on the agenda by making the poor more visible.

There are, nevertheless, problems with using it:

- No poverty line is perfectly objective.
- It needs to be both absolute and adjustable - that is, the minimum basket must be constantly reassessed and modified for cost of living adjustments.
- Efforts must be made to keep it transparent so that it is easily and reliably comparable.

E. Poverty measures[1]

- *Headcount index* (H): measures the percentage of the population whose consumption expenditure is below the poverty line.
- *Poverty gap index* (PG): measures the average poverty deficits as a proportion of the poverty line, where the average is formed over the poor and the non-poor. The non-poor have zero poverty deficits.
- *Squared poverty gap index* (SPG): measures the weighted average of proportionate poverty deficits.

III. Tools for poverty measurement

POVCAL is a computer program designed to calculate poverty measured from grouped data. It has been developed by Shaohua Chen, Guarav Datt and Martin Ravallion at the World Bank. POVCAL can be used on any PC. Its source code is written in Microsoft FORTRAN 5.0 by Shaohua Chen (202) 473-2579, who will provide anyone interested with a copy. This program was developed for World Bank

[1] These three Foster-Greer-Thorbecke (FGT) poverty measures are averages of individual measures. For their corresponding equations, see Appendix 1.1.

staff and so is not a commercial program with a flash-user interface.

OREST KOROPECKY:

"Consumption and Savings Behavior in South Africa: A Cross-Section Analysis"

Using household survey data from South Africa, Orest Koropecky is directing a study in the Office of Economic and Institutional Reform to examine consumption and savings behavior in South Africa. This study is applying the framework and model presented in the book *Patterns in Household Demand and Saving*, by C. Lluch, A. Powell and R. Williams. This is the Extended Linear Expenditure System (ELES), permitting a joint treatment of the allocation of expenditure and saving.

Preliminary findings suggest that consumption or expenditure exceeds income at every location for large, young African households. This is also true for large, old African households in rural areas. The income of small, young African households in Metro exceeds expenditure, but barely. In answer to the question, "Who are the poor in South Africa?", they are, for the most part, African households who: (1) are large and live in rural areas, (2) are large and young and live in urban areas, and (3) are young and live in Metro. These three groups comprise 41 percent of all African households; thus 4 out of 10 African households might be poor. Sixty-eight percent of these households are rural, that is, nearly 7 out of 10 poor households are rural.

POVERTY AND ECONOMIC GROWTH

Labor Markets

Presenters:

Gary Fields
Cornell University

Alan Batchelder
Global Bureau
Economic Growth Center

Mary Norris
USAID / Indonesia

GARY FIELDS:

"Which Labor Market Policies Would Best Improve Market Conditions for Workers?"

I. Labor market institutions

Fields discussed five basic labor market institutions in an effort to illustrate how they differ in different parts of the world.

A. Minimum wages

Minimum wages aim to ensure workers of an adequate standard of living. They exist throughout the developed world but are of little importance in East Asia.

Korea had no minimum wage until 1988. Even today, minimum wage regulations are binding only on a small fraction of workers.

Taiwan has had a minimum wage for decades, but no company in Taiwan has ever been fined for violating the country's minimum wage law. It is simply irrelevant.

B. Trade unions

Trade unions are often encouraged by government policy as a means of entitling workers to a just share of the fruits of their labor.

In Latin America and the Caribbean, studies that compare wage differentials between unionized and non-unionized workers reveal that unionized workers earn nearly twice what comparable non-unionized workers receive.

In Korea, by contrast, unions have been repressed and the union wage differential is negligible.

C. Public sector pay policy

In Costa Rica, the public sector pays higher wages than then rest of the economy. As a result, a majority of workers seek government employment.

In East Asia, the government pays only what it must to compete with the private sector. As a result, there is no public/private wage differential.

D. Multinational corporations

Multinational corporations typically pay wages above market levels, especially in sub-Saharan Africa where various governments have threatened expulsion or expropriation if they do not. This does not happen as frequently in East Asia.

E. Labor codes

Labor codes may regulate hiring and firing, impose payroll taxes or mandate certain benefits.

In Panama, the labor code was estimated to have raised labor costs by 90%. It was ultimately abandoned as unsustainable.

In India, the labor code does not allow companies to dismiss workers or go out of business. As a result, employment levels are artificially high and economic efficiency levels are, as a consequence, artificially low.

In East Asia, labor codes are less stringent, though severance payments tend to be required in the event of layoffs. But the costs of such regulations tend to be lower and their effect on labor markets are smaller.

F. Summary

Fields argues that these five types of labor market interventions are well-meaning and benefit workers who are fortunate enough to work in the public sector. However, he notes they have also had adverse employment and efficiency effects and have contributed to the informalization of the economy in many countries.

II. A simple analytical model

It becomes an empirical question in each country as to whether a direct or indirect approach towards labor markets works better. The direct approach to improving labor market conditions includes imposing the five kinds of institutional factors cited above. The indirect approach pursues economic growth of a type that benefits workers.

Some argue that the only way countries can succeed in today's global economy through export-led growth is to keep labor costs down. If they fail to do so, rising real labor costs will stifle any economic gains. Fields provides empirical evidence from Taiwan to argue that countries in which export-led growth has been achieved also show significant gains in real labor earnings. In contrast, he also presents data from Brazil to demonstrate that worker welfare suffered in tandem with the overall economic decline that characterized the early 1980s in Latin America.

In conclusion, Fields refutes popular opinion that suggests labor simply cannot benefit in today's global economy. His evidence reveals incidents in which labor markets successfully translated both the benefits of macro-economic growth and the costs of economic decline into worker welfare. However, he cautions against misinterpreting the data to mean that labor can only benefit through economic growth *in the absence* of labor market interventions. Fields is not recommending the complete deregulation of labor markets in countries blindly seeking economic growth. Rather, he observes that abusive working conditions exist and certain regulations should be mandated in an effort to protect workers from them.

III. International labor standards

With the creation of the World Trade Organization, the OECD has been commissioned to (1) propose what international labor standards should be, and (2) determine whether or not such standards should be linked to international trade. At this point, the set of "core labor standards" upon which OECD members have been able to agree include:

- Freedom of association and protection of the right to organize and bargain collectively.
- Prohibitions on forced or compulsory labor.
- Provisions for equal remuneration for men and women and non-discrimination in employment or occupations.
- Restrictions on child labor.

Fields urges the international community to adopt these standards in an effort to convince countries to change their current practices and to guarantee all people a basic level of protection. He expects to see a set of international labor standards in place by the year 2000.

ALAN BATCHELDER:

"Not Enough Employers: The Failure of Past National Economic Policies in the Philippines. Hope for Accumulating Reforms."

Batchelder observed that during 1960-85, ill-conceived economic policies in the Philippines stifled the growth of the private sector and, by extension, the ability of private businesses to absorb an increasing supply of labor. Depressed wages, widespread unemployment, even wider underemployment in services, and the emigration of Philippine labor to other countries resulted. Batchelder is optimistic that long-term economic reform offers hope that this situation can be redressed.

In Batchelder's view, the Philippine government failed in eight distinct areas. He reports that over the past 16 years USAID staff have been extensively involved in assisting the government to design and implement reforms in each of these areas to re-ignite the entry of new, competitively successful employers. These eight areas include:

- Import substitution policies discouraged employment in the export sector.
- Government designated monopolies excluded additional employers.
- Discriminatory laws and regulations kept out potential foreign employers.
- Various government policies encouraged the substitution of capital for labor.
- Financial sector policies depressed savings and misdirected investment away from employment-generating activities.
- Regulations restricted growth of demand for rural labor.
- The tax system resulted in the government's inability to finance needed public expenditures.
- Underfunded public budgets were inadequate to finance infrastructure projects and education.

Thus where Fields' model from Taiwan reveals that a favorable macro-economic environment can have a favorable long-term impact on wages as labor moves from agriculture to manufacturing, Batchelder argues that no such movement was possible in the Philippines in the near term due to two and a half decades of unfavorable policies.

Batchelder reports that USAID is now contributing to the economic reforms necessary to reverse this trend. By assisting Philippine officials who went to change policies and institutions to encourage, rather than repress, the private sector, USAID is helping to stimulate and expand the number of successful private employers who will draw down the surplus Philippine labor in the mid-term.

MARY NORRIS:

"Gender-Based Wage Differentials in Indonesia: A Preliminary Analysis"

I. Evidence of gender-based wage differentials

Using household-level survey data collected under the National *Labor Force Survey (Sakernas)* in Indonesia, Norris focuses on wage and salary employees. Among these, she reveals a pattern of persistent wage differentials between men and women who possess similar skill levels. Using worker education as a representation of skill level, she argues that the data reveals a "rather curious relationship between skill level (education level) and the female-male wage differential — what we might characterize as a "snake" pattern":

Education Level	*Female/Male Differential**
No Education	58%
Primary Education	50%
Junior High Education	51%
High School (general)	84%
High School (vocational)	91%
Diploma I/II	83%
Academy/Diploma III	71%
University	73%
TOTAL	**64%**

* Female wages as a percentage of male wages

This S-shaped relationship reveals that wage differentials are most pronounced at lower and higher education levels, while earnings tend to be most equal between men and women who both have vocational high school training.

Norris argues that "the presence of wage differentials for the same skill level implies that labor market institutions are accommodating "non-economic" motivations, e.g. discrimination and adverse self-selection."

II. Possible explanations

At fixed levels of education, men and women choose to participate in different activities which, correspondingly, have different rates of remuneration. For example, at low levels of education, women tend to be employed in the social service sector (as housemaids), while men choose public service jobs in construction and maintenance.

Certain sectors become "sex-typed" and remain so under conditions of relative labor surplus. For example, "the 'crowding' of women into a few manufacturing sectors [like textiles] might well explain their lower absolute and relative wages" since these sectors call for "patient, less assertive workers who are more deferential to authority than men" and who may therefore tolerate poorer working conditions and lower wages.

More skilled workers are more likely to be employed in the public sector which, through official labor practices, helps diminish the gender-based wage gap.

University educated women are less likely to earn degrees in the hard sciences and engineering. Since these fields tend to pay better than those requiring training in the softer sciences, women's wages suffer.

III. Policy implications

A. Expand female education

Despite its intuitive appeal, this policy option may not be preferred given the S-shaped nature of the relationship between education levels and the female-male wage differential. Of those with a high school education, twice as many women as men are unemployed in Indonesia. Unless sufficient job opportunities are generated to absorb these women who already have skills, educating more women will not solve the problem.

B. Eliminate all forms of gender-based labor market distortions

This kind of policy is extremely difficult to implement. It is only possible if there is open discrimination that can be legislated against and effectively prohibited.

IV. Conclusion

Both the sources of gender-based wage differentials and possible policy solutions to their adverse effects need further study.

POVERTY AND ECONOMIC GROWTH

Capital Markets

Presenters:

Guy Pfefferman
International Finance Corporation

Glenn Rogers
REDSO/West Africa

Jerre Manarolla
Asia/Near East Bureau

Donald Harrison
USAID/M

GUY PFEFFERMAN:

"Capital Markets and Poverty Alleviation."

I. Stock markets are more important to the development process in developing countries than they are in industrial countries

Using data from ten developing countries, the IFC is examining how large, manufacturing enterprises finance investment.[2] It has found that developing country corporations depend more on extra-enterprise sources of investment financing -- especially stock issues -- than do OECD corporations. Well-functioning stock markets and efficient banking systems are more important to growth and employment creation in developing countries than is often realized.

An active secondary market in securities is also essential to modern sector growth since there can be no sustained stock market development unless the public trades shares actively.

From empirical studies conducted by the World Bank, it is clear that a strong association exists between stock market liquidity and the rate of long-term economic growth.

How does this relate to poverty alleviation? Growth and poverty alleviation go together. Since stock market development is positively related to overall growth and growth reduces poverty, capital market development is, by extension, related to poverty alleviation.

II. The re-orientation of government resources in favor of the poor is greatly facilitated by the existence of an active securities market

Development demands a re-deployment of government resources away from commercial activities and subsidized services and toward

[2] The IFC maintains a data base of the balance sheets and profit and loss accounts of up to the 100 largest manufacturing enterprises in each of ten developing countries: Brazil, Mexico, India, Pakistan, Turkey, Jordan, Zimbabwe, Malaysia, Korea, and Thailand. These data are available to the public.

poverty alleviation. There are several ways this can be done:

•*Privatization:* The sale of state assets provides a tremendous impetus for stock market activity and frees government resources for redeployment to the poor. Mutual funds can make privatized assets available to small savers.

•*Private infrastructure:* This not only frees government resources for other uses, it can also enhance the provision of transportation and utility services from which all strata of society benefit.

•*Private pension funds:* The lack of long-term savings instruments is holding back investment in developing countries. Private pension funds can remedy this. Chile has shown the way. In other countries, such as Brazil and Mexico, reform of the pension system would greatly improve the distribution of pension benefits to the poor.

III. Individuals and communities are also directly affected by capital markets and financial institutions

Banks which are burdened with bad debt are less likely to lend to small and medium enterprises or directly to the poor than are healthier financial institutions.

Specialized micro-lending institutions that rely on subsidized interest rates are not sustainable in the long term. Banks require more sustainable sources of funding. Since the evidence from most micro-lending schemes indicates that the poor are bankable - at market rates of interest - capital and financial institutions such as rural savings banks and leasing companies should be able to provide sustainable financial services by tapping the enormous savings potential of the poor.

IV. Conclusion

Capital and financial markets are an essential part of a growing economy. Without them, long-term growth and poverty alleviation are much harder to achieve.

GLENN ROGERS:

"Evaluating Financial Sector Development Linkages to Economic Growth."

Rogers outlined four key issues in evaluating the impact of financial sector development on employment and income generation in rural Africa.

First, he predicted that financial sector development will lead to larger employment generation in the non-farm sector than in the farm sector for three reasons: (1) new tradable agricultural production stimulates non-tradable production via a multiplier effect, (2) agricultural producers have a greater ability to obtain credit on the basis of their farm collateral (advance-purchased crops for example), and (3) investment in existing agricultural production appears to be a substitute for farm labor whereas investment in non-farm businesses appears to be a complement to labor. Rogers argues therefore that the impact of financial sector development on employment should be tracked in the non-farm sector.

Second, Rogers called for the analysis of financial market development to be based on both supply and demand in well-defined geographic and product markets. He noted that supply and demand characteristics of local capital markets are highly correlated due to the "local" nature of credit provision in most developing countries. The supply of equity capital in such countries tends to rely on the availability of highly personalized information about possible borrowers (between family and friends). In the absence of such information, debt capital could be supplied but only with adequate collateral to satisfy commercial lenders. In the absence of adequate information or collateral, financial institutions serving distinct geographic markets may inadequately assess the creditworthiness of new businesses. Thus access to credit problems and financing gaps are frequently a function of both supply and demand problems in a distinct geographic area and should be analyzed as such.

Third, Rogers advocated the use of a clear model for analyzing the impact of financial sector development and for comparing the "with" and "without" financial development scenarios. Such a model is presented in Roger's paper which is cited in full in Chapter III.

Finally, Rogers urged using such a model to evaluate the impact of such development strategies as export promotion or micro-enterprise support on broad-based economic growth and to evaluate the role financial sector development plays in pursuing those strategies.

DONALD HARRISON:

"Honduras: Financial Sector Reform."

In 1990, the Honduran government undertook a comprehensive structural adjustment and stabilization program. Elements of this program that have been implemented are the decontrol of interest rates, the virtual elimination of directed credit lines, and a movement towards the rationalization of the State Agricultural Development Bank (BANADESA).

Elements of this program that await action are a reduction in bank reserve requirements and development of Honduras' capital markets. The next two sections outline issues related to these remaining agenda items.

I. Bank reserve requirements

The reserve deposit requirement in Honduras is currently 34%. This significant requirement has contributed to a large gap between deposit and lending rates in the commercial banking system.

II. Capital market development

Currently, formal financial credit in Honduras is provided by BANADESA, banks, credit unions and non-governmental organizations. The informal sector is also active in credit provision.

BANADESA is mired in financial difficulties. It has failed in its principal objective to channel funds to the poorest of the rural poor. The World Bank and the IDB would like to dissolve it.

New banking legislation is being considered by the Honduran Congress and - if passed - represents the centerpiece of USAID/Honduras' ESF Program. This legislation will: (1) help impose civil and criminal penalties on institutions providing credit on the basis of nepotism or favoritism of any kind, (2) legalize a market-based interest rate system, (3) promote competition in the banking industry, (4) strengthen prudential oversight in the banking system, (5) legalize holding companies, (6) facilitate the seizure and liquidation of collateral.

Credit unions are currently a priority for USAID/Honduras. Despite improvements in coverage and financial viability, these unions still suffer from the need to (1) cover a greater portion of their costs, (2) improve administrative practices, (3) resolve conflicts between net creditors and debtors, and (4) enact a prudential oversight system. Nevertheless, they are providing competitive access to both savings and credit services.

NGOs in Honduras have significant problems: (1) they lack internal control systems and good management, (2) they lack financial discipline, (3) they have high operating costs. As a result, they see a high number of loan defaults.

Informal markets provide credit to approximately 43% of agricultural producers. But these, too, have problems: (1) loans tend to be small in size, (2) the costs of a loan are high, (3) maturities are short. In that they offer no deposit services, they are unable to successfully mobilize potentially significant rural savings.

III. Conclusion

While it has made progress, Honduras still has a long way to go before it has completed its financial sector reform process.

JERRE MANAROLLA:

"The Employment Impact of Capital Markets Development in Indonesia."

For many years, USAID has been involved in capital market development. Now it is interested in measuring the impact of an expanding stock market on poverty.

I. Methodology

A study currently being undertaken by the Economic Growth Center in conjunction with the Asia/Near East Bureau examines the effectiveness of USAID/Indonesia's Financial Markets Project. The methodology adopted by this study includes the following approaches:

- *A micro approach.* Data from firms registered with the Jakarta Stock Exchange (JSX) who have raised new capital on the exchange were used to measure the effects of capital markets on job creation.
- *A macro approach.* Regression analysis was used to estimate the portion of Indonesia's economic growth since 1989 that might be due to the development of the JSX. By regressing GDP growth rates on a set of stock market and banking sector development indicators, this study hopes to estimate the portion of Indonesia's economic growth since 1989 and, by extension, the gross employment generated from this additional growth, that might be due to the development of the JSX.
- *A sectoral approach.* Aggregated estimates of the capital raised by all firms in a particular sector were used to estimate the employment generated by this new capital using capital/labor ratios.

II. Preliminary results

A. Firm-level results

For one tenth of responding firms, new equity capital led to their expanding employment by 300%. Most of these jobs were for skilled workers.

B. Macro-level results

Due to econometric problems, the results from this part of the analysis are uncertain.

C. Sectoral-level results

Analysis reveals that new equity capital resulted in one million new jobs created. Only foreign portfolio investment (40% of total new equity purchases) is considered "additional" - i.e., it would not have been available through external bank loans, FDI or remittances without the JSX. It is assumed that the rest would have been made available even in the absence of the JSX.

As a conservative estimate - counting only 30% of the additional savings mobilized by the JSX - such savings generated 300,000 new jobs, or 4% of the 7.5 million jobs created in the non-farm sector over the same period.

III. Future issues

A. Circular causality

Capital market development is both a cause and the result of economic growth. It is difficult to distinguish the direction of causality between capital markets, growth and employment.

B. National savings rates

Since most of the additional capital flows appear to be coming from abroad, it is questionable as to whether or not the JSX is increasing *domestic* savings.

C. Substitutability of equity capital and bank credit

What is the relationship between equity capital and bank credit? Could firms just as easily raise capital through the banking sector as through initial public offerings? Has the JSX improved firms' debt/equity ratios and thereby improved their chances of obtaining bank financing?

POVERTY AND ECONOMIC GROWTH

Trade Liberalization and Poverty Alleviation

Presenters:

Chris Clague
IRIS and the University of Maryland

Tony Chan
REDSO/East

CHRIS CLAGUE:

"Trade, Trade Policy and Poverty Alleviation"

I. Effects of trade and trade policy on growth in LDCs

New theories of economic growth suggest that the degree to which a country is open to international trade plays an important role in determining its potential for long-term growth.

The role trade policy plays in this process, however, is uncertain since the effects of trade policy continue to be very difficult to measure. Cross-country regression studies show that while an export orientation does have a positive influence on growth, trade policy *per se* is not proven to be the determining factor. One measure that does seem to explain growth directly is a purchasing-power-parity based measure of exchange rate distortions. This measure, as it is used as an indication of a country's outward orientation, is explained below.

II. Effects of trade and trade policy on inequality and poverty

The traditional (Heckscher-Ohlin) relationship between trade policy and factor prices is now frequently modified to include considerations of skill levels. Since capital is now regarded as a factor that is available in most countries for the same price, the real variation in factor endowments may be explained by the relative differences between skilled and unskilled labor. Some argue that North-South trade in manufactures represents an exchange of skilled and unskilled labor. Recent work on this issue by Adrian Wood (1994) reveals that the effects of North-South trade on the relative wages of skilled and unskilled labor in both the North and the South are much larger than had previously been determined.

Others now argue that factor prices may matter little if comparative advantage stems more from a country's culture and institutions than from its factor endowments. For example, much recent literature emphasizes the importance of institutions like property rights, contract enforcement mechanisms and bureaucracies. If a country possesses an efficient institutional infrastructure, it may benefit from international trade and reduce income inequalities regardless of its factor endowments.

III. New ideas in trade and consequences for the case of free trade

There are a number of new ideas in international trade that are useful in assessing a country's degree of outward orientation. These include:

- A country's **relative price level.** David Dollar (1992) has developed a technique for estimating a cross-country index of real exchange rate distortion using new data on purchasing power parity (PPP) made available by Robert Summers and Alan Heston.[3] This technique involves using the United States as a benchmark to calculate a country i's relative price level (RPL):

$$RPL_i = 100 \times e \cdot \frac{P_i}{P_{US}}$$

where e is the exchange rate (dollars per unit of domestic currency) and P_i is the consumption price index for country i. This index can reveal the extent of a country's real overvaluation or undervaluation with respect to a norm (the price level that corresponds to a country's particular resource endowment) and so provide an indication of that country's outward orientation (or the degree to which its exchange rate is distorted away from a free-trade level).[4]

If there were no nontradables, cross-country variation in these price levels could constitute a direct measure of a country's inward or outward orientation due to its trade policy. Given that nontradables do exist, their prices will differ across countries based on factor endowments. Dollar corrects for this by regressing price levels on factor endowments and using the residuals from that regression to construct his index.

On the basis of this index, Dollar has found that "there is a significant, negative relationship between distortion in the real exchange rate and growth of per capita GDP, after controlling for the effects of real exchange rate variability and investment level."[5]

- Monopolistic competition theory as applied to international trade shows that trade can lead both to a larger scale of production and greater product variety. It thereby reinforces the case for free trade.

- The quality of bureaucracy can be a very important variable in international trade as demonstrated by the East Asian countries. Successful exporters such as Korea, Taiwan and Singapore have tended not to follow the neo-classical, market-oriented approach to trade. Rather, they have intervened extensively in international trade (limiting imports, assigning products, directing credit) and have thereby enhanced growth by correcting market failures. The quality of that intervention thereby becomes an important variable in assessing trade-related growth strategies.

IV. Economic and political interactions in trade policy

Due to the very strong redistributional effects associated with liberalized trade, there tends to be a strong political opposition to liberalization in many countries. However, experience has shown that interests can grow up around exporting activities resulting in a pro-liberalization constituency. USAID economists may want to keep this in mind as they identify key players in export markets and develop a strategy for achieving more outward-oriented trade policies.

[3]Robert Summers and Alan Heston, "A New Set of International Comparisons of Real Product and Price Levels: Estimates for 130 Countries, 1950-1985," *Review of Income and Wealth* 34 (March 1988): 1-25.

[4]David Dollar, : "Outward-Oriented Developing Countries Really Do Grow More Rapidly: Evidence from 95 LDCs, 1976-85," *Economic Development and Cultural Change* (April 1992): 524-525

[5]Dollar, 525

TONY CHAN:

"Trade Policy in Action in East African Countries."

I. Recent developments in the trade environment in Eastern and Southern Africa: Kenya, Tanzania, Zambia and Zimbabwe

A. Four major types of changes in the region

- *Changes in exchange control.* Across all four countries, (1) exchange controls have been completely liberalized and (2) export retention accounts are permitted. In Zambia and Zimbabwe, remittance of profits and dividends is fully permitted. In Zimbabwe, direct foreign investment is allowed in the stock market.
- *Changes in import policy.* Import licensing has been eliminated in all four countries.
- *Changes in export policy.* Export legislation has been tremendously simplified. There are no export taxes. There are duty drawback schemes, though they are not working as they should in Zambia and Zimbabwe.
- *Regional initiatives on greater market integration.* There are a number of initiatives in the region. The largest is the Preferential Tariff Area from Ethiopia to Swaziland. COMESA, SADC, SACU are all cross-border initiatives. Some of these are duplicative in nature.

II. Some methods to evaluate the probable impacts of trade liberalization policies

- Indicators of openness: (X + M)/GDP. In all of these countries, international trade is a much more significant percentage of GDP. There is also evidence of a strong, positive correlation between this measure of openness and the real growth of GDP.
- Commodity import programs (CIPs). In most cases, these have become obsolete. In many countries, the private sector avoids CIPs because of the paperwork involved. Importers find it easier to go to the bank. Perhaps this is an indication that the foreign exchange gap in these countries is no longer relevant or binding with respect to import financing.

Poverty impact analyses. There are a number of ways to look at the impact of these trade policy changes on poverty. These include: (1) the relationship between income growth and poverty reduction, which empirical studies show to be positive; (2) the initial distribution of financial and human assets, which can determine how income distribution takes place in a growing, liberalizing economy; (3) the effect of exchange control reform on the poor who should benefit from a reduction in black market premiums; and (4) investment incentives which are frequently only given to foreign and not local investors. Computer general equilibrium (CGE) models can be used to simulate the impact on the poor of counterfactual policies.

REFORMING THE STATE AND TRANSITION TO A COMPETITIVE ECONOMY

Presenters:

Elaine Grigsby
Global Bureau, Economic Growth Center

Mancur Olson
IRIS and the University of Maryland

Samuel Skogstad
Georgia State University

John Williamson
Institute for International Economics

ELAINE GRIGSBY:

Countries undertaking structural adjustment programs have found that this effort often leads to the need to reform the state, and take measures that lead to the transition to a competitive economy. This forces these countries to confront several key questions posed by the restructuring process; namely, to what extent should the private sector expand its role in providing public services - and the extent to which the public sector should disengage from productive sectors?; how to establish a market-oriented economy that supports an efficient and equitable private sector?; and what should be the relationship of the central government to the local and regional governments? Fiscal policy reform has been largely responsible for forcing government to deal with these issues. The lack of success in privatization has led to serious questions about how to move to a competitive economy.Decentralization is a critical feature of policy reform which must be taken into account in redefining the government's fiscal responsibilities.

I. Fiscal policy reform

Fiscal policy and budgetary reform requires a re-evaluation of the role of the public sector: What kind of services will it provide and what role can the private sector play? When can the market be used for allocation? What are the priorities in terms of allocation across social sectors?

II. Privatization

The success of privatization rests on: (1) market incentive structures based on full information and free entry and exit, and (2) an enabling environment that promotes private property, rewards risks, and honors contracts.

III. Decentralization

Public institutions that provide social services are often centralized. One reason for the poor quality of delivery of such services is the lack of coordination with those who receive these services. Decentralization, therefore, has been proposed as one solution.

MANCUR OLSON:

I. Essential ingredients of reform

Two things are required for a country to successfully make the transition to a competitive economy: (1) the government and society at large must be influenced by good ideas, and (2) the incentives in the political system must be such that the motivations of political actors are linked with those of society as a whole. That is, the interests of politicians should be tied to those of society.

One example of such incentives in a political system is the case of a strong, secure autocrat. In this instance, political leaders have an incentive to make the economy work because they can directly profit from its success in the form of higher tax receipts. Examples include Taiwan under Chiang Kai-shek since 1960, South Korea under Park and Sun, and Chile under General Pinochet.

Another example is that of a democratic majority. A majority's incentive to make an economy work should be even stronger than that of a dictator because it has both the dictator's control over the tax and subsidy system as well as direct access to market income as participants in the economy. So majorities face the most constructive incentives to run economies well. The democracies of post-war West Germany, Japan and Italy are good examples of countries run well by majorities.

Is the United States run by a majority? The answer is no. The political system in the U.S. is largely driven by the political power and incentives of narrow interest groups. For example, the subsidization of the maritime industry and the production of sugar beets in the United States result from the power of special interest groups in the maritime industry and among the growers and processors of sugar beets.

In a long-standing democratic system such as the United States, various industries and occupations have organized themselves into collusive and cartelistic bodies with tremendous power. With that power they are able to control government policy with respect to their industry or occupation. Such organizations serve their members' interests by getting:

- redistribution for their members
- a cartel or collusive price
- subsidies and tax loopholes

While the members of these organizations benefit from such subsidies and tax loopholes, the social costs of such policies are diffused throughout the society. Instead of uniform arrangements and a competitive economy, the United States embodies all sorts of monopoly pricing and narrow, special interest groups which distort the allocation of resources.

II. Collusive behavior as a source of the collapse of communism

The preceding argument provides insight into the collapse of communism. Using the same line of reasoning about dictators in Taiwan, South Korea and Chile, Olson argued that Stalin had an incentive to make the Soviet Union as productive as possible so he might personally gain from its productivity. He did not apply an egalitarian ideology as much as he used a system of carrot-and-stick incentives to increase output. He thereby worked the system so as to take a larger portion of society's output for himself to further his own power. His ideology only served his own quest for power.

Ultimately, however, this carrot-and-stick methodology collapsed because of a *crucial information problem.* To control output, the center had to rely on information from subordinates (factory and plant managers) in the field. By playing these subordinates against each other, the center was able to secure the information about production it needed through *bureaucratic competition* in which regional managers knew they would have to compete with other managers to get the resources they needed. They would tattle on each other in an effort to secure resources or more lenient quotas for themselves.

Yet if all factory managers stopped competing and started colluding with each other, the center would be starved of the information it needed to control output and factory managers would have greater autonomy and control over output. This is eventually what happened. Once factory managers perceived their common interests and agreed to cooperate - through *covert collective action* - they successfully excluded the center.

However, each of these bureaucratic collusions was small with respect to the economy at large. Where the center may have had an incentive to raise output, each of these groups of colluding bureaucrats received only a minuscule share of any increase in output, so it had no incentive to increase output. Rather, each group had an incentive to get as much for itself as possible, without regard to the total level of output. This led to bankruptcy, stalled production and, ultimately, the collapse of communism.

Today, many of these producer groups have degenerated into lobbies with a large degree of lobbying power. This remains one of the biggest challenges facing the new regime - even after privatization - since these groups face a greater incentive to lobby for their own gains (such as subsidies, loans at interest rates below inflation, or loans that may be cancelled) at the cost of the greater society.

This results in the resources of the former Soviet Union being used to maintain dinosaur industries. These are now the main drag on the economy. This problem is especially bad in Beloruss, Ukraine, and certain countries in central and eastern Europe where there is little democracy.

III. The solution

The solution to reducing the power of these narrow interests is to see to it that each collective group is aware that it is damaged by the actions of the other collective groups. In this way, they will all eventually support reform because they will come to realize that behavior based on narrow, parochial interests makes each group worse off.

JOHN WILLIAMSON:

In 1989, Williamson convened a conference in Washington to discuss those things countries in Latin America ought to be doing in order to move towards a competitive market economy. Out of this grew a list of reforms which Williamson published as the "Washington Consensus." This list included:

- *Fiscal discipline.* Countries should not have large budget deficits, nor should they rely on an inflation tax.
- *A reorientation of public expenditure priorities* away from administration, defense, big white elephant projects in favor of education, health and infrastructure.
- *Tax reform.* Countries should broaden their tax base, reduce marginal tax rates and improve enforcement.
- *Financial liberalization.* Countries should move towards positive real interest rates in order to remove incentives for capital flight.
- *Trade liberalization.* Countries should eliminate all quantitative restrictions. There was some debate as to whether or not to eliminate protective tariffs all at once or to phase them out slowly so as to protect infant industries for a time. The answer should depend on the efficiency of the country's bureaucracy.
- *A competitive exchange rate.* This is seen as a vital mechanism for countries to get their exports moving - though there is some debate as to its usefulness for other purposes. Some argue that the exchange rate should be used as a nominal anchor to stop inflation.
- *Liberalization of foreign direct investment.* Countries should create an environment favorable to foreign direct investment.
- *Deregulation.* Countries should eliminate regulations that restrict entry and competition. Prudential supervision of financial institutions, environmental and health standards is in the public interest so reform of these sectors should be done with this in mind.
- *Privatization.* Countries should reform unregulated monopoly power in an effort to create better incentive systems.

- *Property rights.* Countries should develop a clear, enforceable set of property rights.

Although the "Washington Consensus" was originally directed at Latin America, it contains elements that are applicable to other countries. There are also other requirements not on the list that are absolutely essential for the transitioning economies of Eastern Europe, such as:

- *Institution building.* Countries must develop the legal infrastructure necessary for a market economy to function.
- *Social dimensions.*[6] Countries should develop a social agenda that includes: (1) decentralization of public provision of education and health care, (2) advanced labor legislation, (3) pay-as-you-go private pension systems, and (4) targeted subsidies to replace indiscriminate subsidies.

This social agenda compliments the elements of the Washington Consensus. Whether or not this agenda is politically saleable depends on whether or not special interests can be persuaded to concede their special privileges at the same time. On average, democracies tend to be more capable of implementing an agenda like this than are dictatorships.

SAMUEL SKOGSTAD:

Skogstad reviewed five issues of current research on policy reform and authors who are pursuing these topics. These issues address the transition of less developed economies to more developed economies rather than from Soviet-style economies to market-driven economies.

I. Economic convergence

This neo-classical idea is based on the assumption that as capital is formed in very poor countries it earns a higher rate of return. *Ceteris paribus,* this should lead to a convergence of incomes between these countries and wealthier countries. According to this theory, the income disparity between the two types of countries will ultimately disappear.

Paul Romer has observed that convergence *does not actually occur*. Looking at historical data, he found that those countries that have always been poor are still poor.

Jeff Sachs and Andrew Warner,[7] on the other hand, argue that convergence *does occur* among countries that have "good policies." These policies include property rights and an open posture vis-à-vis the rest of the world.

II. Policy reform and income distribution

Paul Krugman and Anthony Venables[8] have identified two stages of change when the relationship between an intermediate-goods producing country and a final-goods producing country is liberalized. First, intermediate goods producers will agglomerate near the final goods producers when transportation costs reach a critical low level. As a result, industrial activity (final goods production) - and therefore the distribution of relatively high value-added jobs - will be concentrated at the center, while countries in the periphery will experience declining real incomes. Second, with low transportation costs, wage rates become a more significant determinant of industrial location. Final goods industries therefore re-locate to the periphery where wages are lower.

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[6] Williamson cites a paper by Ricardo Houseman in Redefining the State in Latin America, Colin I. Bradford, ed. (Paris: Organization of Economic Cooperation and Development, 1994).

[7] Jeffrey Sachs and Andrew Warner, "Economic Convergence and Economic Policies." (Cambridge, MA: NBER Working Paper 5039, February 1995).

[8] Paul Krugman and Anthony J. Venables, " The Seemless World: A Spatial Model of International Specialization." (Cambridge, MA: NBER Working Paper 5220, August 1995).

III. Policy reform and changes in the structure of production

Ricardo Caballero and Mohammad Hammour[9] have found that the process of economic transition involves wrenching changes in the core of the economy during which some industries contract dramatically while others expand vigorously. However, the speed of these two processes are different. Contraction tends to happen much faster than expansion.

Caballero and Hammour conclude that this does not necessarily mean that economic reform should be undertaken slowly. Rather, a set of public policy measures should be implemented that recognize explicit losers in this kind of transformation and perhaps use a system of "safety nets" to address the inevitable employment shift and re-training problems for such losers. Government should simultaneously produce incentives for those who are in the expanding sectors.

IV. Policy reform and public sector and private sector "Cross Dressing"

Economic transition involves the re-assignment of the respective roles of the public and private sectors: getting the public sector out of commercial activity and getting the private sector out of education.

V. Economic theory, policy reform and the state

Skogstad sees three rounds of this debate:

Round 1: Keynes' General Theory (1930s-60s)

Round 2: Neo-Classicism (Reagan/Thatcher)

Round 3: A current resurgence of Keynesian principles characterized by:

- turning back to a preference for fixed exchange rates
- a shift back to directives on interest rates
- a need for directed credit
- a preference for optimal trade restrictions
- a belief in the infant industries argument
- a belief in monopolistic competition models
- a belief in the prevalence of downward inflexibility in wages

REFORMING THE STATE AND TRANSITION TO A COMPETITIVE ECONOMY

Building a Competitive Economy

Presenters:

Tim Brennan
University of Maryland

Larry Forgy
REDSO/East

Cindy Clement and Robert Thorpe
IRIS

TIM BRENNAN:

The field of Industrial Organization (IO) has undergone some dramatic changes in the last few years. Many of the most influential contributions to the field come out of the University of Chicago and the University of California,

[9]Ricardo Caballero and Mohammad L. Hammour, "On the Ills of Adjustment." (Cambridge, MA: NBER Working Paper 5198, July 1995).

Los Angeles. Professor Brennan summarized the "top ten" of these contributions as follows:[10]

I. Top ten recent developments in industrial organization theory

A. New views on vertical restraints

Contractual relationships between manufacturers and retailers or input suppliers and manufacturers are frequently used to establish exclusivity or to maintain a certain price level. For example, General Motors may require its distributors to charge a certain price for its given wholesale price. Rather than see such arrangements as foreclosure or price fixing, however, they should be examined in terms of what they accomplish. If such an agreement does not involve direct competitors, it is likely that there is a cost-saving rationale for it. In general, these relationships tend to grow out of information flow and coordination problems more than from an interest in price fixing or gouging.

B. New ideas about vertical integration

Vertical integration is frequently seen as a way to reduce transaction costs. By internalizing certain functions or processes, firms can become more efficient. When this idea is applied to the idea of privatization, however, there are a number of other issues to keep in mind.

If privatization means replacing an unneeded monopoly with a competitive market, the real gain is from moving from monopoly to competition. But if the choice is between a publicly-owned monopoly or a privately-owned monopoly that the public still needs to regulate, the trade-offs are more subtle. The decision to integrate a number of activities frequently depends on informational subtleties or culturally formed expectations. For this reason, certain structures may work well in one place and not in another. In other words, vertical integration is not always bad. By extension, the privatization of vertically integrated activities is not always good.

C. Incorporation of game theoretic concepts

The IO field has almost entirely adopted the language of game theory. In particular, it has adopted three important concepts:

- *Strategic substitutes and strategic complements.* These models are used to characterize the interaction between companies. An action is a strategic substitute (complement) if one expects one's competitors to reduce (increase) the amount or intensity of that action if one increases it, e.g., by matching price increases. Whether the strategic decisions taken by firms involve substitutes or complements affects whether firms find it more profitable to be passive or aggressive, or to be lean or large.
- *Subgame perfection.* The idea of subgame perfection is about whether or not threats are credible. For example, an incumbent firm might threaten an entrant with low, post-entry prices. However, the entrant will take the threat seriously only if it is credible, i.e., that the incumbent will find it profitable to carry out the threat if the entrant actually enters.
- *Supergames.* The idea of supergames is most relevant to the idea of collusion in that they are iterative games. Some view it as a revived idea of passive collusion. The main problem with supergame models is that they treat history as relevant whereas economists treat it as sunk and therefore irrelevant. Strategies that are contingent on what happens in the past may not be that useful.

D. Revival of concern with deterrence to entry

Economists have examined ways for firms to make credible threats in order to deter entry, such as building industry-specific capacity.

E. Contestability

A market is contestable if an entrant could come in and undercut the incumbent, and then could leave the market at low cost, if and when

[10] Suggested readings in the latest development in the field of Industrial Organization are listed in the bibliography.

the incumbent responds by cutting its own price. Whether an entrant's investment is reversible rather than fixed is key. If substantial costs are sunk, the entrant may not be able to make enough money to cover them before the incumbent can respond, thus making the market not contestable and preserving the incumbent's ability to set high prices.

F. Rescuing limit pricing

In theory, only post-entry prices, and not pre-entry prices, should affect an entrant's decision whether to come into a market. However, if the entrant does not know the incumbent's cost, the incumbent may be able to signal that its costs are low and that entry would be unprofitable by setting low pre-entry prices.

G. Rescuing predation

To cope with the problem of credibility in examining predatory pricing, economists have employed sophisticated sequential models to study situations where firms have an incentive to predate, in order to preserve a reputation that they will not tolerate entry. How this reputation is established in the first place remains an open question.

H. Vertical integration and strategic theories

On the surface, vertical integration should have little to do with keeping markets from being competitive, since it involves operations at different stages in a production chain. However, economists have investigated models where vertical integration may change the "horizontal" strategic game, reducing competition.

I. Raising rivals' costs

Some economists argue that a firm has a strategic incentive to raise its rival's costs. However, to effectively raise a rival's costs, a firm must be able to create a monopoly over the price of something its rival needs.

J. Crossing the regulatory boundary

What happens if a firm that is regulated gets involved in unregulated markets? What are its incentives? If a firm is regulated, that provides an incentive for it to get involved in related markets and try to deny its competitors access to the regulated products and services. In developing countries, it may be a good idea to draw lines around the regulated and unregulated parts or a regulated company and to put each part in a separate business.

II. Concluding observations

IO has gotten much more complicated in the last few years. A good question to ask is, how many of these models are really robust as far as policy is concerned? They tend to be useful for academics, but may not offer more than heuristic value for policymakers.

LARRY FORGY:

"The effectiveness of USAID Efforts to Promote Private Sector Growth in East and Southern Africa."

I. Barriers to private sector growth

USAID has identified three main barriers to the growth of the private sector in East and Southern Africa: (1) a lack of entrepreneurship, (2) a perception of a lack of credit, and (3) government policy.

II. Direct interventions to eliminate these barriers

USAID has also identified three interventions that can be targeted at eliminating these barriers. These are:

- Providing direct business services to potential entrepreneurs such as management training, starting business centers, marketing information systems.
- Improving credit institutions. There is still a great deal direct provision of credit on the part of USAID. It is starting an Enterprise Development Fund in Southern Africa (40$ million for venture capital). In recent years, however, there has also been a movement toward creating and improving credit market

institutions rather than providing credit directly.

- Reforming policy and privatizing industry. Getting the state out of commercial activities is a priority for REDSO/East.

III. Issues related to USAID's involvement in private sector promotion

USAID economists are constrained by USAID's reliance on linear logical frameworks in terms of planning. The assumption that an intervention on the part of USAID will ultimately induce the government to act and, consequently, the private sector to grow, is false. There is no such linear causality. Rather, it is the reverse. A strong private sector will be the strongest advocate for policies conducive to private sector growth. Therefore, USAID should focus its efforts on creating a better environment for private business rather than on helping individual businesses directly.

With respect to the provision of business services, USAID has traditionally sought to train entrepreneurs. However, most Africans tend to be very risk averse and are not interested in being entrepreneurs. Most would prefer to be employed for a steady wage than to be involved in starting a risky venture. Experience with microenterprises and the results of GEMINI work in East Africa bears this out. Microenterprises should therefore be viewed as a safety valve that is relied on in times of economic downturn rather than a major source of private sector growth.

Similarly, USAID should not be distrustful of successful entrepreneurs. While smaller firms may need USAID's help more desperately, larger, more successful firms are a better bet in terms of generating long-term sustainable growth and job creation.

With respect to credit markets, USAID loves to provide credit directly; however, there is ample credit in the system. The more significant problem involves identifying projects in which investors are motivated to invest. While credit shortages may exist because governments are borrowing all that is available, that is not a credit market problem, it is a macro-economic problem.

With respect to government policy, government involvement in the economy results in unhealthy concentrations. South Africa suffers from a high capital-labor ratio that is very inefficient. In Malawi, former President Banda owns everything. In Zimbabwe, most resources are concentrated in the hands of a small minority. In all cases, a removal of government from commercial activity is in the best interest of long-term growth.

ROBERT THORPE AND CINDY CLEMENT:

"Creating a Competitive Regime in Outer Mongolia."

I. The drafting process

IRIS helped the Mongolian government draft an anti-trust law. This process involved several stages:

- Involving long-term advisors in the design of anti-trust legislation in Mongolia (since 1991).
- Holding workshops on what the institutions necessary for a market economy to work are for the emerging leadership and others who would be involved in drafting the anti-trust legislation.
- Conducting competition studies of three major industries (conducted with Mongolian researchers) in livestock/meat packing, telecommunication, and wool spinning.
- Providing interim support. IRIS provided information regarding all of the laws that had been adopted in Central and Eastern Europe and Russia. Many transitioning economies are eager to model themselves after others and adopt similar anti-trust regimes.
- Incorporating the criticisms and suggestions of Mongolian counterparts into the final legislation. The Mongolians critiqued manuscripts

prepared by IRIS. The process thereby became collaborative.

- Drafting the actual legislation. The resulting law did not resemble American law as much as it did laws from Central Europe.
- Monitoring the adoption and implementation of the legislation. From this experience, the IRIS team suggested the following guidelines for implementing anti-trust legislation.

II. Guidelines for implementation

A small cadre of local professionals who are well-trained and well-informed of the intricacies behind the theory and ideas of anti-trust law is essential to the successful implementation of such a law.

There also needs to be a process of publicity and education of the public about why anti-trust legislation is important and what its purposes are. This will garner needed public support and create a constituency of players invested in the success of anti-trust legislation.

REFORMING THE STATE AND TRANSITION TO A COMPETITIVE ECONOMY

Health

Presenters:

Verdon S. Staines
World Bank

Bob Aten
USAID/Indonesia

VERDON S. STAINES:

"Economic Issues in Designing Health Sector Reform."

I. The health sector around the world

Improvements in health around the world have resulted from **income growth** (particularly for the poor), **improved medical technology**, and the **spread of knowledge.**

Appropriate government policies can have an impact. Such policies are:

- enacting pro-poor economic growth policies
- increasing education, especially for girls
- universal access to public health and clinical services
- promoting competition among health care providers
- increasing efficiency of government spending on health

II. Economic issues in designing health sector reform

A. Market structure: competitive ideal vs. health sector

Many advocates of health sector reform argue that health care services can be better provided within the structure of a competitive market. However, there are several characteristics of the health care sector that may preclude a competitive allocation system from working. These include:

- Imperfect information. Neither consumers nor insurers have a clear understanding of the medical or technological aspects of health care. This is largely due to the fact that health care is not a clearly defined, standardized product. Rather, the subjectivity with which it is measured makes it a non-normal good.
- Market power. While there are many independent buyers and sellers, each small relative to the market, there are also many groups (such as hospitals, insurers, employers and

others) who have a strong degree of market power.

B. Implications of a departure from the competitive ideal

That the health sector may not possess the characteristics of a competitive market can result in efficiency and equity problems. A lack of clear information on price and quality can result in escalating costs and inappropriate incentives for consumers and providers as well as insurers. Similarly, price discrimination on behalf of those with market power (principally the sellers and insurers of health care) can limit the availability of health care services and insurance, resulting in serious equity problems.

ROBERT ATEN:

"Why Economics is Key to Successful USAID Support for Improved Health Care: The View from Indonesia."

Indonesia has launched a comprehensive program of health sector reform with the intent of moving to the private provision of health-care services through a managed care system (known as JPKM). While still largely not implemented, the reform effort's primary objective is to provide all Indonesians with a basic package of benefits regardless of ability to pay.

I. Managed care

A system of managed care would include:

- universal coverage
- pre-paid/capitated payment systems
- emphasis on prevention and promotion
- quality assurance
- delivery of these services through both the public and private sectors;
- and social equity

II. Health care financing from the private sector

The managed-care financing strategy that has been adopted by the government of Indonesia calls for shifting the financing of care from the government to households (except in the case of the absolute poor). Before this can be achieved, however, health-care services must be improved. Results of an USAID-funded study demonstrate that "Indonesians are willing to pay more for medical care when the medical care is significantly improved over the previous standard of care."

Other potential sources of financing for a managed-care system can come from Indonesia's financial markets. These sources include term bank loans made affordable by domestic borrowing. Since interest rates currently may be too high for health sector services, the government can issue domestic bonds to pay off foreign borrowing, thereby lowering the interest rate and allowing the health sector to borrow on a private-market basis.

III. Conclusion

If the quality of medical services is improved in Indonesia, the demand curve for those services will be shifted out. If interest rates are brought down, medical activities can leverage this increased demand to secure credit in Indonesia's financial markets. This demand-side strategy is an improvement over USAID's traditional supply-side approaches to improving health care in that it eliminates the need for non-sustainable subsidies.

REFORMING THE STATE AND TRANSITION TO A COMPETITIVE ECONOMY

Education

Presenter:

George Psacharopolous
World Bank

GEORGE PSACHAROPOLOUS:

I. Rates of return on investment in education

The rate of return on investment in education tends to be higher than those in infrastructure and agriculture.[11] Yet in most countries, public resource allocation is not determined on the basis of rates of return but on the basis of politics.

II. Different kinds of education projects yield different rates of return

Evidence from World Bank research reveals that primary education has a much higher rate of return than higher, vocational or secondary education. Gary Becker's original theory indicated this to be the case; now there is enough data from household surveys to confirm it empirically.

Investment in women's education has extremely high rates of return stemming from mostly non-economic factors such as reduced infant mortality, better nutrition, and lower fertility rates.

Returns to vocational education are quite low. The Bank's experience shows that a diversified curriculum enjoys higher rewards than vocational education programs in developing countries.

III. Methods of valuing education

Poor methods of valuing education

- International comparisons (in terms of enrollment rates or percentage of GDP spent on education) are meaningless. Countries differ in so many respects other than education that these comparisons are impossible.
- Manpower requirements are too inflexible. There is no way to accurately forecast or assess them.
- Expectations of the formal school system are too high. People can be trained in a number of other ways as well. Emphasis on formal schooling leads to too much emphasis on the public school system.

Good methods of valuing education

- The net enrollment ratio: how many children in a particular age group go to school at the appropriate grade level. If this is below 70% in a country, primary education should be the focus of any intervention.
- The unit cost of intervention. This is a good indication of whether or not a given education project is cost-effective (compared to alternative uses of the resources involved).
- Sources of financing. There should be more cost sharing at higher levels of education for both equity and efficiency reasons. Cross-country studies show that the wealthy benefit disproportionately more from higher education than the poor. The existence of student loan programs is a good indicator of cost sharing.
- Quality measures. Measure quality in terms of what students are learning (incrementally for a given amount of money) not by the value of inputs per student. For example, when the productivity of farmers with and without four years of primary education are compared, the increase in the agricultural output of educated farmers is greater than the cost of educating them.

[11] For methods of determining the rates of private and social returns to investment in a given level of education, see "The Profitability of Investment in Education: Concepts and Methods," by George Psacharopoulos. (Washington, DC: World Bank, March 1995).

REFORMING THE STATE AND TRANSITION TO A COMPETITIVE ECONOMY

Social Safety Nets

Presenters:

Tarsicio Castenada
Advisor, Government of Colombia

Carol Graham
World Bank and The Brookings Institute

TARSICIO CASTENADA:

"Safety Nets During Structural Adjustment: Some Principles and Experiences of Latin America."

I. Objectives of safety nets

The principal objectives of social safety nets are to (1) protect human capital, and (2) to protect the consumption and income levels of vulnerable groups.

II. Possible interventions

Social safety nets refer to a number of possible interventions such as: (1) employment generation programs to build social infrastructure such as water & sanitation, latrines, small irrigation systems, feeder roads, aforestation; (2) retraining programs for displaced and young workers; (3) direct food assistance programs for vulnerable groups such as children and the elderly (e.g., food coupons); and (4) school aid for poor children in primary school.

III. Problems in designing and implementing safety nets

There are a number of problems involved in both the design and implementation of safety nets. These include:

- Lack of political commitment of governments.
- Slow response of government agencies to change priorities.
- The influence of powerful interest groups that oppose government spending on the poor.
- Institutional and legal constraints.
- Lack of administrative capacity.

IV. Recommendations

There are also a number of policies that can address these problems. These involve:

- Introducing competition in the delivery of social programs. Safety net programs should be executed by many providers, not just by government agencies. This will help promote "accountability" among the providers of social services in that the capacity of local, decentralized providers of services who are more responsive to the needs of beneficiaries will be strengthened.
- Promoting freedom of choice by beneficiaries. Beneficiaries should participate in the design, monitoring and evaluation of these programs.

CAROL GRAHAM:

"The Political Economy of Safety Nets."

I. The role of compensation in the context of economic reform

While there is a great deal of consensus in the literature as to the nature and necessity of macro-economic reform in many countries, there is little consensus regarding the role of compensation to the various groups negatively affected by reform in the short run.

II. Research assumptions

Graham's research on the importance of compensation in the context of economic reform in six countries (Chile, Bolivia, Peru, Senegal, Zambia and Poland) is based on the following assumptions:

- Despite the debate about reform being bad for the poor, non-reform is worse for the poor. Reform provides a policy context in which one can design coherent protective measures. Non-reform allows a bad macro-economic situation to persist which hurts the poor.
- Market-oriented reform provides a favorable context for adopting a new approach to adopting social safety nets. It limits the role of centralized solutions and allows for the participation of beneficiaries.
- Safety nets cannot substitute for reforms of the macro economy, nor for reforms of social sector institutions. Macro policy reforms must be a priority. Establishing safety nets without a comprehensive reform effort is a waste of resources.
- The success of all reform and safety nets hinges on political factors.

III. Popular assumptions challenged

It is assumed that the poor have a weak political voice and are unlikely to be the focus of compensation efforts during reform. The poorest are often the most difficult and costly to reach. Most governments, therefore, direct scarce resources available for compensation to the more vocal and organized opponents of reform even though these groups are less needy than the poor.

Graham argues that it is not cost effective, from either a political or poverty-reduction point of view, to direct all compensatory resources to vocal opponents of reform. These opponents are unlikely to be as well off as they were prior to reform regardless of the level of compensation that governments can afford. Governments simply do not have the resources to buy off these opponents of reform and make them strong supporters of reform.

Rather, in some contexts, it is possible to encourage new coalitions for reform by focusing compensation on groups previously marginalized from state benefits. The effect of reaching people with benefits for the first time is much greater than giving previously privileged groups a fraction of that which they enjoyed prior to reform.

The ability of the government to use the context of reform to re-orient resources to the poor hinges on the political context and relative political weight of the opposition vis-à-vis the government. Sometimes governments have no choice but to placate the opposition. In Eastern Europe, for example, large, powerful labor unions represent workers who are the net losers of reform. Governments in these countries have a harder time re-directing resources to other groups.

IV. Research findings

Open political environments are more conducive to building a broad base of support for reforms and therefore a policy environment in which poverty reduction can take place.

The pace and scope of economic reform is a determining factor of the success of social programs. Rapid and far-reaching reform can provide unique opportunities to re-direct resources to previously marginalized groups. In contrast, slow or stalled reforms allow the opposition more opportunity to coalesce and to continue to monopolize the benefits of public expenditure.

The role of government in providing information about reform explaining it to the public is very important. Clear government communication is critical to the political viability and sustainability of reform.

The incorporation of beneficiary participation (through a demand-based approach of safety net delivery) and private sector management techniques in the implementation of safety nets (such as relying on local demand for resource allocation, reducing administration, subcontracting out to NGOs and the local private sector) can result in state services being delivered in a non-partisan and more efficient manner.

There are trade-offs. Demand-based approaches to providing safety nets are not always effective at targeting the poorest groups. These groups often face obstacles to participation in such programs. In these instances, centralized delivery of social services may be a better option.

V. Conclusion

If a system of social safety nets is implemented well and if it is linked to broader economic and sectoral reforms, it can have a positive effect on poverty reduction and can help sustain economic reforms until longer-term growth sets in. However, if they are poorly implemented or implemented without the context of broader reforms, safety nets can have negative effects on the efforts of the poor to help themselves.

REFORMING THE STATE AND TRANSITION TO A COMPETITIVE ECONOMY

Municipal Infrastructure

Presenter:

Mark Gellerson
USAID/Egypt

MARK GELLERSON:

Gellerson is spearheading a multi-year effort to assess USAID's investment in the water and waste water sector in Egypt. To do this, he is employing contingent valuation (CV). CV is a technique that relies on surveys to estimate the value of non-market transactions. It can be extremely useful in valuing non-market goods and services so that cost-benefit methods can then be used to measure trade-offs between the provision of these and other goods and services.

I. Background

In the mid-1970s, the water and waste water system in Cairo was characterized by a high degree of sewer flooding. Many parts of the city had no adequate sewer connections. Treatment of sewage before it was dumped back into the Nile was inadequate. Many parts of Cairo still have inadequate supplies of water.

Since the mid-1970s, USAID has invested more than US$ 2 billion into the improvement of the water and waste water systems in Egypt. By way of making an economic assessment of the returns to this investment, Gellerson hired a team from Michigan State University to employ a contingent value (CV) approach to determining the value of these improved systems. As they have the characteristics of a public good, this approach was used as a means of estimating the willingness of consumers to pay for these systems.

II. Three phases of the CV approach

The contingent valuation approach is executed in three stages. These are:

- *Reconnaissance and design*. The study team visited the areas impacted by the water and waste water systems (2 weeks).
- *Focus group research*. "Typical" individuals from affected areas were included in discussions focusing on (a) their view of the existing water and waste water services; (b) their knowledge of the previous situation before; (c) their recommendations for a solution. Results of focus group discussions were incorporated into the survey design (2-3 months).
- *Survey execution*. A 4,000 household survey was conducted in Cairo. Another 1,000 household survey is being conducted in a smaller city outside of Cairo (1 1/2 years).

III. Results of the CV approach

The study team conducted a total of four surveys, one each on: (1) the benefits to households of having connections to sewers which they did not have before, (2) the benefits to households of reduced sewer flooding, (3) the benefits to households of having access to water who had not previously been connected to the water system, and (4) the benefits to households of having improved water pressure.

Survey results are just coming in. They should reveal estimates of the average willingness of water consumers to pay for these four categories of benefits - aggregated over the universe of consumers. The results will provide information for an ex-post evaluation of USAID's investment in Egypt's water and waste-water system as well as information that can inform the determination of future water tariff levels.

REFORMING THE STATE AND TRANSITION TO A COMPETITIVE ECONOMY

Inter-Governmental Finance, Fiscal Federalism and Local Government

Presenters:

Jorge Martinez and Sally Wallace
Georgia State University

JORGE MARTINEZ AND SALLY WALLACE:

I. The nature of decentralization

In recent years, decentralization has become a key priority with respect to fiscal policy for many governments. With the end of the socialist state and the expansion of democracy, many countries are realizing the benefits of decentralization. There are, nevertheless, a few negative consequences that are possible as well. These are discussed below.

A. Pros of decentralization

- Economic efficiency. Competitive markets can be better approximated if locales become involved in decision making. This normally results in the provision of better services.
- Greater political accountability.

B. Cons of decentralization

- Greater inequity. Since tax bases tend to be unequal, decentralization usually results in increased regional inequality.
- Economic instability. A devolution of power over fiscal policy away from the central government, may lead to the central government losing control over the economy which, in turn, may lead to greater economic instability.

II. The process of decentralization

A. Expenditure assignment: who should do what?

There are three questions regarding the vertical structure of government (federal, state, local). First, is an intermediate level of government necessary? In large countries, the answer is generally yes. The delegation of tasks to lower levels allows for the better coordination and provision of services. In smaller countries like Mongolia or Latvia, however, it may not be necessary.

Second, what if communities are very small and lack the capacity necessary to perform certain services like water and waste management? Possible options are: (1) cooperation and integration of geographically disparate regions for administrative purposes; (2) purchase agreements between large and small municipalities where the smaller of the two can buy services from the larger.

Third, once the vertical structure of government is clear, what should be the division of responsibilities between the different levels? Public finance theory advocates a benefit principle such that the beneficiaries of a service manage the provision of that service. Obviously, things like national defense and air traffic control need to remain the responsibility of a central government. But everything that can be managed locally should be managed locally.

B. Common problems with expenditure assignment

Some central governments use decentralized finance to balance the budget at the central level. They devolve expenditure obligations to the local level despite the inability of local capacity to meet them.

There has been a tendency to shift expenditure assignments without shifting revenue assignments. This had left local governments unclear in terms of their responsibilities.

Central governments have off-loaded social expenditure responsibilities onto local groups without taking equity issues into account. If the purpose of social safety nets is to equalize society, they should be paid for from centralized sources although they may be better managed locally, by those who are closest to the poor.

Capital investment responsibilities for basic infrastructure and social sectors (water, sewage, roads, health and education) must be in the same hands. Otherwise coordination between the construction and maintenance becomes extremely difficult and local communities have little incentive to maintain centrally designed and financed projects. Keep the responsibility for both designing and maintaining capital investment in local hands.

Local governments frequently lack the resources to finance all of the goods and services for which they are responsible. Matching grants, budgetary savings, and borrowing are possible solutions. Local governments should be able to borrow with well-defined controls. This can be done via a well-managed, non-subsidized municipal development fund since capital market will not offer much of a solution in developing countries in the short term.

C. Budgeting

Budgetary autonomy at the local level is the key to successful decentralization. Without it, the benefits of decentralization such as economic efficiency, accountability and responsiveness to taxpayers can not be realized.

D. Problems with budgeting

In the former Soviet Union, there has been extensive use and abuse of extra-budgetary funds. Under the old regime, this was the only way for local governments to have a degree of autonomy. Now there is no longer a need for them and they should be eliminated.

There is also a lack of knowledge in many countries about budget preparation, regional forecasting, budget execution and even internal and external auditing.

III. Revenue assignment

While there is no uniform procedure for determining tax collection responsibilities, there are several guiding principles:

- Local governments should collect and keep taxes for which the burden of collection is on them.
- Local governments should not be able to levy taxes that have a harmful effect on business or economic efficiency. Otherwise, this may prompt businesses to move from one tax location to another, creating unemployment and instability in other regions.
- The central government should not impose taxes that impose a high administrative burden on local governments. Examples of such taxes are: value-added taxes (VAT) which are based on the location of collection, and business income taxes. Again, this might create an incentive for businesses to move. Taxes with moderate administrative burdens are: the individual income tax, property tax, user fees and charges and retail fees.

IV. Inter-governmental transfers

Inter-governmental transfers tend to be a last-ditch effort to provide local governments with the revenue they need. In most cases, such transfers depend more on the political environment than they do on the demands of economic efficiency. There are two principle dimensions to the inter-governmental transfer problem:

A. How is the size of the original revenue sharing pool determined?

Inter-governmental transfers can be based on: (1) a legislated percentage of national taxes, (2) an ad hoc decisions in which the size of the pool changes from year to year, or (3) the central government's calculation of how much money it will need to reimburse local government expenditures.

B. How is the method of distribution determined?

There are a number of inter-governmental distribution methods: the return share method, a formula allocation method, ad hoc methods, or cost-reimbursement methods. Under the return share method, the central government should return shares of revenue based on where they were collected. This is not a very equitable method. Under the formula allocation methods, there are typically two components: (1) an equalization component based on per capita income or other measures of poverty; and (2) a tax capacity component in which local governments can be rewarded if they do well.

Ad hoc methods include methods like the gap-filling method by which local governments collect and spend revenue expecting the central government to fill any remaining deficit gap. This is similar to the cost-reimbursement method which simply involves the central government reimbursing the local government for whatever it spends. This imposes little discipline on local officials and may lead to rampant spending.

V. Summary

Decentralization and inter-governmental fiscal relations are part of a system. This system should contain the following elements:

- A stable tax code.
- A legislated assignment of taxes on both the revenue and expenditure sides and a clear delineation of responsibilities for the two.
- Some autonomy for local governments in determining tax rates and taxes bases.
- An opportunity for local governments to borrow for certain capital purposes.
- The local election of local officials (rather than officially appointed officials), otherwise the incentive for accountability is minimal.

VI. Recommended policy tools

There are a number of policy tools available to USAID and other policy makers. For example, there are written case studies of countries that have made it through the decentralization process successfully. There are also case studies of countries that have not been successful. Both would be useful in the formulation of decentralization policies.

Computer modeling that allows governments to see the implications of their actions is also a valuable tool. Simple spreadsheet models based on budget data that allow for sensitivity analyses or micro-simulation models that can help assess policy implications can be easily generated.

REFORMING THE STATE AND TRANSITION TO A COMPETITIVE ECONOMY

Governance, Corruption and Economic Growth

Presenters:

Mancur Olson
IRIS and the University of Maryland

Michael Stevens
World Bank

Glenn Rogers
REDSO/West

Oscar Antezana
USAID/Bolivia

MANCUR OLSON:

Official corruption tends to be much greater in poor, unsuccessful countries than in rich, more successful ones. This has little to do with differences in morality. Rather, it can better be explained by private sector incentives for law-abiding behavior. In richer countries, the private sector is organized to prevent the violation of the law. Private firms employ locks, accounts, guards and a system of well-defined property rights to protect themselves. In poorer countries, on the other hand, price and quantity controls create opportunities for rent-seeking.

Thus policy distortions, as well as the passive collusion of the police, lead to greater corruption in developing countries.

MICHAEL STEVENS:

I. The costs of corruption

There is a disenchantment with foreign aid on the part of developed country taxpayers and a subsequent reluctance to finance development projects. Costly and uneconomic projects (white elephants) have wasted untold resources over the years which makes the funding of new projects more and more difficult. And, while donors currently emphasize the role of the private sector in development, corrupt and inefficient bureaucracies create obstacles to private business in that they undermine the rule of law, discredit nascent democratic regimes and impede the effective implementation of policy.

II. What can be done?

A. Rent-reducing policies

- Trade regime reform. Adopting market exchange rates. Removing quantitative restrictions.
- Tax reform. Going to low, uniform rates.
- Regulation reform. Abolishing price controls.
- Privatization. Taking enterprises out of the public sector where an uncompetitive relationship between public and commercial concerns can exist.

B. Institution-building policies

- Civil service reform. Civil servants tend to be underpaid and are therefore corruptible.
- Competitive procurement system implementation. Making public procurement procedures more transparent.
- Accounting and auditing system modernization. Making financial transactions more transparent.

C. Problems with implementing these policies

Implementing exchange rate and tax reform are relatively easy. Privatization, however, is more difficult. In a country riddled with informal payment systems in the public sector, squeezing externally at one end by forcing a market-clearing exchange rate will simple transfer the problem to the other end. If the power of the elites to finance their needs through the sale of foreign exchange is eliminated, they will simply resort to financing it via corruption of the tax system. This kind of "waterbed problem" is very difficult to deal with.

Civil service reform is also difficult. The more the public sector has expanded beyond the domestic tax base, the more difficult it is to reform that sector. There is tremendous stability in the public sector due, in part, to donors involved in perpetuating salary supplements.

Procurement and accounting reform are more technically difficult to implement; however, they require a certain discipline. Without discipline at the head of official departments, discipline elsewhere is impossible.

III. Remaining questions

Why is corruption more dysfunctional in some countries than in others? For example, it seems to do less damage in South East Asian to economic growth. Perhaps it is a question of who the participants in a transaction are. When corruption is a matter of the private sector bribing the public sector, there is a limit to it. Once bribes start cutting into profits, the private sector will not pay. When corruption is a matter of a public enterprise wasting resources that will be borne by the national debt, there is no limit to it.

Does corruption harm development? Yes, there are economic, social and environmental costs to corruption in all cases. But perhaps we should view it in an historical context, remembering that corruption in industrial countries lessened over time. We might assume that it will ease with trade and greater economic cooperation between countries.

GLENN ROGERS:

"Anti-Corruption Initiatives in Niger."

I. History

Anti-corruption legislation was enacted in Niger shortly after independence. At issue since then has been the ability of officials to enforce this legislation. Salary arrears created incentives for public officials to extract elicit payments. A new government in 1991, however, made the reduction of corruption a priority. It reduced the rights of police officers, army personnel and customs officials on the road. They were no longer allowed to prohibit, delay or require the unloading of vehicles. It also distributed copies of anti-corruption laws to drivers as well as to the police and other officials. Informing both sides of a possible transaction of the law changed the bargaining power between them and so reduced the ability of the police to extract payments. Trade policy reform and the removal of export taxes also eliminated any legally-based possibilities for rent-seeking.

II. Effects of the government's anti-corruption campaign

USAID measured the cash costs of corruption in the transport sector prior to the campaign and estimated that cash payments represented approximately one third of the total costs of corruption to transporters. Where the remaining two thirds stemmed from the loss of produce and time.

USAID put together a traffic-weighted, per kilometer illegal payment (payment without a receipt) survey of drivers along major transport routes in Niger. Based on these survey results, the mission estimated that the total cash payments due to corruption were reduced by half of previous levels after the government's information campaign. Rogers argues that transporters' unions, a national conference on corruption and the strengthening of the democratic regime all played an important role in making sure the information campaign was a success. This capacity building proved to be critical. The freedom of expression and the rule of law as evidenced by the statements of union leaders and their ability to dialogue and extract commitments from the government clearly played an important role in determining the success of the campaign.

III. The limitations of a purely domestic anti-corruption campaign

While Niger has been successful in curtailing corruption among its police, gendarmes and customs officials and in removing export taxes, there is evidence that illegal payments in neighboring countries rose correspondingly. Transporters of onions from Niger to the Abidjan market have seen no significant decrease in their overall payments since officials in Burkina Faso and elsewhere have stepped in to collect the rents that had been reduced in Niger. This evidence of regional corruption raises the question as to the limits of USAID's ability to fight corruption via bilateral programming.

OSCAR ANTEZANA:

"The Governance Dimension of Economic Stabilization and Structural Reform: the Case of Bolivia."

Antezana identified three elements of good governance: accountability, openness or transparency, and the rule of law. He argued that good governance is an essential condition for economic development and that a lack of good governance in Bolivia can explain its inability to achieve high rates of growth. Reviewing the last four administrations in Bolivia, Atezana made the case that those who have made good governance a priority have enjoyed greater success in stabilizing and restructuring the economy than those who have not.

ECONOMIC REFORM IN POST-WAR AND TRANSITION ECONOMIES

Presenters:

Elaine Grigsby
Global Bureau, Economic Growth Center

Samuel Skogstad
Georgia State University

ELAINE GRIGSBY:

I. A taxonomy of transitioning economies

USAID is increasingly involved in countries that differ dramatically from the traditional profile of developing countries. For example:

A. The former Soviet Union and East and Central Europe

USAID now has twelve missions in these countries.

B. Former satellites of the Soviet Union

The fall of communist ideology and the regimes held in place by aspects of the Cold War has contributed to a number of civil conflicts in countries like Nicaragua, El Salvador, Cuba, Angola, Mozambique and Ethiopia. While USAID has had a longer presence in most of these countries than in Eastern Europe and Russia, its role in them has changed considerably since the fall of the Berlin Wall.

C. War-torn countries

Countries like Haiti, Rwanda and Sudan.

D. Middle-Income Countries

Countries like South Africa, India and Argentina face similar issues of transition in their efforts to restructure their economies.

II. Economic triage

In a sense, stabilization is a form of economic triage. Putting an end to "fiscal hemorrhaging" involves both immediate, stabilizing measures as well as more medium-term structural reforms in the banking sector, budget constraints, privatization and reform of state-owned enterprises. Distinguishing between what needs to be done immediately and what needs a longer-term effort is a necessary first step in working in transitioning economies.

III. The political economy of stabilization

Political consensus is vital to implementing any type of reform but particularly so in enacting the initial stages of a stabilization program. Once such a program is in place and individuals are visibly benefiting from it, constituents in favor of reform can develop. In Nicaragua, for example, it became difficult to persuade "rogue groups" from the opposition to go along with the government's stabilization program. These groups ultimately sabotaged the program by harvesting other people's coffee, thereby precluding coffee growers from realizing any short-term income gains from the stabilization effort.

USAID needs to consider the political economic reality of countries undergoing reform and to keep in mind the inter-play between existing institutions and constituencies. The economic rationale for reforms is frequently insufficient to gain the support of all interest groups involved. Rather, their political economic incentives must be incorporated into the stabilization strategy.

IV. USAID's role in transitioning economies

Given the taxonomy of transitioning economies cited above, one third of the world's population is living in war-torn or transitioning economies. Developing a type of "paramedic strategy" for these countries should therefore be a priority for USAID. Its newly established Office of Transition Initiatives is a first step in this direction. Yet the need to articulate a short-term strategy for these countries remains, as does the need to examine whether USAID should be thinking about economic policy reform in these countries differently than it does in more traditional developing economies.

SAMUEL SKOGSTAD:

Skogstad outlined five principal components of economic restructuring in transitioning economies, with a focus on the former Soviet Union.

I. Five components of economic restructuring

A. Product mix

Many of the goods and services produced by the public sector in command economies are more efficiently produced by the private sector. A re-definition of public and private as well as tradable and non-tradable goods is required.

B. Scale of production

Command economies have traditionally viewed competition as wastefully duplicative. This has led to a bias toward large-scale production facilities which needs to be redressed.

C. Factor proportions

A bias toward large-scale production can imply a bias in favor of capital intensity. This is reinforced by a penchant for high technology and an emphasis on military-related industries in the former Soviet Union. It may be interesting to examine whether inefficient factor proportions are endemic to command economies.

D. Location of productive activity

In an effort to create employment in remote locations and relieve pressure on municipal facilities, centrally planned economies frequently locate productive activities in areas remote from markets and consumers. Such locational distortions must be addressed.

E. Size, output and organization of the public sector

Many of the goods and services produced and distributed by central authorities are better handled by local or other sub-national governments. The decentralization of tax and spending authority and a formal revision of intergovernmental fiscal relations is required.

APPENDIX 1.1
Foster-Greer-Thorbecke Poverty Indices

These measures are averages of *individual* poverty measures.

Let:

z = poverty line

x_j = income (or consumption expenditure) of individual j

for $j = 1,2,\ldots.n$ such that $x_1 \leq x_2 \leq \ldots \leq x_q \leq z \leq x_{q+1}\ldots \leq x_n$

Define d_j = 1 if individual j is poor ($x_j < z$)

= 0 if individual j is not poor ($x_j \geq z$)

The individual poverty measure is then defined as:

$$P_{\alpha j} = \left[\frac{z - x_j}{z}\right]^{\alpha} \cdot d_j$$

The poverty measure for the population is then written:

$$P_{\alpha} = \frac{1}{n}\sum_{j=1}^{n} P_{\alpha j}$$

I. Headcount Index (a= 0): measures the *incidence* of poverty

$$H = P_0 = \frac{q}{n}$$

- H measures the percentage of the population whose consumption expenditure is below the poverty line.
- A drawback of this measure is that it is totally insensitive to distribution below the poverty line.

II. Poverty gap index (a= 1): measures the *depth* of poverty

$$PG = P_1 = \frac{1}{n}.\frac{q(z-\overline{x}^{p})}{z} = H.I$$

where

$$I = \frac{(z-\overline{x}^{p})}{z} = \text{average income gap ratio}$$

- PG is the average of poverty deficits as proportion of the poverty line, where the average is formed over both the poor and the non-poor and the non-poor have zero poverty deficits.
- PG is better than H because it is sensitive both to the incidence of poverty and to the average consumption deficit of the poor
- Its drawback is that it violates the strong transfer principle

III. Squared poverty gap index (a= 2): measures the *severity* of poverty

$$SPG = P_2 = \frac{1}{n}\sum_{j=1}^{q}(1 - x_j / z)^2$$

SPG is a weighted average of proportionate poverty deficits where:

1. the weights are the proportionate poverty deficits themselves (the poorer the individ ual, the higher the weight)
2. the average is formed over both the poor and non-poor
3. the non-poor have zero poverty deficits

Note: The squared poverty gap index (SPG) is the preferred poverty measure of the three presented here if the welfare of the poorer individuals is deemed to be of greater concern than those of the less poor.

Chapter 3
Workshop Papers

THE GOVERNANCE DIMENSION OF ECONOMIC STABILIZATION AND STRUCTURAL REFORM: THE CASE OF BOLIVIA

by

Oscar Antezana[1]

USAID / Bolivia

At present, nobody dares propose a solution to underdevelopment that disregards the market. But governance determines how well, or how poorly, markets and the economy perform independent of the kind of political system adhered to. Those countries that spend their energies ensuring good governance are likely to join the community of developed countries before those that focus largely on macroeconomic policy. The major cause of lack of good governance in Bolivia has been the historical instability of constitutional rule in the country as battles for political power have been battles for shares of the national pie. Governance, unfortunately, may not necessarily be unidirectional, that is, it may not automatically improve over time, at least until market institutions (e.g., that create and enforce the rules, establish law and order, and ensure property rights) mature as part of the development process and the market economy progressively transforms society. Meanwhile, governance may be determined by isolated and personalized factors such as leadership, vision, ownership, commitment and even limited political openness. This does not mean, however, that desirable and feasible cultural or historic solutions need to be in place first nor that a minimum level of development be in place as a necessary condition. There is room for policy induced remedies that can accelerate change towards perfectible modes of governance.

I. Introduction

To arrest the hyperinflation that ravaged Bolivian society between 1982 and 1985, Bolivia adopted comprehensive stabilization and liberalization programs usually found in economic "textbooks". Yet, results have not

[1]Prepared for the USAID Economists' Training Workshop in Annapolis, Maryland, September, 1995.

been a "textbook" case. Ten years later, Bolivia has achieved relative economic stability but only modest economic growth rates. What is the principal "missing link" between textbook and reality? Governance.[2]

How can we identify good governance (as defined in this paper), even in a rough manner? Three fundamental elements of good governance are:

1) accountability, that is, congruency between public policy and implementation and efficient allocation and use of resources;

2) openness or transparency, referring to low levels of government controls on the flows of commodities, ideas, information, and participation; and

3) the rule of law, implying standard operating procedures, clearly promulgated and objectively applied rules, non personalized decision making with only modest levels of discretion, and standardized procedures for establishing and implementing policies.

Well administered, these three elements of good governance result in high government credibility and predictability, efficient allocation of resources, and clear and simple policies and rules. This environment should be conducive to economic growth.

Although there are several theoretical approaches and proposals that identify the governance dimension of the development process as important, available literature does not provide practical analytical models and meaningful measurements of governance and its impact on development. Since there is little scientific theory of governance and its determinant factors (e.g., culture, institutions, historical circumstances), economists need to find and study success stories. Developing countries would be greatly assisted if they could know what works and what doesn't and learn from mistakes and successes of others. This short paper takes a small step in that direction, drawing from the Bolivian experience.

This paper seeks to (1) identify a first approximation of the relationship between governance and economic development, (2) describe a major cause for lack of governance in Bolivia, and (3) analyze the governance dimension in Bolivia's stabilization and structural reform programs. Throughout the paper, lessons learned will be identified from actual experience in the field with the purpose of improving our understanding of the development process.

II. Governance and economic development

If we ask ourselves why some developing countries fare better than others under practically the same international conditions, we cannot simply point to differences in their natural resource base or even human resource base (Argentina is an excellent example of a developing country with adequate human and natural resources).

Economic performance as measured by inflation and economic growth is mainly the result of domestic economic policies. World economic conditions, including the international terms of trade, are secondary.

[2] For the purposes of this paper, governance is defined as "the manner in which power is exercised in the management of a country's economics and social resources for development," from the World Bank's Managing Development: The Governance Dimension, August, 1991.

TABLE 1: Economic Growth, Inflation and Terms of Trade for Selected Countries: 1970-1994

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
INFLATION(%) high inflation co's																									
Bolivia	3.8	3.7	6..5	31.9	62.5	8.0	4.5	8.1	10.4	19.8	48.6	32.0	123.1	276.7	1280.3	11736.7	276.3	14.5	16.0	15.2	17.0	21.4	12.1	8.5	7.9
Argentina	13.6	34.8	58.4	61.2	23.7	182.7	444.1	177.0	174.6	159.3	101.2	104.1	164.6	343.6	7171.6	672.2	90.1	131.3	343.0	3079.8	2314.0	171.7	24.9	10.6	4.3
Brazil	22.3	20.2	16.5	12.8	27.5	29.1	42.1	43.3	38.9	52.6	82.2	106.2	97.7	147.1	192.3	226.3	144.4	230.0	682.3	1287.0	2937.8	440.0	1012.4	2146.7	2669.4
Chile	33.0	19.2	77.3	360.9	505.2	374.4	211.9	91.3	41.0	33.1	35.0	19.9	9.7	27.3	19.9	30.7	19.5	19.9	14.7	17.0	26.0	21.8	15.4	12.1	12.0
Mexico	5.2	5.3	5.0	12.0	23.8	15.1	15.9	29.0	17.4	18.2	26.4	27.9	58.9	101.8	65.5	57.5	86.2	131.8	114.2	20.0	26.7	22.7	15.5	9.7	6.9
Nicaragua	na	na	na	27.1	13.4	7.5	2.8	11.3	4.5	48.8	34.6	24.3	30.2	25.3	35.6	219.4	681.2	911.9	10205.	4771.4	7489.6	2734.6	20.4	na	na
Peru	5.0	76.8	7.2	9.5	16.9	23.6	33.5	38.1	57.8	66.7	59.1	75.4	64.4	111.2	110.2	163.4	77.9	85.9	666.3	3400.0	7484.0	409.7	73.4	48.6	23.7
Uruguay	17.0	24.0	76.5	100.0	50.0	100.0	50.0	55.6	42.9	65.0	63.6	35.2	19.2	49.4	54.6	72.6	76.1	63.7	62.2	80.5	112.5	102.0	68.5	54.1	44.7
Low inflation co's																									
Colombia	6.8	9.0	13.4	20.8	24.3	22.9	20.2	33.1	17.8	24.7	26.5	27.5	24.6	19.8	16.1	24.0	18.9	23.3	28.1	25.8	29.1	30.4	27.0	22.6	na
Costa Rica	4.7	3.1	4.6	15.2	30.3	18.2	3.4	4.1	5.6	9.8	17.8	37.2	89.8	32.6	12.0	15.0	11.9	16.8	20.8	16.6	19.0	28.7	21.8	9.8	13.5
Ecuador	5.1	8.4	7.9	13.6	24.0	15.1	10.3	13.6	11.2	10.7	12.7	16.7	16.1	48.4	31.0	28.2	22.9	29.5	58.2	75.7	48.5	48.7	54.6	45.0	27.3
Paraguay	0.7	4.8	9.5	13.0	24.8	7.1	4.6	9.5	10.4	28.3	22.4	14.0	6.7	13.4	20.3	25.1	31.8	21.8	22.6	26.4	38.2	24.2	15.1	18.2	na
South Korea	16.1	13.4	11.7	3.2	24.7	25.2	15.2	10.0	14.6	18.2	28.8	21.3	7.1	3.4	2.3	2.4	2.8	3.1	7.1	5.8	8.6	9.6	6.3	4.8	6.2
GDP growth (%)																									
Bolivia	7.8	4.9	5.8	5.3	5.1	6.6	6.1	4.2	3.4	0.0	-0.9	0.9	-4.4	-4.5	1.0	-0.7	-3.2	2.6	3.8	2.9	2.4	4.7	3.8	4.1	4.2
Argentina	2.6	3.4	1.9	3.1	6.1	-0.7	00.4	7.1	-3.7	7.2	2.7	-5.9	-3.2	3.8	1.8	-6.6	7.3	2.5	-1.8	-6.3	0.2	8.9	8.6	6.0	na
Brazil	2.6	12.2	10.9	14.4	9.0	5.2	9.8	4.6	3.2	6.8	9.1	-4.4	0.6	-3.4	5.4	7.9	8.4	3.3	-0.3	3.3	-4.6	-0.4	-0.9	na	na
Chile	1.4	9.0	-1.2	-4.9	2.5	-11.6	3.5	8.6	7.5	8.7	8.2	4.8	-10.4	-3.7	8.0	7.0	5.6	6.5	7.3	10.1	2.9	6.1	10.3	6.0	na
Mexico	6.9	4.2	8.5	8.2	6.1	5.7	4.2	3.2	8.2	9.3	8.4	8.8	-0.6	-4.2	3.7	2.7	-3.9	2.0	1.3	3.4	4.5	3.6	2.6	na	na
Nicaragua	1.3	4.9	3.2	6.5	14.3	-0.2	4.8	8.9	-7.9	-26.7	2.5	5.7	-0.8	4.8	-2.2	-4.4	-2.2	1.4	-11.4	-0.9	0.0	-1.0	1.3	-0.9	na
Peru	7.3	5.1	5.8	5.4	9.2	3.4	2.0	0.1	0.3	5.8	3.1	7.2	-0.4	-12.6	5.8	2.1	9.3	8.3	-8.2	-11.8	-4.3	2.6	-2.8	6.4	na
Uruguay	4.6	-1.0	-1.6	0.4	2.9	6.0	3.9	1.4	5.0	6.0	6.1	1.8	-9.6	-9.9	-1.5	1.6	8.4	8.0	0.0	1.4	0.9	2.4	7.4	1.5	na
Low inflation co's																									
Colombia	6.6	6.0	7.7	6.7	5.7	2.1	4.8	4.1	8.4	5.4	4.1	2.1	1.0	1.6	3.6	3.3	6.1	5.4	4.1	3.4	4.1	2.0	3.7	5.3	na
Costa Rica	7.5	6.8	8.2	7.7	5.4	2.0	5.4	8.9	6.2	4.8	0.7	-2.3	-7.0	2.8	7.9	0.8	5.5	4.8	3.4	5.7	3.6	2.2	7.3	6.4	4.5
Ecuador	6.5	6.3	14.4	27.1	5.8	5.3	9.7	6.3	7.0	5.4	4.6	4.1	1.1	-2.1	4.1	4.2	2.9	-6.3	10.7	0.2	2.9	4.8	3.5	2.0	na
Paraguay	6.2	4.4	5.1	7.2	8.3	6.4	6.8	10.7	10.9	11.1	14.5	8.6	-3.5	-3.0	3.1	4.0	-0.1	4.4	6.5	5.8	3.1	2.4	1.8	na	na
South Korea	8.8	9.2	5.9	14.9	8.9	7.7	13.5	11.0	10.9	7.5	-3.3	6.9	7.4	12.0	9.2	6.9	12.3	11.8	11.4	6.1	9.0	8.4	4.8	5.5	na
TERMS OF TRADE high inflation co's																									
Bolivia	132.8	104.0	93.5	106.3	170.7	138.5	152.9	172.2	163.9	183.8	197.7	187.0	178.5	175.5	174.7	167.0	121.5	100.0	83.7	95.2	82.9	73.0	52.9	54.8	57.1
Argentina	162.7	161.4	155.2	204.0	164.4	148.5	146.3	134.4	127.6	130.9	122.2	119.8	110.4	117.7	118.6	109.8	104.3	100.0	105.6	99.6	113.0	112.6	110.5	na	na
Brazil	205.4	188.7	169.3	194.4	132.6	124.8	142.2	162.7	140.9	124.5	102.9	94.5	93.0	93.7	96.8	91.7	113.2	100.0	105.3	108.5	107.9	108.7	107.5	na	na
Chile	261.2	197.7	223.8	271.4	196.5	138.8	139.6	12.93	122.3	141.1	128.4	110.9	102.4	110.2	103.7	101.9	93.4	100.0	114.9	116.7	115.3	122.4	117.7	na	na
Mexico	128.8	129.6	166.2	190.6	149.9	128.2	143.7	134.8	114.8	117.8.	136.6	146.0	141.7	133.2	134.5	133.4	90.1	100.0	101.5	110.3	116.5	117.9	119.5	na	na
Nicaragua	165.4	155.9	141.1	121.4	102.4	92.7	127.7	159.3	134.0	110.1	117.8	110.0	10.7	98.9	119.2	108.3	103.6	100.0	102.9	96.7	86.8	88.7	75.2	na	na
Peru	175.0	155.7	185.9	238.0	194.4	128.5	162.8	168.4	126.7	133.8	137.6	126.8	115.6	116.1	116.1	111.3	92.4	100.0	102.1	109.0	98.0	88.2	85.8	na	na
Uruguay	173.1	155.1	217.6	215.0	136.8	117.6	124.8	113.4	12.7	115.4	102.5	97.2	91.0	91.6	92.5	89.4	100.5	100.0	104.7	104.3	93.6	97.8	97.1	na	na
Low inflation co's																									
Colombia	115.5	105.0	110.6	113.8	123.4	112.6	167.3	219.5	168.1	160.9	142.2	128.6	137.0	134.3	140.8	139.7	142.0	100.0	100.6	79.8	86.5	84.0	78.9	na	na
Costa Rica	155.8	132.5	142.6	148.8	117.4	139.4	139.4	162.1	132.0	129.5	117.1	108.5	108.7	112.4	110.8	111.1	121.8	100.0	110.7	103.4	89.5	90.9	84.9	na	na
Ecuador	153.5	131.3	104.4	54.8	128.1	106.8	122.4	140.7	123.4	132.3	163.0	165.3	162.2	158.3	156.1	152.7	98.2	100.0	78.4	91.3	99.2	88.2	91.3	na	na
Paraguay	202.9	190.0	215.2	304.1	199.6	159.3	173.5	16.5	158.0	151.5	131.4	120.8	114.1	126.6	122.6	108.3	98.7	100.0	107.4	104.7	95.9	98.4	88.4	na	na
South Korea	149.8	145.1	144.4	125.7	106.8	110.6	120.5	114.2	113.5	110.5	96.7	98.0	100.8	100.5	102.7	102.6	108.1	100.0	102.8	106.1	105.1	106.3	106.1	na	na

Sources: 1. World Bank Tables, 1994; 2. International Financial Statistics, April 1995, International Monetary Fund; 3. Banco Central de Bolivia, Dic 1994, Gerencia de Estudios Economicos   na = not available

Table 1 shows a sample of developing countries grouped as "high" and "low" inflation countries.[3] The upper section shows the inflation rate by country; the middle section the economic growth rate and the lower section shows the terms of trade for each country in the sample .

First, note that the economic performance of "low inflation" countries throughout the period of analysis, and in specific decades, has been significantly better than "high inflation" countries despite terms of trade deterioration which affected roughly all countries analyzed. It is interesting to observe that the 1980s was a relatively bad decade for all countries in the sample, including South Korea, basically due to terms of trade deterioration and the debt crisis.

Second, note that the sample countries have different natural and human resource bases. Almost all depend mainly on one or two export products (except South Korea, but it was affected to a similar degree by declining terms of trade) and are heavily indebted. The countries are characterized as having disparate political systems for most of the period under analysis, e.g., military regimes in Chile and Paraguay, democratic governments in Colombia, Costa Rica and Ecuador, military and democratic regimes in Argentina, Bolivia, Brazil and Peru, and dictatorial in South Korea); and some have experienced serious internal disorders like active terrorism in Colombia and Peru. And yet, some did considerably better than others. What is clear is that the group of countries that had credible governments, predictable and consistent policies, and managed well available resources (experiencing relatively low fiscal deficits as reflected by low inflation rates), achieved higher and more sustained economic growth paths. This was the case regardless of actually existing political systems over the period. *Lesson number one: democracy is not synonymous with economic growth nor is it key to economic growth. The critical element is good governance.*[4]

III. A major cause of lack of good governance in bolivia.

The Bolivian hyperinflation of 1984-85 was one of the most dramatic inflations in world history and the first of its kind in the twentieth century that did not result from the dislocations of war or revolution. A chronic absence of good governance has been, to a large extent, the cause of Bolivia's recurring economic crises and chronic underdevelopment.

Table 2 shows a brief political chronology for Bolivia since the National Revolution of 1952.[5] The most striking aspect is the instability of constitutional rule in the country. With the State viewed as an instrument of redistribution, governments have used the public purse and public enterprises as private slush funds for personal gain and political patronage. Moreover, many social groups have looked to the central government to satisfy popular redistribution agendas and battles for political power have been battles for shares of the national pie. Not surprisingly, the result has been government continuously stretched far beyond fiscal capacity, a business environment inimical to long term investment, and the inability of key political actors to settle on sustained strategies for national economic development. While governments of the left have sought redistribution through higher wages and a larger public sector, governments of the right have sought to bolster favored segments of the private sector through generous government subsidies. Governments of the left have generally paid for higher public salaries through printing money (i.e. inflation tax) or

[3] Since cultural and historical factors could partly explain the difference in governance, the sample was limited to a relatively large sample of Latin American countries. South Korea was added to help highlight and explain the importance of good governance.

[4] Robert J. Barro, in Democracy: A Recipe for Growth?, reaches the same conclusion through an econometric analysis that included some 100 countries at various stages of economic development from 1960 to 1990.

[5] Based on Bolivia's Economic Crisis, by J.A. Morales and J. Sachs, 1987.

through foreign borrowing, since they were forestalled by the private sector from raising taxes. Governments of the right, on the other hand, have rejected higher taxes outright and have instead sought to finance the government by reducing public sector wages (often with overt repression of labor), and also through foreign borrowing. *Lesson number two: one common theme of both types of government: let the foreigners pay.*

As shown in Table 2, governance has been clearly absent as personal and political agendas shaped government actions with profound effects on economic policy and economic performance. Let's name a few. First, the deep politization of almost all instruments of economic policy. Most economic policy tools in Bolivia have been judged mainly on the basis of distribution rather than efficiency. Exchange rate policy is a clear example. Second, the uncertainty created by the widely varying agendas of alternating regimes which deterred private investment. Third, the degeneration of politics into fierce battles of "ins" versus "outs" have continuously threatened economic and political order.[6]

[6]Robert Barro has been able to identify key determinants of economic growth. According to his studies, Bolivia grew on average at a rate of 0.8 percent per capita per year during 1960-85, compared with an overall average growth rate among a sample of 110 countries of 2.2 percent per capital annually. What accounted for this slower growth? The statistical analysis suggests that Bolivia's political instability alone reduced its growth rate relative to the average by 1.5 percent per year, the largest single negative effect on Bolivia's economic growth.

TABLE 2: BOLIVIAN POLITICAL CHRONOLOGY: 1952-1995

Years	Type of Government	President	Political Characteristics
1952-1956	Bolivian Revolution (1952)	Victor Paz Estenssoro	—
1956-1960	Democratic	Siles Suazo	—
1960-1964	Democratic	Victor Paz Estenssoro	—
1964-1964	Democratic	Victor Paz Estenssorro	Deposed in a military coup led by Barrientos.
1964-1966	Military	Barrientos and Ovando	Co-presidency.
1966-1969	Democratic	Barrientos	Dies in plane crash, April 1969.
1969	Democratic	Siles Salinas	Vice President Siles Salinas becomes president and is deposed in a coup by Ovando.
1970	Military	Ovando, Miranda, Torres	Ovando is deposed by Gen Miranda. Miranda is deposed by Torres.
1971	Military	Torres	Rules left-wing radical government. Deposed in a coup jointly sponsored by the military and the two largest political parties.
1971-1973	Military	Banzer	Rules with the support of the two main political parties.
1974-1978	Military	Banzer	Rules without political support.
1979	Military	Pereda, Padilla	The first becomes president in election marked by accusation of fraud. Pereda is deposed by Padilla who calls for election.

TABLE 2: BOLIVIAN POLITICAL CHRONOLOGY: 1952-1995 *(continued)*

Years	Type of Government	President	Political Characteristics
1979	Military and democratic	Guevara, Natush, Gueiler	Election results in stalemate (no majority); Senate President Guevara serves as interim President. Guevara deposed by Ntusch who resigns for 15 days. President of Chamber of Deputies Gueiler becomes interim President.
1980	Democratic and military	Gueiler, Garcia	Electoral statement. Gueiler deposed in a coup by Garcia.
1981	Military	Garcia, Bernal, Torrelio	Garcia forced to resign in favor of Gen. Bernal. Gen Bernal resigns in favor of Gen. Torrelio.
1981	Military	Torrelio, Vildoso	Gen. Torrelio deposed in a coup b Gen. Vildoso. Congress reconvenes; names Siles Suazo as President.
1982-1985	Democratic	Siles Suazo	Resigns before end of mandate. Calls for early elections.
1985-1989	Democratic	Paz Estenssoro	Second in the ballots, rules with the political support of former President Banzer, winner in the popular vote.
1989-1993	Democratic	Paz Zamora	Shares 50% of the economic and political power with former President Banzer.
1993-date	Democratic	Sanchez de Lozada	Wins by overwhelming majority, but needs to conform political alliances with smaller parties.

Based on "Bolivia's Economic Crisis," by J.A. Morales abd J. Sachs, 1987.

Bolivia has resembled early European states. Spain in the 16th and 17th centuries, for example, was caught between cumbersome taxation systems and the need for revenues. Monarchs had to borrow heavily and operated with chronic deficits resulting in several financial crises that brought Spain to bankruptcy five times between 1575 and 1647[7]. In the United Kingdom, control on government actions was effectively purchased by the money granted to Edward I and Edward II[8]. In France, elite based support for the 1789 Revolution on conditions such as limits on royal financial discretion, public debate and influence on economic policy, and viable public institutions to carry out these objectives.[9] These events parallel Bolivia's need to develop the legal systems and institutions necessary for market economies to operate efficiently. *Lesson number three: governance seems to be an integral part of the*

[7] Eggertsson, Thrainn, Economic Behavior and Institutions, New York: Cambridge University Press, 1990.

[8] North, Douglass, Institutions, Institutional Change and Economic Performance, New York: Cambridge, University Press, 1990.

[9] Cited in Eggertsson, p. 348.

development process, and as such, is a long term undertaking.

IV. The role of governance in the stabilization and structural reform programs.

How power and authority is exercised lies at the heart of governance and affects economic activity. The powerful ability of governments to select and implement policies (which is not learned in textbooks), together with the integrity of government bureaucracy determine how well, or how poorly, markets and the economy perform. This explains the current concern with governance in Bolivia. Since regaining democracy, political openness has encouraged citizen demands for accountability. Similarly, the rapid transformation to a market economy in 1985 underscored the need to establish clear and predictable policies, legal guidelines and well defined property rights in order to secure needed private investment. A market is not just an economic mechanism where the simple laws of demand and supply are applied; it is a legal regime where institutions play fundamental roles. Bolivia's democratic and free market reforms have brought the governance dimension to the forefront.

A. *The Siles Suazo Government (1982-1985).*

This administration attempted to stabilize the economy six times (November 1982, November 1983, April 1984, August 1984, November 1984 and February 1985) but failed, due, in large part, to pressures for economic gain from different groups (e.g., labor, the government's political "ally"). The fiscal deficit exceeded 27 percent of GDP in 1984 and inflation reached 23,000 percent during the twelve month period ending August 1985. And yet, average wages in the public sector increased by 11 percent in real terms during this presidential term. GDP fell by 6 percent during the same period. Clearly, the government's rationale was distributional rather than economic as it attempted to muster political support from its labor allies. Moreover, government and party officials at the highest levels had vested personal financial interests in retaining discretion over the allocation of resources such as foreign exchange (the gap between official and parallel exchange rates was as much as a factor of fifteen times), bank credit (interest rates were negative in real terms), import licenses (in a highly protected economy) and jobs (with an unemployment rate that reached 22%). Of course, in a period of economic chaos and social convulsion and, therefore, no predictability, state officials were mostly concerned about personal agendas of benefiting from speculation and arbitrage. On the other hand, consumers were concerned with spending their money through whatever means at any (nominal) price. With a local currency depreciating at two percent a day, demanding accountability from the government was not in anybody's mind. This extreme case of bad governance led to demands that the government curtail its administration, and it did so.

B. *The Paz Estenssoro Government (1985-1989)*

The deep economic crisis and hyperinflation of the mid 1980s left little alternative to the newly elected Paz Estenssoro government but to adopt policies aimed at arresting inflation and preventing social revolt. To this end, Paz Estenssoro signed an agreement with former President Banzer, winner of the popular vote, to be able to implement the stabilization program with Banzer's support.

Since the stabilization cum recovery program was basically designed by Bolivian nationals, "ownership" played a key role in determining the quality of governance. This not only led to recognition of the legitimacy of the government's drastic economic policies by the electorate, but was also viewed as a kind of social relief.

The economic program was unveiled just three weeks after the government assumed power. The program was simple, clear, wide ranging, and indeed radical. It introduced some fundamental elements of good governance: 1) low government interference in the allocation of resources; 2) clear and simple policies and implementation procedures with modest discretionary power in economic decision making; and 3) consistency between public policy and implementation. For these reasons, the government's pledge to spend only what was available was met with widespread public approval. The exchange rate stabilized almost immediately as did other prices. Information on principal macroeconomic variables such as exchange rates, money supply, tax revenue collections and transfers were made available to the press and to the public on a regular basis. Two months into implementation of the stabilization program (October 1985), world tin prices plummeted by half. To preserve fiscal balance and promote private sector confidence and economic recovery, the government launched a bruising, indeed brutal, battle to reduce employment in the largest state owned mining company despite the social unrest generated and the promulgation of the legally permitted "state of emergency." The fiscal deficit declined from more than 27 percent of GDP in 1984, to 10 percent in 1985 and 3.5 percent in 1986.

By controlling inflation through congruent public policy and implementation, the government showed accountability. Moreover, it established more openness by setting clear rules and regulations. For example, the tax reform program promulgated in May 1986 reduced the number of taxes from about five hundred to only seven, thus introducing more transparency in the tax system and reducing opportunities for corruption in revenue collection. After failing to do so for years, the government submitted a public sector budget every year to Congress, thus contributing to more transparent management of public resources and greatly reducing government's arbitrariness. The Paz Estenssoro administration also adhered to the rule of law by executing policies and procedures more even handedly (mainly by eliminating state control and regulations over economic activity that sharply reduced the discretion of state officials) and by setting clear lines of authority mandated by an experienced and highly respected President.

C. *The Paz Zamora Government (1989-1993)*

Although finishing third in the popular vote, Paz Zamora was elected President by Congress. Former President Banzer, the runner up, delivered votes for Paz Zamora in exchange for a fifty percent share in the government's political and economic apparatus. Maintaining this new government coalition for four years, despite clear ideological differences between the parties (characterized by their leaders as "two political parties divided by a river of blood" making allusion to the 1970s when Banzer, a military officer that once assumed power through a coup and persecuted leftist, armed political groups led by Paz Zamora, among others), was a priority concern. Basically, the shared agenda was to survive politically. The clear and simple formula was to manage routine and mind one's own turf. Within this context, anything was possible and permissible as long as one party did not step on the toes of the other. This implicit agreement was a negation of a key element of good governance accountability.

This administration was able to maintain economic stability despite growing fiscal deficits mainly financed with external resources. Not only did actual deficits exceed target deficits programmed by the GOB and the IMF every single year, but the gaps between programmed and executed budgets increased progressively. These policies, however, again led to rapid accumulation of external debt. *Lesson number four: external economic assistance must find ways to stimulate and support the process by which accountability becomes a matter primarily between governments and citizens, not only between governments and donors.*

Owing mainly to the need to maintain the political structure of two parties in public positions (bestowed as political or personal rewards) and to a lack of vision and leadership, the Paz

Zamora administration also failed to focus on the important reforms identified or initiated by the previous government. It slowed implementation of the SAFCO program[10], limited privatization of the 154 small state owned enterprises to a mere handful, and distorted the adoption of a far reaching civil service program by poor and politicized execution. Contradictions among ministers (separated by different ideologies) of the economic cabinet delayed the adoption of important reforms which undermined the public's confidence in the government, the predictability of policies, and the rule of law. Many important laws (e.g. the hydrocarbons, mining and investment laws) were promulgated only hours before deadlines just to comply with agreements signed with the IMF and the World Bank. Other sectoral reforms, such as a critical banking law, were not carried out until the Minister of Finance (a prominent banker in the high ranks of one of the ruling parties) left office. The export law was promulgated just days before the government left power, after immense pressure from the private sector and appeals in newspaper advertisements from the administration's own Minister of Exports. The administration's hesitant attitude towards the promulgation and execution of important laws and reforms generated widespread lack of confidence. The economy, pulled out of the hole by the previous administration, retreated to a "wait and see" mode pending clear signals to investors and ideological and operational acceptance by the administration of the "economic model" adopted in 1985.[11] *Lesson number five: ownership of stabilization or reform programs seems to be an essential ingredient for success.*

It is important to note, however, that the Paz Zamora administration adopted a relatively open political agenda designed to reach political consensus in the introduction of important elements of good governance. For example, political consensus was reached in the designation of the president of the Central Bank and the Controller General by a mechanism mandating submission to the President for his selection of three candidates approved with a two thirds vote in the Upper house of Congress. Approval of the SAFCO law was passed under the Paz Zamora administration under pressure from the donor community.

Only weeks after the Paz Zamora administration left the government, about a dozen serious corruption charges were made against high ranking members of his administration (particularly against his political party). Included is a narco political scandal still under investigation that, to date, has sent Paz Zamora's acting party chief to jail and raised concerns about Paz Zamora's friendship with certain narcotraffickers.

In sum, the Paz Zamora administration successfully executed party agendas and was able to "manage" the economy with IMF and World Bank pressure, while the parties that shared government busily executed a "predatory agenda" to benefit from public office.

D. *The Sanchez de Lozada Government (1993 to date)*

Chief executor of the stabilization program under the Paz Estenssoro government, Gonzalo Sanchez de Lozada won the 1993 elections (he had won a plurality of the votes in the 1989 elections), by an overwhelming majority. His ambitious electoral platform and his main adversaries' tarnished and worn out political image propelled his party to an easy victory.

Now two years into his administration, Mr. Sanchez de Lozada is making every effort to meet campaign promises. These include radical,

[10]The purpose of the Integrated System of Financial Administration and Control (SAFCO) is to standardize public accounting systems and improve transparency and accountability in the management of public financial resources.

[11]Inaction to promulgate the export law (which was finally passed two months before the government left power) and failure to sign a 40-year contract with Lithium Corporation (what could have been the first significant foreign investment agreement with the Bolivian State), are only two examples.

yet long overdue economic, social and political reforms that demand political courage and produce high political costs, but enhance the possibility for better governance in the future (see Annex). The government, however, not only believes in the longer term benefits its program will bring to the country but hopes to benefit politically after the reforms are in place, before the next presidential elections. Accordingly, the political opposition and labor, each acting in its own interests, fiercely resist the execution of most of the reforms. But pressure is also being brought to bear on the international front. The U.S., for example, recently declared an "ultimatum" to Bolivia on the eradication of coca as a condition for U.S. continued economic assistance and support in the international donor community. The most affected and well organized sectors, particularly the teacher's union and coca growers, have organized street demonstrations and strikes in major urban centers provoking significant social unrest. To overcome such resistance, the government has not only declared a constitutionally permitted "state of emergency" to stop social unrest and proceed with the reforms, but has extended it (legally) beyond the 90 day initial period.[12]

The Sanchez de Lozada administration has also been actively pursuing investigation and indictment of: 1) two supreme court judges on corruption charges; 2) a number of political leaders from the Paz Zamora party, including Paz himself, on narcotrafficking cover up; and 3) a prominent banker on alleged misuse of public money. These actions and the capture and jailing of former dictator Garcia Meza, constitute breakthroughs in Bolivian justice and should set a precedent for future administrations.

President Sanchez de Lozada's commitment to the implementation of critical reforms, even resorting to extreme constitutional powers such as the declaration of a "state of emergency" and reduced political openness, has provided a sense of direction to his administration, has set relatively adequate standards for the application of the rule of law and has sent clear signals to the public of what the government intends to accomplish. The high priority placed on important reforms, however, has left unattended more routine management tasks and drafting of regulatory frameworks for such critical sectoral priorities as the export law approved in the previous administration. In other words, this administration has moved slowly in making government policies fully consistent with the existing legal framework. In addition, his desire to govern with qualified technocrats, not necessarily from his own party, has upset mid level GOB party officials as party demands for jobs have not been satisfied. Thus, the implementation of a well functioning civil service system, where the rule of law would insulate the civil service from politics, has been partially resisted by the governing coalition parties because it does not represent a crystallization of the parties' and society's values and, therefore, are not seen as legitimate. This has slowed execution of economic policies and reforms (exacerbated by a "reform" in the Executive branch which increased bureaucracy) and generated anxiety with the public.

Actual implementation of the Sanchez de Lozada administration's reform program is expected to generate higher, more sustainable economic growth. The Popular Participation law, which mandates the distribution of central government revenues to local governments on a per capita basis, is having a tremendous leveling effect in the smaller and poorer provinces receiving the largest gains. For example, increases in co participation funds between 1993 and 1995 were about forty fold for poorer provinces. This law and the Decentralization law also promoted by this administration, should have, in and of themselves, a positive impact on the quality of governance. In the case of the first capitalized

[12] Each one of the previous governments under analysis have resorted once to this constitutionally permitted measure to preserve social order.

company (ENDE, the national electric company), international investors have judged the bidding process to have been remarkably transparent. In the case of Education Reform, the government has had only limited success in reaching consensus with the teacher's union. Pension reform has been postponed until 1996 as part of a strategic move in negotiating with labor on education reform.

The objectives of the Sanchez de Lozada administration has not been only to maintain economic stability hoping for an automatic effect on economic growth. Consistent with its electoral platform, this administration intends and is making radical reforms that will change the country permanently. This process is, undoubtedly, disrupting social, economic and political orders that will likely affect income distribution and introduce better governance practices.

Macroeconomic indicators show acceptable performance during 1994 as indicated by 4.2 percent GDP growth and 8.5 percent inflation. The fiscal deficit was halved to 3.3 percent and preliminary official estimates show that unemployment is slowly declining.

V. Conclusions

With the remarkable success of the Marshall Plan, many saw progress in the welfare of poor countries as almost inevitable. This optimism is now being replaced, for many, with a sense of self doubt. Development is now viewed as an uncertain process and, by inference, highly correlated with the quality of governance.[13] Why is this important to donor agencies? Because in an era where resource transfers are more limited, more bang becomes more important for development than more bucks.

This brief analysis of Bolivia's last four administrations is consistent and demonstrates that the impact of governance on stabilization and structural reforms in Bolivia has been more substantial than what economic theory would normally predict.[14] As such, many economists have tended to take for granted that once decisions are made, they will be effectively translated into operational realities. But four different governments, administering the same country under roughly similar circumstances, have performed distinctively different. This indicates that models generally found in textbooks may work differently depending on the quality of governance. Those who address the issue of governance and economic performance tend to examine regime types (e.g. authoritarian, democratic, etc.) rather than the narrower elements of accountability, openness and the rule of law. In fact, governance cannot be understood outside a country's political and historical context, the context that gives political "mismanagement" its underlying logic and creates the environment in which economic activity operates. The nature of governance is multidimensional. It cuts across the boundaries of economics, political science, management and sociology. This, and the fact that concepts of governance often elude practical measurement, make judgmental approaches inescapable.

Governance is very difficult to measure. Maintenance of economic stability alone could provide a hint of good governance. However, economic stability mixed with large scale corruption or large, imprudent build ups of domestic or external debt are not signs of good governance. Social unrest may be negatively related to good governance. However, if caused mainly due to implementation of reforms that benefit a majority of the population, particularly the poorest, it may instead be characterized as good governance.

[13]Douglass North, 1990.

[14]For examples, economist L.G. Reynolds' analysis of economic growth from 1850 to 1950 in forty developing countries suggested that "political organization and the administration of government" constituted "the single most important explanatory variable" (Lloyd G. Reynolds, "The Spread of Economic Growth to the Third World," *Journal of Economic Literature* 21, [September 1983]).

Consider the following equation based on the three fundamental elements of governance presented at the beginning of this paper:

$$G = G\,(A,O,L)$$

where: G is governance,
A is accountability,
O is openness or transparency, and
L is the rule of law.

Governance would be a function of the degree of accountability (i.e., congruency of economic policies and consistent and efficient implementation), openness (i.e., access to information and consensus building) and the rule of law (i.e., clear rules of the game and even handed application). What determines these is probably an area for institutional economics. But clearly, governance refers to the quality, not necessarily the type, of government administered by the Executive branch. Nevertheless, other branches of power, namely, the legislative and judicial, are likely to be partly responsible for the quality of governance.

Openness is central to an effective functioning of the three branches of power. Accountability is more a responsibility of the Executive and Legislative branches, the latter representing and responding to the demands of the public at large, while the rule of law is of primary concern to the Executive and Judicial branches.

For countries in the developmental and general cultural environment of Bolivia, some specific lessons can be drawn. A president's vision and leadership seem to be the principal determinants of good governance, as these induce changes in the values that affect the quality of governance and set performance and moral standards for other elements of the Executive branch. Ownership and commitment to an appropriate economic program seem to be fundamental to predictability, accountability and efficient public sector management because its implementation is of highest priority to the administration. Economic openness and limited political openness during the exercise of government seem to have been additional common characteristics to both the Paz Estenssoro and the Sanchez de Lozada administrations.

Governance, unfortunately, may not necessarily be unidirectional, that is, it may not automatically improve over time, at least until market institutions (e.g., that create and enforce the rules, that establish law and order, and ensure property rights) mature as part of the development process and the market economy progressively transforms society. Meanwhile, governance may be determined by isolated and personalized factors such as leadership, vision, ownership, commitment and even limited political openness. This does not mean, however, that desirable and feasible cultural or historic solutions need to be in place first or that a minimum level of development be in place as a necessary condition. There is room for policy induced remedies that can accelerate change towards perfectible modes of governance.

The democratic process regained since 1982 has allowed the Bolivian people to judge the quality of governance of previous administrations at the ballot box. Siles Suazo had to cut his administration short and his party obtained some 5 percent of the popular vote in the subsequent elections. Despite the adoption of the radical Decree 21060, Victor Paz Estenssoro's party won the 1989 elections with 26 percent of the popular vote. In the 1993 elections, former President Banzer, supported by Paz Zamora's party, obtained a distant second place (22 percent of the popular vote) to Sanchez de Lozada's 36 percent of the popular vote. The people will judge Sanchez de Lozada's administration in 1997.

Annex

The **Capitalization Program** (approved in March 1994) is aimed at attracting private sector management and up to fifty percent of the company's equity capital (estimated at about $2 billion) to sectors now dominated by public enterprises. This would put an end to political deals and corruption in Bolivia's six major state owned enterprises, free public resources for social works, improve efficiency and spur economic growth. Moreover, the Capitalization program would transfer the State's ownership of the corresponding assets to the country's adult population through a new pension system.

The **Popular Participation Law** is a revolutionary effort by the GOB to enfranchise rural areas by incorporating quasi local governments into the Bolivian public administration framework. It formally divides the country into 305 municipalities and transfers twenty percent of national tax revenues (about $ 144 million in 1995) to these newly constituted municipalities on a per capita basis. For the first time, rural populations have been given both the power and the resources to fund sorely needed public projects and services.

The **Decentralization Law** was promulgated after close to two decades of intermittent action. It decentralizes and provides public administration autonomy to the country's nine different departments. This new public administration arrangement is expected to constitute a linkage between national and municipal government, and improve efficiency and promote political and economic democratic participation.

The **Pension Reform** will introduce a new system whereby compulsory contributions will be deposited in individual capitalized accounts to be administered by privately owned pension fund administrators. This reform is expected to contribute directly to more efficient allocation of both public and private resources, including domestic savings, and stimulating capital market development over the longer term.

The **Education Reform** is expected to provide effective basic education for the entire population in school age. Given the nature and depth of the problems in education, significant improvements in both quality and coverage at primary and secondary levels are required. While full implementation is likely to require ten to twenty years, the first phase will include: rationalizing the institutional framework, including establishing a new legal framework for the sector; enhancing educational quality by developing curriculum, material, texts, and teacher training programs; and improving access, equity and efficiency, including strengthening sector finances.

The **Reform of the Constitution** approved in 1994 amends thirty five articles. The main amendment affecting the representativeness of member of Congress is the election of one half of the lower house from single member districts. At present all one 130 lower house members owe their seats to party bosses who place them in the upper ranges of party lists. The presidential mandate was extended from four to five years, and the mandates of majors have been extended from 2 to 5 years, with a provision that includes the possibility of revoking the mandate of majors under certain circumstances.

The **Reform of the Judicial System** will establish a separate constitutional court and the creation of council of the judicature charged with screening qualifications of judges, applying disciplinary measures in the court system, and supervising all court management matters. A new Code of Criminal procedures is also revised to bring better human rights protection provisions into Bolivian criminal law. The Constitutional amendments also include a new office of the Ombudsman and an independent prosecutorial function.

WHY ECONOMICS IS KEY TO IMPROVED HEALTH CARE: THE VIEW FROM INDONESIA

by

Robert H. Aten

USAID / Indonesia

In Indonesia, the USAID health-care strategy involves the selection of low-cost high-payoff up-front activities. For these selected activities, USAID usually provides assistance by financing supporting endeavors such as technical assistance and training that underpin restructuring efforts and the eventual delivery of improved health-care services. The restructuring focus, often prevention based, avoids most finance of high-cost treatment activities. Restructuring activities are largely carried out via a supply-oriented strategy — so described here because the principal beneficial impacts of USAID funded activities arise directly or indirectly based how such health-care services are supplied. The restructuring is sometimes incorrectly described as demand based because, unusually compared with standard economic analyses, several of the major activities supported have their most important beneficial impacts on demand (see the appendix for more details). In the analysis of health-care activities, in Indonesia and elsewhere, demand and supply activities are not independently determined, contrary to standard economic assumptions.

The highest priority health-care activity financed by USAID/Jakarta in Indonesia is proving out and thereby encouraging Indonesia to adopt generally a managed-care strategy for financing health care. By helping to spread the risks of high-cost treatments among a number of participants in carefully structured managed-care plans, adoption of managed care helps assure that both prevention and treatment occur. A reasonable expectation is that USAID health-care expenditures necessary to help achieve the same benefits could eventually decline if managed-care finance is successful, because a privately financed managed-care-based system of health-care could eventually generate sufficient resources to finance many restructuring/prevention activities now funded by USAID and other donors (this discussion ignores the possibility that declining USAID health-care expenditures may occur more rapidly because of budget constraints). Managed care has the potential to finance the health-care benefits provided indirectly through other USAID/Jakarta health-care strategies by providing the necessary financial wherewithal. (Other priority USAID-funded health-care activities in Indonesia include maternal care and child survival, HIV/AIDS prevention, and family planning).

Health-care activities would be made generally available under managed-care finance — perhaps at lower costs, the latter an especially important factor for poorer consumers. In Indonesia, the vast bulk of the population has perhaps barely adequate fiscal resources (median income in 1994 of perhaps $400 [all dollars US] per year and income per capita of about $920 per year) and a demonstrated willingness to pay for improved health care. Under a managed health-care strategy, cost subsidies could assure that managed-care activity also provides improved health care for the absolute poor — to help make such improved health care universal in Indonesia. Wider acceptance outside Indonesia of the USAID/Indonesian managed-care model for delivery of heath-care services could bring these important benefits to other developing nations.

I. The Indonesian government budget constraint and health care

In Indonesia, there are enormous and legitimate demands both for health care and outside the health-care sector on the growing fiscal resources of the government of Indonesia. Indonesia has relatively low per capita income compared with those in the developed world. Because of its large size and rapid growth, however, Indonesia has about a $185-billion-per-year economy. If Indonesia sustains a 7-percent real rate of economic growth, within five years it could have nearly a $265 billion economy, and within a decade nearly a $400 billion economy (despite many economic management difficulties, this rate of growth looks feasible; moreover, the Indonesian government has recently committed itself to a slightly higher rate). Indonesia has also committed itself to increase its health-care sector from around 2.9 percent of GDP in 1992-93 (or about $4.7 billion per year in 1996) to more than five percent of GDP over the current five-year planning period. Meeting that commitment implies at least a $13-billion-per-year health care industry in Indonesia in five years and a $20-billion per year industry in ten years, very ambitious targets. This assessment implies an increase of average annual real spending in the Indonesian health sector of at least 29 percent per year for the next five years or so.

Despite reasonable prospects for continuing nearly the more than 20-percent per year of past increases in yields from major taxes in an economy now largely tax financed, sufficient net additional fiscal resources will not be available in the GOI's budget in the near term for Indonesia to spend five percent of GDP in the health sector out of the government budget within five years and address its other serious problems. In addition to severe limits on the human, physical, and social infrastructure available in Indonesia, about 26 million Indonesians remain in absolute poverty — meaning that they do not obtain enough food to eat every day. Indonesia has ambitious plans that will also require major fiscal resources, e.g., universal junior secondary education, decentralization of governmental activities from Jakarta to provincial and district governments, large-scale infrastructure investment in both the public and private sectors, poverty alleviation programs, etc. Within the health sector, overall just 8.6 percent of the Indonesian population currently has access to health care insurance coverage in any form. With the exception of family planning, Indonesia has weak performance in health care, given its level of GDP per capita (although there are conceptual problems with that international comparison).

Indonesian government budget (GOI) outlays cannot be expected to rise sufficiently rapidly to finance directly the major increase in spending for health-care costs. Support from other donors is expected to help provide finance. For high-income groups in Jakarta and other large cities, improved health care is likely to come rapidly courtesy of the private sector. However, a principal factor that makes the ambitious Indonesian health-care strategy potentially feasible is that Indonesian financial markets may well nearly be ready to provide loan funds under suitable terms and conditions to private entities to finance improved health-care facilities or other aspects of managed health care. However, this approach probably would require credit enhancements (already advocated by USAID and possible [unlikely in the short-term] from the GOI).

For health-care delivery to improve substantially in Indonesia, most additional financial resources must come from the private sector (this goal has been a GOI objective for more than half a decade). For Indonesia, the correct strategic decision is therefore the one that appears already to have been made — that by and large, the public sector must learn to limit its financial activities in health care to encourage additional private provision of health care and to provide fiscal support for it for those Indonesians who cannot fend for themselves — principally those who remain in absolute poverty. The public sector continues to have a duty to provide leadership and set appropriate standards in private health-care activity. Full implementation of these sophisticated ideas will not occur immediately.

II. Considerations of market efficiency and health care

Standard economic arguments provide a presumption against government intervention in markets, including health care markets, if those markets are working reasonably well without the necessity for such intervention. In part this presumption exists because interventions often fail. In principle, considerations of fairness require that certain goods such as adequate health care should be available to all persons, regardless of incomes. In developed nations, there is probably general agreement on this point. However, there can be endless disagreement about how and how much of goods such as health care should be provided, relative to other goods. To help sort out disagreements that arise when considering such matters, it is usually helpful to examine efficiency arguments — the details of the case for or against public intervention.

Efficient systems of organization for a static economy must meet several standard tests. Under certain circumstances, a market economy meets these efficiency tests.[15] If private markets in health care satisfy these tests, these markets would also be efficient. However, there are well-known significant market failures in health-care markets often used to justify government intervention. These market failures occur in Indonesia and elsewhere. For example, in a standard market, there are many sellers. In most hospital catchment areas outside major cities in Indonesia, there is usually only one hospital. Health care is generally a heterogeneous commodity, rather than a homogenous commodity as standard economic theory presumes. Standard theory assumes well-informed purchasers of a commodity, while in health care most purchasers know little about the product they are buying. Most hospitals in Indonesia are public not private. Part of the standard reason for public facilities is that the quality of health care is difficult to assess, and the existence of a public or a non-profit health care facility provides a statement to users that profits do not matter. Such a statement implies a non-market signal of the possibility of a higher standard of health care, a possibility not met in Indonesia because of the drastic budget constraint limiting public health-care spending. Moreover, health insurers usually know relatively little about the condition of specific patients; insurers thus often have difficulties determining whether they are meeting their obligations. In addition, health costs tend to arrive in large erratic bundles when someone is very sick, with the total encompassing income foregone and the direct costs of treatment. This makes non-insurance-based approaches to finance health care very difficult for most patients. Finally, substantial potential additional benefits are potentially available from government intervention or private collaborative efforts due to the peculiar nature of health-care markets (issues such as the asymmetries in information available to health-care providers and recipients), particularly as those markets arise in developing countries.

The bottom line is that there is a significant economic case for public intervention in health-care markets. For at least these reasons, such intervention is common in developing

[15]The market outcome is usually judged acceptable and fair provided the pre-existing distribution of income is adequate, a test dependent on value judgments and often not satisfactorily met.

nations. However, governments have grave difficulties achieving efficiency in the direct delivery of all services, including health-care services. The managed-health-care strategy being supported by USAID/Indonesia offers a glittering prospect for Indonesia and later for other governments of developing countries to limit intervention in health-care markets and to concentrate on what they do best while still preserving an appropriate regulatory stance and helping to meet equity/fairness concerns.

III. Insurance and moral hazard

Nearly all individuals are risk averse. Risk aversion provides the underlying rationale for insurance. For an individual to be risk averse means that the individual prefers to bear a given cost with certainty rather than face an uncertain cost that involves the prospect of a much greater loss, even where the expected values of the two costs are the same. The role of health insurance is to make available that certain cost at the same expected value as the uncertain cost. Those persons who experience losses are compensated from the premium payments made by those who do not experience those costs. There are few reasons from their culture or current behavior to anticipate that Indonesians will behave significantly differently regarding risk in ways that will make establishing large-scale managed-care system more difficult here (in fact, as will be discussed in section 4, there are reasons for optimism about the likely behavior of Indonesian under insurance).[16]

Payment of health-care expenses by a third-party insurer such as an insurance company (not either the doctor providing the care or the person being treated) raises the problem of moral hazard. The problem is most easily envisaged when the third-party payer pays the entire amount of the loss. This circumstance occurs normally, for example, if hospitalization is required, but not for treatment in the doctor's office.[17] In the doctor's office the insured patient normally bears part of the costs, known as a co-payment. In these circumstances, suppose the size of the loss being insured against depends partially on the insured person's own behavior. For example, he or she could choose treatment via a hospitalization rather than the normal treatment in the doctor's office to treat a non-life-threatening situation that adequately can be treated in either location. Because there is no out-of-pocket cost to the insured individual to being treated in a hospital, out of consideration for the patient's finances, the patient and the treating physician may choose a more expensive hospitalization solution. Insurance companies call their concern that this problem may arise moral hazard. That is, moral hazard is the additional insurance costs that are at risk from the insurance company's perspective because of such behavioral choices by the insured or his/her agent.

In the market for health care, standard analysis suggests that insurance increases ability to pay for health care on the part of the insured and thus shifts the demand curve for health care to the right, increasing equilibrium health care provided (the appendix includes discussion of shifts in supply and demand). Because the supply curve for health care slopes upward to the right (except perhaps in the very long run), such a demand shift induces increased equilibrium consumption of the insured commodity at a higher price. Over time, such a shift in demand will raise the costs of health-care services. Moreover, given moral hazard, the gain from insurance protection (people are risk averse)

[16]While an insurance perspective is reasonable for most individuals, it makes little sense to insure against all risks. Insurance has administrative costs (marketing, calculating the various costs, administration, etc.). For example, if a risk that might be insured against is not expensive (treatment for a cold) or sure to occur, there is no sense to pay the administrative costs of spreading the risk. Developing adequate health-care insurance policies therefore involves care and judgment in assessing the choices among risks to insure against.

[17]The strategy of not insuring against all costs from visits to a doctor's office discourages too frequent visits.

must be weighed against the cost of possible over utilization of health-care capacities.

For health-care treatment for insured persons in life-threatening situations, questions of price do not matter as much. Most health care does not concern life threatening situations. In these latter circumstances, in developed countries the likelihood is that insured persons will tend to consume more health care when the price is lower — that is, the price elasticity of demand for the services is greater than zero. These elasticities are known to differ, depending on the nature of the service being provided. Demand is much more likely to be inelastic for hospital procedures for serious illness than for less serious procedures that can be carried out in a physician's office. This circumstance suggests that insurance companies will be able to anticipate costs more successfully for more serious procedures. Rational insurance companies will therefore be more willing to insure against activities that require hospitalization than against visits to doctors' offices.

Insurance companies use several techniques to deal with moral hazard. First, insurance policies may be written to provide only up to a fixed payment in response to a particular problem that is insured against. This approach is feasible as a general strategy to be used by government to help control health costs incurred in broader circumstances. Second, insurance companies require deductibles or coinsurance. These latter two approaches have the advantage of reducing the welfare loss due to overconsumption of health-care services because of moral hazard, but require those who may not have the financial resources to pay part of the risk and the costs of illness. Moral hazard can be reduced, but does not go away. Any strategy that seeks to rely on health insurance must deal with moral hazard.

In its health-care activities, USAID is often deliberately engaged in encouraging the additional consumption of health care services in developing countries. The USAID strategy is to generate additional consumption of a particular health-care service (prevention) because the external benefits involved may far outweigh any adverse effects due to moral hazard. In the case of the HIV/AIDS crisis situation, for example, the market failure due to the major health-care risks from the potential pandemic spread of the disease are judged so important a market failure as to outweigh most other potential considerations. However, even for USAID in these circumstances, the choice of financing strategies is relevant — some strategies are more likely than others to encourage moral hazard in ways that undermine other important objectives.

IV. Status of health care and financing in Indonesia

To provide health care, Indonesia has established public-health clinics and public hospitals throughout the nation. However, these public facilities are often staffed with health-services providers of relatively limited capacity who usually have only limited stocks of health-care equipment, relatively weak capacities for offering diagnostic and treatment services, and limited supplies of medicine to support their operations. As a result, those who can often rely on private facilities where more adequate capacities are available, which frequently can occur only when patients are wealthy enough or advantaged because insurance is offered in the workplace. Many Indonesian physicians, with excellent training and capabilities, often practice by day in government facilities and by night in private facilities. Because of the limited availability of western medicine, many Indonesians also rely heavily on traditional practitioners who utilize herbs and massage in the treatment of health-care problems.

Private-sector hospitals are now also major providers of Indonesian health services. In 1993, there were 830 hospitals in Indonesia, which 531 were government-run and 299 were private. Private hospital beds are growing at 7.4

percent per year, compared with 0.4 percent growth in public-sector beds. Of the 24,104 doctors practicing in Indonesia in 1993, nearly 75 percent were general practitioners. Private physicians constituted 28.4 percent of total physicians practicing in Indonesia in 1993.

In its preliminary initial report in 1995 on its large-scale survey work on family life in Indonesia (called the Indonesia Family Life Survey or IFLS) carried out in 1993, RAND reports interesting data on health insurance coverage.[18] The IFLS found that 8.6 percent of the Indonesian population is covered by health insurance. The largest provider of health insurance is the ASKES program for government workers which covers 4.8 percent of the population. The second largest source is workplace clinics (often on-site facilities in the workplace for employees). Nearly two percent of the population is insured through employer health care allowance payments, usually reimbursements to employees of either full or partial repayment for health-care costs they have incurred. As education levels increase, health-insurance coverage also increases. The population with no formal education has but two percent health-insurance coverage, while nearly 41 percent of those who have completed middle school have such coverage.

In the developed world, those with health problems are more likely to purchase health insurance. This pattern has yet to be repeated in Indonesia. Indonesians reporting themselves healthy have about the same level of health-insurance coverage as those reporting themselves as unhealthy. Information on the availability of health insurance suggests that much needs to be done to provide adequate insurance even for those able to pay for it. Thus, a private pooling of the health-care risks of the Indonesian population would help enormously in the finance of health care. If such a system were in place, Indonesia would be able to provide substantial additional financial resources to the health-care sector, far in excess of those that could be made available by additional tasking of the Indonesian public-sector.

Only two percent of the poorest quintile of Indonesians report health-insurance coverage. In the wealthiest quintile, 28 percent are covered by health insurance. Regardless of source of health-insurance coverage, Indonesians with higher household expenditures (or incomes) tend to have more insurance coverage. Outpatient visit rates are highest in the wealthiest quintile of the population. Those Indonesians (both male and female) with health insurance tend to have much higher rates of outpatient visits than those without insurance. Health insurance raises the utilization of health-care services by all types of providers, but in the private sector those Indonesians with insurance use relatively significantly more health-care services than those without insurance. For households without health-care insurance, there is a clear trend in usage upwards from low-expenditure to high-expenditure households that correlates with rising incomes. Households with higher incomes exhibit significantly more outpatient visits.

However, for those Indonesians *with* health-care insurance, the poorest quintile of households has the same level of utilization as the richest quintile. These data suggest very strenuously that a significant program of increased health-care insurance in Indonesia would improve access and equalize access to health care and thereby improve utilization of health-care services across all income classes. The strongest effects of insurance are found in the utilization behavior of the elderly, for whom insurance would more than double the rate of utilization of outpatient services.[19]

[18]RAND, *The Indonesian Family Survey: Overview and Descriptive Analyses*, Santa Monica, CA: The Rand Corporation, 1995.

[19]The overall story is very similar with respect to inpatient admissions, in that insurance will raise utilization by poor people.

A managed-care strategy is technically feasible in Indonesia. These gains from managed care strategy would occur in part by equalizing the access and use of low-income Indonesians to health-care services, and in part by increasing the use of health-care services by all levels of the population. High-quality health care is relatively inexpensive in Indonesia, compared with the United States. Moreover, the demographic profile of Indonesians is such that one principal driver of additional health care costs in the United States — the additional treatment costs of the elderly — is not yet a major factor in Indonesia. Most Indonesians are relatively young, a group that normally has few health problems. However - 1) these young people are entering their reproductive years, which has major implications for health-care; and 2) they are aging. HIV/AIDS is still in an early stage in Indonesia, so that its costs have not yet impinged in a serious way on the Indonesian health-care system. When they do (and they will), a managed-care system solidly in place could help finance these anticipated large-scale costs and improved health-care delivery generally.

V. The Indonesian strategy

Indonesia has underway a process of health-sector reform designed to make five major improvements in its health-care system. These changes include managed-care reform, hospital reform, contract doctors, pharmaceutical reform, and quality assurance.[20] The desired national system of health care for Indonesia has a number of characteristics: a) universal coverage, b) pre-paid/capitated payment systems, c) emphasis on prevention and promotion, d) quality assurance, e) the delivery of these services through both the public and private sectors, and f) social equity. The national health strategy was established in National Health Law No. 23 of 1992, which established the JPKM.[21] This strategy is beginning to be carried out privately in major cities for upper-income Indonesians as an alternative to treatment in Singapore, but is still not yet implemented successfully for many middle and lower-income Indonesians. A USAID-funded integrated field trial in Klaten, Central Java, is an early effort to test implementation for middle- and lower-income Indonesians (discussed in section 6 infra).

A potential implication of the GOI strategy is that eventually all Indonesians will be provided with a basic package of benefits regardless of ability to pay. The benefits are planned to cover all significant preventive services, including vaccinations, maternal-child health, and family planning. Primary and specialist walk-in care and a limited hospitalization benefit are also included.[22] Success with the JPKM strategy will provide the financial underpinning for all the other reforms, including higher cost recovery to the finances of the reformed hospitals, funding to employ the newly created contract physicians, and economic incentives for the success of the pharmacy and quality-assurance interventions. The JPKM provides a regulatory framework within which any legal body may agree to develop a JPKM program and deliver JPKM services.

[20] The discussion of Indonesian strategies for health care, including the details of the five major strategic components, relies heavily on Dr. Widodo Sutopo, Advisor to the Ministry of Health and Chairman of the Task Force for Managed Care Development, Ministry of Health, Indonesia, *Indonesian Health Care Reform: Private Delivery — Public Accountability.* Unpublished Working Paper, March 1995. The Indonesian objectives overlap extensively with the USAID-funded managed-care activities, which principally include the Health Sector Financing Project.

[21] JPKM translates into English as "Guaranteed Maintence of the Public's Health." Dr. Widodo Sutopo, *ibid.*, p.11, reports that the National Worker's Security Law No. 3 established compulsory enrollment and employer contributors in a workers' benefit approach that features the managed-care benefits of the Health law. In 1993 and 1994, national and ministerial regulations were promulgated to implement these laws. USAID Health Sector Financing Project activities help encourage the GOI to take these steps.

[22] The hospitalization benefit covers most surgery, etc., but not certain high-cost procedures, e.g., liver or heart transplant operations.

The JPKM strategy involves a pro-active management of risk and direct involvement with the delivery of health-care services in a "managed care" system:[23] 1) All JPKM are required to provide the established basic benefits. Additional benefits beyond the basic package may also be delivered for additional fees, but only as part of an integrated package. 2) Capitation payments are made to providers of health-care services by beneficiaries in a framework that also includes a risk/profit sharing mechanism.[24] The latter provision is intended to provide an economic incentive to encourage capitated providers to continue to provide services. 3) The JPKM and its health-service providers agree contractually to deliver all services to "mutually recognized standards of care." This provides an economic incentive to increase both the quality and the cost-effectiveness of JPKM-provider service delivery. Expensive health-care services such hospitalization are financed readily through a managed-care approach in which the risks are spread over a large population and costs are relatively low per month even for Indonesian households of moderate means. 4) JPKM benefits are structured to encourage more self care and better compliance with treatment recommendations. To be eligible for curative benefits, the JPKM member would be required to comply with the schedule of preventive and promotive services. For example, chronic-disease patients (e.g., those with hypertension) are subject to penalty copayments for missed maintenance visits. Or, again, pregnant women would be required to receive necessary shots (tetanus toxoid) and attend prenatal visits to avoid a possible copayment for maternity services. The logic is to increase preventive care, and thereby reduce the costs of more expensive tertiary care. In addition, too much of Indonesia's drug use is for self-limiting diseases such as influenza. In such circumstances, the standard Indonesian practice of treatment with penicillin for influenza is economically wasteful.[25] 5) As the process goes forward, JPKM procedures and benefits could be structured to help improve social equity. All health-insurance or managed-care financing systems involve cross subsidies, some desirable and some undesirable. Desirable cross subsidies include those from the healthy to the sick, and in the case of JPKM, from the rich to the absolute poor. Providers could be included in the cross subsidies, so that accepting a high-risk population would not result in adverse economic consequences. However, there can also be undesirable cross-subsidies, such those from the sick to the healthy or from the poor to the rich. For example, if the rich are, as is the case in Indonesia, the principal users of the subsidized governmental health care that is now provided, that is an undesirable cross subsidy. The GOI strategy aims seriously to consider the encouragement of desirable cross-subsidies and the elimination of undesirable ones.

The Indonesian strategy contemplates the necessity of supplementing the managed-care proposal just described. First, Indonesian physicians graduating from medical school are no longer being given permanent appointments in government that permit them to practice privately on the side. Instead, contract physicians have been hired on three-year contracts, which will expire in a timely fashion. Contract physicians may not practice "on the side." This approach will encourage the provision of a ready supply of trained physicians to work in any new managed-care facility. Indonesia is also strongly encouraging

[23]Similarities with the US HMO system include the use of capitation payments to the provider by enrollees, and emphasis on prevention rather than just curative services.

[24]The adverse US experience with fee-for-services systems provides an ample incentive for Indonesia to avoid this approach. Unlike its US counterparts, the Indonesian physicians' association has taken a stand against fee-for-services arrangements.

[25]Dr. Sutopo believes more than half of Indonesia's outpatient visits, 40 percent of its drug expenditures, and about 30 percent of admissions to hospitals are for health-care conditions that could have been prevented or treated in clinics. This factor suggests the structuring of JPKM benefits to manage treatment to reduce these copayments is likely to generate significant savings.

midwives. Second, hospital procedures have been changed. Government regulations now permit public hospitals to discriminate in the prices and quality of collateral services they offer. Health care must remain of the same quality for all, but private rooms, special foods, and extra facilities can be provided for those willing to pay extra for them. This step ensures that potentially at least public hospitals even in remote areas can make sufficient improvements so that their facilities become attractive to those who have choice. Third, procedural reforms affecting the availability and use of prescription drugs under the managed-care strategy will reduce the current wasteful use of those scarce expensive resources. Fourth, equipment providers must be located and provide the needed improvements in health-care equipment, supplies, etc. The Indonesian medical association is establishing a cooperative buying system to improve the purchasing power of Indonesian physicians using donor funds. Fifth, the quality-improvement initiative directly addresses perhaps the most difficult problem with the public-based health care system. Indonesians know how strapped current public health-care facilities are for funds, and are skeptical therefore that they can obtain adequate treatment in them. This problem must be overcome before Indonesians will trust a new system.

VI. The integrated field trial in Klaten, Central Java: status and prospects

Klaten is a lower middle income district in Central Java where a USAID-funded field trial of most of the necessary institutional changes are already in place to determine whether the Indonesian managed-care strategy is workable.[26] The GDP per capita in Klaten in 1993 was about $320. Per household in Klaten, there were about 2.3 workers, and each worker usually earned $649.28 per year. Household size is 4.67, with an average of about 1 dependent per worker. Population in Klaten was nearly 1.2 million in 1993. In Klaten, expenditures for health as a percent of per capita income ranged from 2.85 percent income per month for the lowest quintile through 2.47 percent for the 25-50 percent of income bracket to 2.85 percent of income per month for the 10 percent of the population with the highest incomes.

Based on actual expenditures, probably 2-3 percent of income is reasonable to expect as a contribution rate to finance managed care. To finance the basic health care package in Klaten, the proposed plan was costed out in terms of actual costs with some allowance for profit. Then, a 3-percent contribution rate is assumed. On this basis, the feasibility of the basic package can be seen for Klaten. The costs are about $0.70 per month per person. Numbers for Klaten suggest the financing of the basic package can readily be carried out for those who are employed. Average contributions per household of about $3.10 per month can be contemplated. By costing out the health-care services delivered carefully and adjusting potential costs anticipated generously upward from available data, estimated actual costs of $0.52 per month per person are obtained for delivering all health-care services in the standard package. This profit rate of $0.18 per month per person seems sufficient to pay for the costs of providing the basic managed-care package in Klaten with a considerable margin for error.

In Klaten, many of the desirable characteristics of the proposed health-care system are already in place in the integrated trial. These are the managed-care program, the hospital pricing and service-delivery program, the prescription drug-management activity, and the quality improvement program. The JPKM in Klaten have been recruiting members for about a year, and health-care services are being delivered. The other activities necessary for full implementation have not yet impacted Klaten. The

[26] These improvements have occurred partly as a result of the USAID-funded Health Sector Financing Project which has been conducting an integrated trial in Klaten.

contract-doctor program has just started to produce additional doctors who are seeking employment as private-sector physicians. Procurement of equipment to support improvements in health-care quality at the hospital in Klaten have already been carried out. However, the group purchasing system for health care equipment more generally in the district is expected to be fully in place in another three months or so on a nationwide basis. Equipment financing questions are being initiated with donor finance, with private loan funds an eventual option.

VII. Relevant developments in Indonesia's financial markets

Finance is at the heart of the proposed managed-care strategy. While the internal costs of a managed-care system are workable and reasonable, there are broader financing questions. One key to adoption of a successful strategy for improving the finance of health care in Indonesia is contemporaneously to improve its quality. The current government-based system has serious deficiencies that are widely acknowledged. The managed-care strategy that has generally been adopted by the GOI and has been set forth in this paper presumes that the two sets of changes can occur simultaneously: health-care services can be improved, and the costs of its financing (except for the absolute poor) can be largely shifted from the GOI to the households themselves through private-sector providers. However, Indonesians generally are too smart to risk their hard-earned funds in a managed-care strategy lottery without first receiving assurances that the results are likely to be favorable — that the health-care services will have be there when Indonesians who pay for financed care require them. Thus health-care services will have to be improved first.

The improvements can be made. If they are made, the results so far in the Klaten field trial show that Indonesians are willing to pay more for health care when it is significantly improved over the previous public standard. The problem is that it takes resources and time to make the necessary improvements and to engage in the social marketing necessary to convince Indonesians that the changes have been made and that they should risk their hard-earned money on monthly payments in advance for the right to obtain improved health care through a managed-care facility. For this to happen, the health-care improvements have to made before the advertising campaign which in turn must occur before a financial commitment will be made to managed-care by ordinary Indonesians. In the Klaten field trial, USAID funds and aggressive pricing by the local public hospital helped upgrade critical health-management systems first, supported programs of rational drug use, and will probably finance social marketing. In the case of those provinces in which the World Bank and the Asian Development Bank are expected to provide loan funds, their financial resources will provide the up-front funds to make necessary improvements and carry out the social marketing.

Elsewhere in Indonesia, the funds for the hospital improvements, the health-care equipment necessary, the doctors' salaries during the initial period, and the social marketing will have to come from Indonesia's private financial markets, or managed-care will have to be delayed (probably unduly) until more donor or governmental funds are available. Both the latter options seem unlikely, even in the medium/long term. Preliminary discussions with Indonesian bankers suggest that there is a willingness to look at the question of Indonesian loan finance for health-care activities. However, there are issues.

Current Indonesian interest rates may well be too high to be feasible even for managed-care activities that eventually will be greatly profitable. Such high interest rates may prevent health-care providers from borrowing the funds that are necessary in order to do such things as: a) to carry out social marketing, or b) to buy the necessary health-care equipment, upgrade facilities, etc. to offer improved health care services. Thus, although all the other factors are in place to solve health-care problems in Indonesia largely through private markets, Indonesia's high domestic interest rates may inadvertently prevent Indonesian financial markets from assisting its health-care sector from borrowing as necessary to make necessary improvements in advance of selling managed care to the public.[27]

Despite major macroeconomic successes, there are plenty of possible explanations for Indonesia's high interest rates. These include much international debt issuance relative to demand in Indonesian securities by foreign investors, continuing international anxieties about Presidential succession arrangements and a number of economic management issues, too many problems with bad debt at Indonesia's financial institutions (particularly State-owned banks), the necessity to attract short-term "hot"money to underpin needed capital investments and give the Indonesian central bank needed "elbow" room to manage inflation and monetary stocks, lack of a fully developed capital market sector to provide alternatives to bank finance, etc. Policy solutions potentially are available in the Indonesian context to help resolve these concerns.

One possible macroeconomic solution for the health sector's dilemma would be for Indonesia to issue domestic bonds at longer maturities than the Bank Indonesia certificates now issued, and use the proceeds to pay off foreign borrowing.[28] This step should reduce the amounts of Indonesian securities held in the portfolios of foreign borrowers.[29] With lower amounts on Indonesian securities in their portfolios, foreign investors would become willing to hold more Indonesian securities. Thus, when Bank Indonesia requires additional reserves to deter additional speculation, foreign borrowers would not demand as high a risk premium on its securities. This Indonesian step should probably also be supported by reductions by the GOI in its foreign borrowing.[30]

This macroeconomic step would have beneficial effects in Indonesia's financial markets. The reduced risk premium on Indonesian securities to a more manageable level should permit lower interest rates to occur in Indonesian financial markets. With lower interest rates, the Indonesian health sector could carry out the borrowing it needs to make the managed-care program a reality on a private-market basis.

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[27]Indonesian financial markets have been open internationally for a very long period in the sense that funds freely flow in and out of the country. Interest rates and exchange rates are managed by the government in pursuit of well-understood longstanding macroeconomic policy objectives. These include a balanced budget, steady growth in the monetary supply, an exchange-rate policy that encourages continued growth in non-oil exports by keeping the real value of the rupiah close to fixed against a market basket of goods dominated by the dollar, and aggressive action against inflation to ensure that the CPI stays under 10 percent per year. The GOI budget is "balanced"in the sense that foreign borrowing plus domestic revenues equals or exceeds domestic spending. In a world of volatile international currency movements, nations with a relatively modest GDP such as Indonesia are generally relatively passive recipients of currency flows.

[28]This approach presumes, as seems feasible, that Indonesian savers and financial markets are sophisticated enough to manage and have resources enough to purchase any newly issued GOI domestic debt. The presumption is that these funds are now going into such areas as land and building speculation in Indonesia. Land speculators probably need instead to purchase domestic-government securities. The ground was laid for this in the 1994 tax law changes which provided increased coverage for land in the land and buildings tax, reducing speculative profits in property transactions

[29]Were international portfolios of Indonesian debt already in balance with domestic portfolios, additional lenders from abroad would rush in with foreign funds to buy new Indonesian domestic debt. However, there is probably a difference in preferences between foreign and Indonesian willingness to hold Indonesian debt. The suggested issuance of domestic debt is designed to exploit that difference.

[30]Indonesia benefits from concessionary interest rates in its foreign borrowing. However, if there is excess demand in Indonesia for longer term securities (e.g., by the growing life and retirement insurance sector), then partially satisfying that demand with GOI domestic securities might make it possible for the GOI to reduce interest rates.

There are major potential problems with this possible solution to the high domestic interest rates in Indonesia. In any governmental system, the balance between the spenders and those who are concerned with overall fiscal stability is usually precious and difficult to maintain. Few in Indonesia's senior governing circles have forgotten the adverse experiences of the 1960s, when Indonesia's fiscal balance and integrity were severely damaged in the international arena. None want to repeat the experience. Many if not all are concerned about the costs of a failure in Indonesia's capacities to manage the domestic budget, once domestic borrowing is permitted by the government. The view has been — better to issue no such debt and not find out. However, the next stages of Indonesian development that require increased reliance on private markets probably also require steps toward a solution to Indonesia's high interest rates. It is also true that simply substituting internal for external debt would not increase total borrowing, and by itself does not undermine fiscal balance.

VIII. Implications for USAID.

Chart 1 presents the market for health-care services. In a demand-side strategy, such as the managed-care approach that has been discussed in this paper, USAID priority activities in the health-care arena would be included automatically as eligible activities for financial support and service delivery. In Chart 1, adoption of such a strategy would shift the demand curve for health-care services to the right, increasing the quantity of USAID priority activities made available. In fact, in order to save funds that would otherwise be spent on treatment, the priority preventive activities USAID desires would be priced at zero in Indonesia's managed-care system. The new equilibrium involves a higher quantity demanded on the old supply curve for health-care services. Adoption of this strategy increases quantity of health-care services demanded in the same way that social marketing increases quantity demanded (see the appendix for a more detailed discussion).[31]

This demand-side approach contrasts with simple supply-side approaches to the delivery of health-care services which was standard and successful in the development community for a number of years. See Chart 2, which shows another possible intervention into market for health-care services. In general, supply-side approaches work by shifting the supply curve for health care services to the right to a new equilibrium with the existing demand curve. This change has the effect of reducing the price for a given supply of health care services (by increasing convenience, availability, or directly reducing prices). Demand is not changed, the demand curve does not shift. Quantity demanded is increased because the new supply curve intersects the old demand curve at an equilibrium point where the demand for health-care services is higher. The supply-side strategy provides subsidies to the delivery of a priority form of health-care services, such as family planning activities (see the appendix for a discussion of the more complex characterization necessary accurately to describe various USAID-funded health-care activities).

One problem in nations such as Indonesia is that the remaining poor and (perhaps) ignorant potential recipients of this care may not be willing to accept such services even if they are supplied at a zero price. That is, as shown, the demand curve may become almost vertical for those potential recipients of those priority health services USAID assists the GOI Ministry of Health and the private sector to provide. As shown, additional supply-side funds for such services would not increase quantity delivered. The advantage of the

[31]In Indonesia, the vast bulk of the population has at least barely adequate fiscal resources (median GDP per capita around $400 per year) and a demonstrated willingness to pay for improved health care. However, cross subsidies could be provided to pay the premiums to assure that the managed-care activity also provided improved universal health care.

demand-based strategy of Indonesia's managed-care plan is that its operation provides leverage to encourage poor potential recipients of USAID priority services to accept those services — helping to increase the foresight of these recipients.

Significant cost efficiencies are possible if health-care services for the poor or for special priority activities such as HIV/AIDS prevention can be delivered through the same mechanism that provides standard health-care services for the bulk of the population. The resources USAID requires successfully to carry out a demand-side strategy targeted to improving managed care are quite likely to be significantly less than those required to help carry out such strategies directly. In a supply-side strategy, USAID encourages government fiscal resources to go into building the clinics, etc., through which USAID-funded services (training, technical assistance, information and communication, and quality assurance) are provided. This strategy is constrained by the resources available to the government and to the donor community. In a demand-side strategy, USAID must only provide seed money to encourage the adoption of managed-care to encourage successful provision of health-care services.

The relative efficiency of the demand-and supply-side strategies may be debated, and depends on the slopes of the supply and demand curves in the relevant markets. However, for slopes of those curves that are exceedingly likely for such services as pre-natal care, obstetrics care, and HIV/AIDS prevention, the demand and supply curves of Charts 1 and 2 suggest it is quite probable that demand-side strategies are much more workable and likely to be effective than supply-based strategies. And generally speaking, this is how USAID Jakarta has structured its health-care activities.

It will be very difficult to carry out this health-care strategy in the short/medium term unless Indonesia reforms its health-care sector and acts to encourage further sophistication in its capital markets. Reforming the later sufficiently to make possible a rational health-care system in Indonesia may require structural macroeconomic reforms Indonesia may not yet be willing to spend the political and technical capital to carry out. Without further macroeconomic change in Indonesia, the fastest and cheapest way of achieving USAID health-care objectives may not be readily available.

Governments in other developing countries may be able rely successfully on analyses like those of this paper to encourage reliance on managed health-care activities. Such countries are likely already to have a predisposition to a market orientation and some success in achieving sustained economic growth. However, nations with such an orientation that also have moderate median incomes (Indonesia had a 1994 median income of about $400 per year and per capita income of about $920) can successfully emulate the likely Indonesian strategy for achieving universal health care based on a managed-care strategy. For poorer nations, careful analyses are appropriate before serious consideration is given to adoption of such a strategy.

Appendix of How Specific Health-Care Services Affect the Supply and Demand for Health-Care Services

The analyses in the paper address generally the market for health care-services. In some cases and for conciseness, the analyses may inappropriately characterize USAID-funded activities as supply side or demand side when the reality is substantially more complex. In the interests of accuracy, this appendix attempts to clarify for health-care specialists how economists are likely to think about the market for health-care services in terms of the dichotomy between independently determined supply and demand curves that economists find useful in the analysis of equilibrium conditions in markets.

Most often, activities impacting a market have their impacts on equilibrium quantity supplied and demanded through either quantity supplied (by shifting the supply curve) or quantity demanded (by shifting the demand curve or though a demand shock) but not both. Most often, as well, it is a useful approximation to assume that actions that shift one curve will not shift the other curve. For example, as a result of an exogenous shock to a market in equilibrium, such as an increase in consumer incomes or an improvement in health insurance availability, a shift in the demand curve for health-care services might occur (in most circumstances, a shift to the right), and a new equilibrium will result. An example of such a demand shift is shown in Chart 1, where the initial equilibrium is marked as 0, and the new equilibrium after the assumed increase in incomes is marked as 1. The income increase directly increases quantity demanded. Of course, at the new equilibrium, 1, quantity supplied must also increase. Economists normally examine causation, and would focus on and describe the increase in income in Chart 1 as causing the change in the quantity of health-care services delivered, even though quantity supplied has also increased. there is slack in the market for health-care services, there will likely be very little price increase from the demand shock, as is shown in Chart 1. However, if the system is at full capacity when the demand shock occurs, then the short-run supply curve is vertical, and there is likely to be a major price increase. This case is not shown in the charts. It is worth remarking, moreover, that in response to higher prices and in search of profits, suppliers will begin to build more facilities; the longer-run supply curve will be flattened by the process. Such changes are the normal way in which initial price shocks are mitigated.

Next, consider factors affecting the quality of health-care services. The analysis of quality is a special case for supply and demand analysis. Activities that improve health-care quality can be shown beneficially to shift both the demand for and supply of health-care services. After the changes, equilibrium health-care services delivered are therefore modified in two ways by one change — improving quality.

USAID activities that help improve the quality of health-care services initially impact on the supply side of the equilibrium market for health-care services. A standard market analysis such as either Chart 1 or 2 is built on the assumption that a unit of health-care services of standard acceptable quality is delivered by quality improvements. See Chart 2. In Chart 2, if a service of less than standard quality is delivered, less than a full unit of such services is assumed to be delivered. Thus, in supply and demand analysis, improvements in quality encouraged by USAID activities shift the curve measuring the supply of standard-quality health-care services to the right, because there has been an increase in the quantity of standard-quality health-care services that would be supplied at a given price. Without any change in the prior demand curve, the new equilibrium between supply and demand is at a higher quantity supplied, the sort of change shown in Chart 2. Hence, quality improvement is first and foremost a method of increasing the equilibrium amount of health care delivered by directly impacting factors affecting the supply of health-care services.

The quality-improvement strategy, however, also yields additional benefits on the demand side that further increase quantity demanded and supplied. As potential consumers realize that, for their money, they are obtaining an increased quantity of standard health-care services (improved quality), there will also be a shift to the right in the demand for health-care services, as the service provides better value for the money or meets minimum quality standards. This sort of change has already discussed and can also be understood by examining Chart 1. The net effect of the quality improvement therefore is to shift both the supply and demand curves to the right, in both cases improving the equilibrium quantity of services supplied and demanded. That is, quality improvements need to be considered as a combination of the analyses of Charts 1 and 2.

- Other health-care services important to USAID/Jakarta have different impacts on the market for health-care services. It is argued in detail in the body of the paper that managed care shifts the demand for health-care services to the right, e.g., it has the impacts of Chart 1. Maternal care, child survival, and family planning activities provide financing for prevention/treatment activities that directly deliver supply-side services, initially following the model of Chart 2. The intention, however, is that these prevention activities also later will reduce the demand for medical services. Because of the interdependence of prevention and treatment activities, these prevention activities will also have beneficial impacts on the demand side by preventing a later rightward shift in the demand for health-care services. Successful HIV/AIDS prevention stops a shift to the right in the demand for medical services that would otherwise occur. If HIV/AIDS prevention fails, and after a pandemic occurs, there would likely be an enormous excess demand in the market for medical services, perhaps raising prices or causing the imposition of price controls or rationing of medical care. Thus, AIDS prevention too can be assessed in the context of Chart 1.

Figure 1. Likely Effects of Insurance on Health Service Delivery

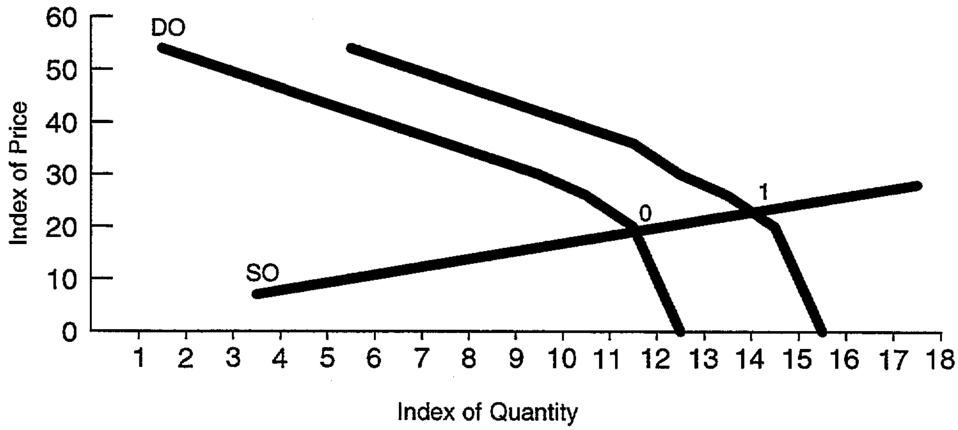
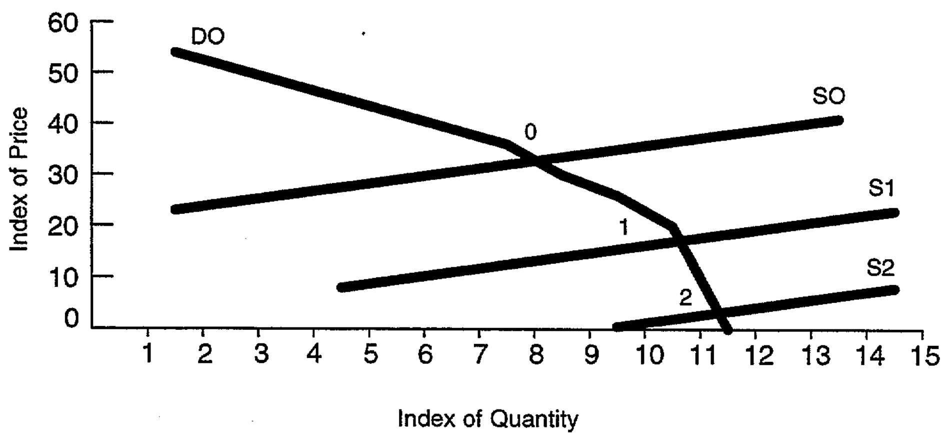


Figure 1. Likely Effects of Subsidies to Supply Costs



FISCAL DECENTRALIZATION

by

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I. Introduction

What is the best arrangement of fiscal powers and responsibilities between the different levels of government? This is a question at the center of policy debate in countries around the world (Bahl and Linn, 1992; Bird, 1993). It is not an issues restricted to big countries, as many believe. Though it is an important concern in China and the United States, it is also under study in Nicaragua and the Baltics. Nor is it restricted to higher income countries — it is presently a major concern in Russia and India. Some countries answer the fiscal balance question with new policy thrusts, some elect politicians with different views, and some use force.

If the question of the proper fiscal balance between central and subnational governments is more important in any particular setting, it is in the developing and transitioning countries. These nations are torn between trying to control unstable economies and trying to invest more decision-making power in populations that have long been disenfranchised. Interest has been heightened in recent years because of the trend toward popularly elected provincial and local councils, and the improved technical ability of local governments to deliver and finance services. Yet many of these countries, facing budget deficits and pressure on prices, recognize that fiscal decentralization could impose a considerable cost and perhaps even an economic risk.

The concern about the division of fiscal powers among levels of government has come to be discussed under the heading of intergovernmental fiscal relations, a subject that many associate with the issue of revenue sharing. In fact, it involves far more. Intergovernmental fiscal relations also includes the assignment of taxing powers and expenditure responsibility, the method of transfers between levels of government (both central-state and state-local), borrowing powers, local autonomy in taxing and budgeting decisions, and many civil service issues. It is a big set of issues, and most are politically charged

II. Theory and fiscal decentralization[32]

Fiscal decentralization has to do with the degree of fiscal autonomy and responsibility given to subnational governments It is a subject on the policy agenda in any developing, transitioning and industrialized countries. There always has been a cry for more decentralization of government, resulting from a combination of people wanting to get more involved in the process of government and the inability of central governments to "get the job done."

Yet many countries around the world have remained highly centralized and have been loathe to relinquish any taxing and spending powers to lower level governments. Others have moved toward more decentralized structures in the past two decades. What are the determinants of this choice? Empirical research has shown that countries that have given greater fiscal powers to their state and local units tend to be higher income and further

[32]These arguments are developed more fully in Bahl and Linn (1992), pp.s 385-427.

along in the development process, larger in population and land area, and tend to have a more heterogenous mix in their populations. It also has shown that countries at war or threatened by war or civil unrest tend to be more centralized (Bahl and Nath, 1986).

Another way to examine the determinants of fiscal decentralization is to consider the a prior reasons why a country might choose decentralization of its fiscal structure, i.e., the theory of fiscal federalism (Oates, 1972). These a prior arguments might be recast in a developing and transition-country framework, and might be thought of, as below, as the advantages and disadvantages of fiscal decentralization.

III. Advantages of decentralization

Economists invoke an efficiency criteria in arguing for small local government when arguing for fiscal decentralization. If preferences for public services differ across subgroups of the population, and if externalities are not present, then national welfare is maximized if local communities vote their preferences and provide the level and mix of public services that they want. Non-economists might take the same view, but couch it in different terms: getting government closer to the people will lead to more participation in government, will likely provide an outcome that is closest to the preferences of the median voter, and will allow the political process to guarantee a more efficient operation of local government. Either way, the results should be the same:

- The mix of services provided will match the demands of the local population.
- Government officials will become more accountable to voters for the quality of services they provide.
- Local populations will be more willing to pay for public services, since their preferences will be honored.

A second argument for fiscal decentralization, not often mare, is that it can enhance revenue mobilization. Some taxes are suited to local government in that their assessment and collection requires familiarity with the local economy and population, and because they are perceived as quasi-benefit charges that finance local services. The property tax and other land-based taxes are usually thought of as local government taxes. It is also true that central government value-added and income taxes often do not reach smaller enterprises. Typically, small firms are legally exempt from income tax and VAT for administrative reasons. Workers outside the formal sector often escape taxation because the administrative apparatus cannot find them. Local governments, it could be argued, might be able to capture this untapped fiscal capacity because of their greater familiarity with the local tax base.

Are these arguments, particularly the efficiency argument, really valid? Can local governments actually respond to citizens' preferences for more or few local services, or to a willingness to pay more tax to receive local services? In fact, the efficiency case for fiscal decentralization is much stronger in industrial than in developing or transitioning countries. This general model does not so easily fit developing or transitioning countries, however, and the efficiency gains from decentralization therefore may not be so great in those settings. This is partly because voter preferences are not as readily translated into budget outcomes as in industrial countries. Local councils are often not elected, chief officials are often not locally appointed, and adjustments in the allocation of local resources are often severely constrained by central government controls. These controls include approval of the budget, central appointment of chief local government officers, central government regulation of tax administration, mandates as to salary levels of local government employees, and the general absence of a mechanism by which local votes can reveal their preferences for a larger or smaller government. In this setting — where the devolution of revenue authority and expenditure responsibility is not accompanied by a relaxation of central government control over local fiscal decision-making — there is less to be gained from decentralization of taxes and expenditure than would be the case in industrial countries.

Given this state of affairs, the situation in a transitioning country which could give maximum gains from a more decentralized local government structure would include: (a) enough skilled labor, access to materials, and capital to expand public service delivery when desired, (b) an efficient tax administration, (c) taxing power sufficient to capture significant portions of community income increments, (d) an income-elastic demand for public services, (e) popularly elected local officials, and (f) some local discretion in shaping the budget and setting the tax rate. This list suggests that the setting for decentralization is clearly present in most industrialized countries, but often is not present in transitioning or developing countries. Where these conditions are present in lower income and transitioning countries, it is usually in the wealthier provinces. This suggests that fiscal decentralization initiatives be limited to such places. This would not likely be a politically popular feature of a decentralization reform movement.

IV. Advantages of centralization

The arguments for fiscal centralization, on the other hand, are stronger in transitioning and developing countries than they are in industrial countries. History has shown that *stabilization policy* is an especially important concern in developing economies and in those economies that are in transition to a capitalist system. This argues for central government control of the main fiscal instruments (taxation, spending and borrowing). Under a highly decentralized system where the local governments have a built-in claim on a share of total revenues raised, the central government will find itself in a difficult position insofar as increasing revenues to reduce the total deficit, or passing structural tax reforms that might be aimed at stimulating savings or reducing imports. By the same token, controlling inflation by limiting government spending may be compromised if local governments have the power to set their own budgets.[33]

A related issue is the relationship between control of the central government budget deficit and intergovernmental fiscal relations. Where the central government has power over all the major fiscal instruments, it can target on an acceptable level of the deficit and control this with either tax increases or expenditure control. In more decentralized countries, central governments experiencing deficits are tempted to try and off-load their shortfalls onto local governments by reducing grants or other subsidies. This is the case in the United States in the past few years, and in present-day Russia. Countries with chronic deficit problems would do well to avoid the dilemma of policy makers being unable to disentangle the question of what to do about the central deficit from the question of what is the right fiscal balance between the central and local governments.

In transition countries that are undergoing privatization and building a public and industrial infrastructure, the need for a coherent *investment policy* is also an argument for fiscal centralization, because capital resources are scarce and must be controlled by the central government to maximize returns. If local governments are given access to major tax bases, they may compete with the central government and therefore limit the amount available for the central tax. As a corollary, centralization allows the national government to allocate fiscal resources to goods and services with national benefits, whereas local autonomy

[33]Gramlich, however, disagrees with this proposition, at least in the context of industrialized countries. "since central government fiscal policy has a limited stabilization effect anyway, the time seems right for some new thinking about decentralization strategies." (Gramlich, p. 234).

would inevitably lead to greater expenditures on those services that have more local benefits.

Several arguments for *income distribution* also support fiscal centralization. The most important is that regional (and rural-urban) disparities in income and wealth may be accentuated by fiscal decentralization because wealthier urban governments will benefit most from greater local taxing powers. Centralization allows the national government more discretion in shaping regional differences in levels of public service and taxation, which is an especially important consideration for governments that intend to use tax and subsidy policy to shape the spatial distribution of economic development. China, Russia, and the United States are all characterized by significant fiscal disparities. China and Russia in particular have faced difficult choices as regards to equalization. China was forced to choose between funneling more resources to the lower income provinces and leaving the revenues in the higher income coastal provinces. Russia has faced the difficult decision of choosing among equalization, central government fiscal solvency, and appeasing the potential breakaway provinces. In both cases, the central governments retained control over the fiscal resources and was in a position to make the important policy decisions. The U.S. federal government is in much less of a position to affect a regional distribution of resources, since it directly collects only about 60 percent of revenues.

V. Conclusions: lessons and guidelines

What lessons from the experience with fiscal decentralization might be useful to developing and transitioning countries? What options for a balance between central and local governments are open and what are the pitfalls to be avoided? The following are seven principles that might be considered by fiscal planners in thinking through the development of the new system.

1. *There is no one best intergovernmental system.* Many different divisions of power and responsibilities among levels of government, and many different kinds of transfer payment systems can work effectively. Everything depends on how the government weighs its objectives. If investing decision-making power in the local councils is of paramount importance, then it is essential to give autonomy to the local governments to form budgets and set tax rates. It is also essential to give them political autonomy as regard to election of local councils and appointment of local officers. If on the other hand, national objectives such as macroeconomic stability or equalization are most important, then the tilt should be toward more centralization. In that case, local governments should be given less taxing and spending autonomy, less power to borrow, and the direction of investment should be given by the central government. This is the strategy that most transitioning and developing countries follow.

2. *Intergovernmental Fiscal Relations is a system, and all of its pieces must fit together.* The system that any country designs must take into account, in some consistent way, the following:

- the assignment of taxing and spending powers and responsibilities,
- local government autonomy in setting tax rates, determining tax bases, and setting budgets,
- the degree to which local councils are popularly elected, and the degree to which local councils appoint and dismiss the chief local operating officers,
- whether the number and salaries of local government employees are determined by the local or the central government,
- whether and how local governments will be able to borrow for capital purposes,
- the structure of intergovernmental transfers.

If an intergovernmental system is designed without considering all of the pieces, it is not likely to accomplish the objectives that the government has set for it.

3. *The place to begin in designing a proper fiscal balance between levels of government is with the expenditure side.* Until the assignment of expenditure responsibilities is decided, it is not possible to decide on the proper division of local taxing and borrowing powers, and the "right" level of transfers. Policy makers should "run the numbers" associated with any particular expenditure assignment to determine revenue needs. Unfortunately, most studies of intergovernmental finances begin with the revenue side, often with the redesign of the revenue sharing system, and predictably end up without having solved the mismatch problem (Martinez-Vazquez, 1994).

4. *Recognize that intergovernmental systems are always in transition, and plan for this.* Among the reasons for instability in systems of federalism are:

- Regional balances in economic power shift over time. As recently as 20 years ago, when the U.S. federal system was going through a major overhaul, there was little thought given to the possibility that Florida and Texas would be the third and fourth largest states by 1990, and that grant formulas would have to reflect this new power. The oil and mineral rich provinces of Russia have realized new economic power, and this has partly shaped the emerging federalism in that country.

- Ethnic differences take on more importance, either because of changing political power or because of civil unrest.

- Politicians change and bring new views and biases with them. For example, China's economic reform, begun in 1983, had profound implications for the system of fiscal relations between central and local governments, moving the balance of fiscal power towards the lower level. The recent 1994 reform shifted the balance back towards the center. Similarly, virtually every new President in the United States in the past three decades has introduced a new federalism.

What can a country do to protect itself against the disruption caused by these circumstances? How can one protect the certainty needed by local governments to plan effectively for the expenditure of tax moneys? One possibility is to set up commissions, as in India and Australia, to periodically review the intergovernmental system. Another is to put in place a data system that will enable a careful tracking of the fiscal performance of subnational governments, and the evaluation of the impact of changes in the federal system on these governments.

5. *It should be recognized that the age of VAT means that there is much less room for assignment of revenues to local governments.* The value-added tax (VAT) is neither suitable as a local government revenue source, nor as a shared tax on a derivation basis. This suggests that grants allocated on a basis other than derivation will play an increasing role in the intergovernmental fiscal structures in many countries. The individual income tax has many characteristics that make it suitable as a local government tax. Other good prospects for local taxes are the property tax and user charges.

6. *In order to capture the benefits of fiscal decentralization, there must be significant local autonomy given, and it must be given on both the tax and expenditure sides.* If local governments do not have the power to set tax rates, then their officials cannot be held fully accountable by voters for the quality of public services delivered. It is also necessary for local councils to be elected, and for local chief officers to be appointed by the council. Otherwise neither will be accountable to the local voting population, and the efficiency gains of decentralization will be lost.

7. *There is an intraprovince dimension to intergovernmental fiscal relations and this should be taken into account in planning the system.* If the central government worries only about the

distribution of resources among the provinces, it may miss the more important issue of how resources are distributed among the rich and poor local governments within the province. Oftentimes, the disparities in income and wealth within a province are much greater than those among provinces.

8. *Countries should undertake comprehensive reviews of their intergovernmental fiscal systems, and these reviews should lead any major reforms in the structure of relations between central and local governments.* The model used in tax studies should be generally followed: (1) analyze the strengths and weaknesses and outcomes of the present system, (2) draw on the worldwide experience, and (3) evaluate alternative reform options. Such an exercise can be used by governments to improve the overall focus of their policy in the area.

NOT ENOUGH EMPLOYERS: THE FAILURE OF PAST NATIONAL ECONOMIC POLICIES–BUT HOPE FROM ACCUMULATING REFORMS

The Philippine Experience Supports Five Conclusions

by

Alan Batchelder

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I. Executive summary

In 1960, Philippine economic development was well-ahead of that of Taiwan, South Korea, Malaysia, and Thailand. With a well-educated English-speaking population and close ties to the United States, the Philippines appeared also to have a more promising developmental future than did any of its East Asian neighbors.

However, by 1985, Taiwan, South Korea, Malaysia, and Thailand were all established on the path of sustained economic development, rising wages, and rapid reduction in the extent and severity of poverty. In contrast, the Philippines suffered continuing economic stagnation with persistent low wages and increases in the number of and percent of poor. Like the other four nations, the Philippines received substantial foreign assistance over the intervening quarter century. These gifts benefitted millions of Filipinos in selected "green-oasis cases" but left the vast majority of Filipinos to suffer the spreading poverty of a non-developing economy.

The reason the four nations were successful is clear. They adopted — all but Malaysia with extensive USAID technical assistance — economic policies and created institutions that nourished the growth in numbers and success of private employers, many producing for export. Because their numbers and general success grew more rapidly than did the number of workers, employers are being compelled, year after year, to pay higher and higher wages. And as competition forced wages even higher, employers were compelled to abandon manufacturing products and processes that delivered high profits using cheap labor and to switch to manufacturing products and processes that delivered high profits using higher — and then much higher — priced labor providing higher labor productivity.

The Philippine contrast was stark. For 25 years, its leaders perpetuated economic policies and institutions that supported a large number of monopolies while repressing the general growth of numbers of competitive private businesses. The result: the numbers of people looking for work grew faster than did the demand for wage employment. Employers had no reason to raise wages, and the press of the excess workers increased the extent and severity of Philippine poverty.

Since 1985, successive Philippine Governments have been changing economic policies and institutions. The USAID Mission has been a central player assisting with reforms. However, the policies and institutions to be changed are so numerous, and the instances of backsliding are so frequent, that the Philippines remains some distance from establishing a policy and institutional environment sufficiently healthy to produce economic growth rates consistently exceeding 5 percent per capita per year, the rate needed to get on the path of sustained economic growth, trade expansion, wage increases, and poverty reduction.

II. The Philippine experience supports five conclusions

Twenty-five Years of Failure, 1960-85: In constant 1994 dollars, annual foreign aid averaged $5.75 per Filipino during the 1960s, $6.50 during the 1970s, and $8.00 during 1980-85. The United States provided forty percent of the total during the 1960s and 70s but only one-third during the early 1980s.[34] Most of the $7.5 billion total of official development assistance (ODA), 1960-85, went into infrastructure, health, education and environmental projects while a substantial portion provided general budget support. Additionally between 1960 and 1985, the number of foreign-based Non-Government Organizations (NGOs) doing outstanding "good works" in the Philippines surged from a few dozen to several thousand.

But throughout this quarter century of foreign "good works," the Filipino labor supply grew faster than did private employers' demand for Filipino labor. This happened because national economic policies suppressed the growth of hiring by private employers. As a result, despite foreign beneficence, the number of poor Filipinos doubled between 1960 and 1990. This history illustrates the hard fact that, unless the economic policy environment nourishes sufficient growth in the number of employers competing to hire workers, the extent of poverty will grow in spite of foreign aid and NGO "good works."

This report is presented in three parts: (1) it briefly describes the great damage done to Filipinos by 25 years of repressive economic policies that were left largely untouched by the donors and NGOs and that kept the demand for

[34]Nominal Official Development Assistance from the OECD Public Data Base on magnetic tape. The ODA dollars were converted to 1994 prices using the "U.S. Exports" price deflator, Table B-3, of the ________.

wage labor from growing as fast as the labor supply, (2) it then describes USAID's new and much more effective role since 1985: its numerous activities that are helping to change policies, practices, and institutions so they will induce increased wage employment and, eventually, poverty reduction, and (3) it reports the obvious fact that, despite budget cuts, the USAID Mission maintains a central role in assisting further reforms that will boost private demand for wage labor and will, with time, alleviate poverty.

There are five conclusions supported by the results of this report: (1) donor projects and NGO activities have done, and are doing, much good for a great many — but a minority of — poor Filipinos, (2) donor projects and NGO activities could not reach the vast majority of the poor because the policy environment remained both a barrier to economic growth and a barrier to increased hiring by private employers, (3) when Philippine policy reform began in the early to mid-1980s, the layered thickets of government barriers to the growth of private demand for wage labor were far more extensive than the initial reformers understood, (4) Manila's USAID mission has been, and continues to be, even after big budget reductions, highly effective in helping local reformers to cut away those barriers, (5) average unskilled wages won't rise until private employers flourish and multiply and discover they either have to pay higher and higher wages or lose employees to competitors. This kind of competition has characterized Britain, Sweden, America, and Japan for a century, and Korea, and Hong Kong for decades. But a great many economic policy reforms have to be implemented and sustained before the competition for Filipino labor approaches this point.

Unhappily, this takes time. There may, therefore, emerge a sixth conclusion that when USAID responds to the voracious political demand for "performance measures," missions should forswear use of poverty, income distribution, GNP per capita, and other such welfare statistics. These ultimate effects of USAID's best policy-reform efforts take a long time to appear. But USAID's political monitors want measures of early results — for which some indicators may be available. One might, for example, measure the quality of the business environment using changes in scale of direct foreign investment (DFI); or one might measure progress on the *ultimate objective* of policy reform by monitoring real wages paid to maids and farm laborers by Filipino families. DFI changes can come quickly and usually will indicate changes in incentives for both foreign and domestic employers. Wage changes in unregulated markets are an early indicator of the extent to which growth is benefiting the main body of the poor.

III. What is broken

In the early 1950s, South Koreans, Taiwanese, Indonesians and Thais suffered poverty at least as oppressive and as wide-spread as did Filipinos. Today, South Koreans and Taiwanese have nearly eliminated poverty. Indonesians and Thais are rapidly reducing theirs. But there were 29 million poor Filipinos in 1991 where there were only 15 million in 1971.

Why did this happen? The Philippines failed to approach East Asian poverty reduction because it failed to approach East Asian economic growth. In turn, that failure was due to economic policies that, unlike most of those in East Asia, repressed the entry and growth of private businesses. As a result, the demand for Filipino wage labor lagged behind the growth of labor supply, and wages stagnated.

The failure of growth of private employers cannot be explained by external forces. The forces crossing the Pacific Ocean brought to the rest of East Asia the same problems and opportunities they brought to Filipinos. Instead, the causes of failure came from within, from Philippine policies and institutions.

The following table summarizes data portraying developments in the Philippine labor market from 1960 to 1994. It divides those years into two periods, 1960-85, the years when policy errors broke the economy; and 1985-94, the years in which repairs began. Cumulatively damaging policies and institutions produced the table's first-column numbers showing the dismal nature of labor market changes between 1960 and 1985.

Table 1

Increase in	1960 to 1985	1985 to 1994
The labor force	112%	28%
Employment		
Total	110	24
Agriculture	68	14
Manufacturing	68	30
Services	261	28
Construction	171	67

In 1960, over 60 percent of all jobs were in farming. But as the labor force grew 112 percent[35] over the following quarter century, the number of farm jobs (including growing numbers of non-wage workers in subsistence-level self-employment and family enterprises) grew only 68 percent.[36] By 1985, only 52 percent of all jobs were in farming.[37] The slow growth in the number of farm jobs is, of course, not surprising given the limited supply of arable land.

But as will be detailed below, a host of Philippine Government (the GOP) policies oppressed traditional agriculture while discouraging agricultural diversification thereby limiting the growth of job opportunities in agriculture. So where was the rest of the growing labor force to work? In similar circumstances in East Asian countries (as in Europe, North America, and Japan in earlier years), most were hired by manufacturers. But not in the Philippines.

By 1960, import substitution had succeeded wonderfully — as it usually does in its first decade — and 12 percent of Philippine workers had manufacturing jobs. But after 1960, implacable import-substitution policies repressed the growth of competitive private employers in manufacturing as well as in agriculture. So jobs in manufacturing grew only 68 percent[38] over the next 25 years; and by 1985, only 9.7 percent of all employed workers had factory jobs.

Many people were hired, at all skill levels, in the growing modern services sector where formal wage and salary contracts were the rule — but not enough to take up the slack. The excess workers, numerous beyond the growth of full-time wage employment, spilled over into four areas: Many fell into unemployment, up from 6.3 percent to 11.8 percent. More became or remained underemployed in subsistence self-employment or family activities in agriculture, crafts, and other services, a condition up, officially, from 20 percent of the labor force at the beginning of the 1960s to 24.5 percent in the early 1980s.[39] A million or more left the country to work overseas. Their remittances ($3-4 billion during 1994) to their folks back home became a principal reason the incidence of poverty has not been greater.[40]

But most of the excess workers tumbled into dumping-ground subsectors of "services" as servants, day laborers, and peddlers working long days for a few pesos. In 1985, some 40 percent of all service jobs were nonwage jobs, many of them ill-rewarded. Thus, subsistence jobs contributed substantially to the 261 percent increase in service employment between 1960 and 1985.[41]

[35]For growth of the population and labor force, see Figure 1. For labor force participation rates, see Figure 2.
[36]For growth of agricultural employment compared with growth of the labor force, see Figure 3.
[37]For sector employment as a percent of total employment, see Figure 4.
[38]For a comparison between the growth of employment in manufacturing and growth of the labor force, see Figure 5.
[39]For unemployment and underemployment rates, see Figure 6.
[40]For remittances as a percent of GNP, see Figure 7.
[41]For a comparison between the growth of employment in services and growth of the labor force, see Figure 8.

The results of all of these trends were that, from 1960 to 1990, the percentage of employed workers:

- fell from 12% to 10% in manufacturing,
- rose from 3% to 5% in construction,
- fell from over 60% to 50% in agriculture, and
- rose from 21% to 32% in services[42]

Since 1965, wage employment has grown at least twice as fast as has total employment in the most rapidly growing economies (e.g., Taiwan and Thailand).[43] But the slow growth of private demand for Filipino wage labor actually reduced the percentage of employed Filipinos earning privately-paid wages from 34.5 percent in1970 to 33.1 percent in 1980 and 33.3 percent in 1990.[44]

The relatively slow growth of demand for wage labor explains why the incidence of poverty among individuals rose from 43 percent in 1971 to 49.3 percent in recessionary 1985. On the other hand, the decline to 45.5 percent in 1988 indicates the powerful effects of economic growth during even a short-term recovery. Finally, the rise to 46.5 percent in recessionary 1991 underlines the importance of achieving sustainable economic growth as distinct from frequent stop and go. Information about the results of accelerated growth into 1994 await analysis of the household survey data of 1994.[45]

This report draws two conclusions from the economic history of the modern world. First, the poor majorities of as-yet-undeveloped Britain, Germany, Sweden, the United States, Japan, Korea, and Malaysia, etc., were able to work their way up from poverty only when they moved, in large numbers, into wage jobs in manufacturing and services. Second, average wages of the unskilled did not begin to rise in any of these countries until the numbers of employers became so numerous that their competition for help compelled them to raise wages. Neither goodness of employers' hearts, nor good intentions of government leaders, nor virtuous NGOs, nor labor unions had anything to do with those increases in the averages.

In contrast with those successful nations' experience, demand for Filipino wage labor grew so slowly, 1960-85, that average agricultural wages fell at least from 1978 (the earliest comparable data) to 1984; and they did not return to 1978 levels until 1992, while urban common laborers' average wages fell from the late 1960s until the early 1980s and by 1992, had recovered only half their fall.[46]

Those lessons from 150 years of experience warn Filipino policy makers that average unskilled wages will not rise and poverty will not fall significantly until the growth rate of successful employers catches up with and surpasses the growth rate of the labor force so employers, in competition with one another, are compelled to pay more or lose employees. And they will not have to pay more until growing demand for labor drains the great reservoir of surplus labor in self-employment and family enterprises in agriculture and services.

This is, emphatically, not to deny the possibility of wage increases for large portions of the population during periods of initial slow growth and of recovery from recessions. The poverty comparisons of 1985 with 1988 and of 1988 with 1991, cited above, suggest that recovery periods may bring both increases in employment and in wages in many sectors as the economy moves irregularly toward new equilibria. Early slow growth in some sectors may also cause some employers to pay more even to the unskilled to induce workers to move to those employers. And there are always some occupations that confront employers with upward sloping supply functions that compel higher wages when demand rises. But increases in the wages

[42]Figure 4 shows the 3-sector breakdown for each year, 1960-94.

[43]Compare growth rates for private employment in selected countries in Table 6.3, p. 269, of the World Bank's __.

[44]"The Transformation of Philippine Employment," Table E.3, p.48, in volume III, ______

[45]Figure 9 shows the incidence of poverty among individuals in 1985, 1988, and 1991.

[46]For agricultural wage averages, 1978-92, see Figure 10. For urban common laborers' average wages, see Figure 11.

of the majority of the poor do not happen until growth in demand for unskilled and semi-skilled labor becomes rapid and sustained.

How to get such growth in labor demand? Import substitution can't possibly do it. Even in a country as large as the Philippines (about the same population, some 67 million in 1994, as California, Texas, and New York combined but with only 1/10 their purchasing power), import substitution is woefully inadequate. Like California, Texas, and New York, past and present, the Philippines can grow and raise wages rapidly only by compelling its producers as to operate within the opportunities and the constraints of competition in a much larger market system. To do this (and to begin to catch up with Indonesia, Malaysia, and Thailand[47]), policies have had to be changed; and here is where USAID has been, and continues to be, helpful in many ways.

IV. What USAID has been and is doing to fix it — long run

Earlier as well, but especially since 1985, USAID has helped persuade GOP policymakers to begin changing policies, practices, and institutions to encourage, instead of repressing, the rise of new successful employers who would use labor efficiently. USAID has also assisted extensively in the design and implementation of such reforms.

The World Bank, the Asian Development Bank, and the IMF have encouraged policy reform. But USAID has been the premier bilateral donor inspiring and assisting reforms. During the 1980s, USAID conditioned Economic Support Fund (ESF) and Multilateral Assistance Initiative (MAI) tranches on specified policy reforms. This was a high-cost approach to convincing Filipinos to do what was good for them. But gradually, USAID has switched to providing relatively low-cost technical assistance to support reforms originating within the government.[48]

However, the figures above on labor market changes between 1985 and 1994 offer little evidence that market forces will raise average real wages anytime soon. As the labor force grew by 28 percent between 1985 and 1994, manufacturing employment grew a little faster, 30 percent, while jobs in services grew only 28 percent. But with the rural population growing and with 60 percent of the poor living in rural areas in 1991, the number of jobs in agriculture grew only 14 percent. Within these numbers for services and for agriculture, the bad news is that much of the growth seems still to have been in subsistence-level self-employment and family enterprises.

The slowness with which cumulating reforms are producing improvements in the employment data may have much to do with the short lives of previous reforms. Since 1960, the Philippines has been something like the person who says, "it's easy to give up smoking; I've done it a dozen times!" Not a dozen times, but the Philippines often introduced economic reforms (e.g., liberalizing imports, freeing the exchange rate) in the 1960s, 1970s, and early 1980s only to reverse the reforms and increase restrictions soon after. Yet under President Ramos's Administration, the reforms have been extended longer and more broadly than ever before. They may be here to stay. If so, long-run prospects will brighten.

Nevertheless, the Philippine history of stop-and-go reform imposes two questions on prospective employers: First, are the many

[47]Figure 12 compares GDP growth, in U.S. $ billions, for these four countries.

[48]USAID's new role may eventually compare favorably with that of its predecessor agency and its own early years when U.S. technical assistance and policy dialogue were critically important in convincing South Korea and Taiwan to switch from the constraints of import substitution to successful outward orientation, for which story, see "The Role of USAID in Economic Policy Reform: Origins and Case Studies," G/EG/EIR, forthcoming.

recent reforms here to stay? And second, will the reforms be extended to pull down the manifold remaining barriers to the entry and success of new employers?

During 1960-85, the Philippines became a paradigm of nearly all the things a government can do wrong — and of nearly all the things a government can fail to do that would be right — resulting in slow growth in numbers of successful employers seeking to hire more people. But little by little since 1985, the Government has stopped doing some of the things it ought not do and has begun to do more and more of the things it ought to do.

USAID has assisted an extremely broad and layered variety of these reforms. To make that range and depth comprehensible and to suggest the significance of their effects, this report assigns reforms among eight areas basic to accelerating the entry of new competitively successful employers. The eight areas requiring reform were:

- import-substitution controls held down employment in exporting,
- government-designated monopolies excluded additional employers,
- discriminatory laws and regulations kept out foreign employers,
- various GOP policies encouraged substitution of capital for labor,
- financial sector policies depressed savings and misdirected investment,
- regulations restricted growth of demand for rural labor,
- the tax system failed to fund infrastructure and human capital, and
- budgets underfunded infrastructure and human capital.

USAID has assisted policy and institutional reforms in each of these areas. For each area, the following summary first cites ways in which inappropriate polices and inadequate institutions discouraged prospective employers and repressed the growth of demand for labor. The summary next cites USAID's accomplishments inspiring, designing, and implementing particular reforms. Finally, the summary reports some of the evidence of subsequent positive effects of the reforms.

V. Eight areas requiring reform

1. Import substitution controls

Trade barriers and foreign exchange controls raised exporters' production costs, diverted inputs away from production for export, cut the domestic currency value of exports, and otherwise minimized production, and minimized the number of employees hired to produce, for export.

<u>USAID assistance with reforms:</u>

- To increase the peso value of exports, the Mission conditioned Budget-Support-Program II (BSP II) tranches in 1987 on ending peso overvaluation by introducing a market-oriented dirty float Then it conditioned Support-for-Development-Program (SDP II) tranches , 1992-93, on ending exporters' retention limits and persuading the Central Bank to permit a fully market-determined foreign exchange rate.
- To reduce the costs of imported inputs, the Mission conditioned Private-Enterprise-Policy-Support (PEPS) tranches, 1991 to 1995, on cutting the average tariff from 31 to 24 percent, simplifying rates, reducing to under 50 percent the excess of effective protection rates on manufactures over the effective protection rates on agricultural products, and replaced quantitative restrictions with tariffs on 182 mainly agricultural products.
- To reduce exporters' overhead, the Mission provided technical assistance as the GOP shortened the time required, and consolidated into one office, the paperwork processing required to return tax/duty rebates to exporters.

- To change public opinion, USAID provided technical assistance to help various export groups to consolidate into PHILEXPORT, now the lead advocate of trade reform and the successful promoter of public support for Philippine accession to the provisions of the Uruguay round.

Further consequences of USAID assistance:

- The effective rate of protection was cut from 49.0 percent in 1985 to 34.5 percent in 1992 to 29.8 percent in early 1995.[49]
- During 1993-94, manufactured exports grew by 21.4 percent and total exports by 18.1 percent. The share of manufactured exports in total export value increased from 76.7 percent in 1993 to 78.9 percent in 1994.
- The "openness" (exports plus imports as a percent of GDP) of the Philippine economy rose from 30-45 percent during 1975-86 to over 70 percent in 1994.
- The foreign exchange reserves of the Central Bank rose from the low level of $2 billion in 1991 to the historic high of $7 billion in 1995.
- The GATT was ratified by the Philippine Senate in 1994.

2. Government designated monopolies

Before Marcos, the GOP gave full monopoly power to the public telephone company and the electric generating/distribution company, the Hybrid Coconut Seednut Farm, and the private inter-island shipping companies. For 40 years, it prevented the entry of foreign commercial banks, thereby giving oligopoly power to the existing 33 private commercial banks. It gave full monopsony power to the copra-buying United Coconut Oil Mills and the National Sugar Trading Corporation. High tariffs and quantitative restrictions gave a high degree of monopoly power to most large-scale manufacturers.

President Marcos set out to replace the formerly economically and politically dominant families with a new elite, the families of his friends. He accomplished this by providing tax, regulatory, and other privileges, various other monopoly powers, and cheap credit to his friends' businesses. For a time, those businesses prospered without regard to their efficiency and largely free from the possibility of new firms beginning to sell in competition with them. When many of these firms dropped into bankruptcy, the Marcos Government bought them and continued or increased their monopolistic powers.

<u>USAID assistance with reforms</u>: To cut back monopoly power and allow in many new employers, the Mission funded the following technical studies of:

- the telecommunications sector confined by the monopolistic Philippine Telephone Co. The study was widely circulated in both the private and public sectors, including the staff of the Presidential Palace from whence came the decree that opened telecommunications to foreign firms;
- the cartels controlling inter-island shipping and port cargo handling (most effectively supported under the USAID Agricultural Sector Assistance Program). The studies' conclusions were instrumental in persuading
  - the Marine Authority to allow competition in inter-island shipping and
  - the Philippine Ports Authority to allow competition in cargo handling;
- the national electric company's monopoly and of the convention that only the GOP could build and operate infrastructure. This study was instrumental in persuading the legislature to allow private firms to construct and operate electrical generating plants as well as roads, and other infrastructure.

USAID technical assistance in the area of privatization resulted in several major policy reforms, including the passage of a new liberal build-operate-transfer (BOT) law in 1994. Government presence in the fuel sector was

[49] The 1985 figure is from Table 9 of E. Medalla, "An Assessment of Trade and Industrial Policy," in ______.

reduced, after USAID TA, with the approval for privatization of some subsidiaries of the Philippine National Oil Company, including Petron, the marketing arm.

Further consequences of USAID assistance: During 1994, prompt private-supplier telephone installations replaced years of waiting; new shippers entered inter-island shipping, and they ordered construction of new ships to provide better service; new companies competed to provide cargo-handling services in each of the nation's 5 largest ports; and the frequent blackouts and brownouts of 1992 and 1993 were largely ended in 1994, both by expansion of capacity of the government's power company and by allowing entry of private companies into power generation with private generators and through BOT schemes. Then by the end of 1994, helped by a 1992-1994 tariff exemption on imports of electrical generating equipment, the National Power Corporation expanded high-volume low-cost capacity to begin to displace the private generators and meet peak user demand.

One hundred and thirty government-owned and controlled corporations (GOCCs) have been approved for privatization, out of a total of 301 GOCCs. Seventy eight of these GOCCs have been either fully or partially privatized by 1993. Cumulative gross proceeds to the GOP from sell-offs, 1987-94, totaled $5 billion.

3. Laws and regulations keeping out foreign employers

The barriers of the two preceding problem categories restricted growth of foreign as well as of domestic employers. Limits on repatriation of interest, dividends, and capital also discouraged foreign employers as did laws and regulations limiting foreign share ownership and land-leasing terms. In a long list of industrial categories, the GOP simply prohibited any foreign firm from setting up and employing Filipinos. Finally, the Government's failure to protect intellectual property rights kept out firms — especially higher tech firms unwilling to risk their patented technologies in a lawless environment.

USAID assistance with reforms: To reduce the following barriers to foreigners creating jobs, USAID used conditioned assistance to support GOP decisions:

- to lift almost all restrictions on international capital movements and on repatriation of capital and interest and profits,
- to lift the requirement that the Central Bank approve all foreign investments, and
- to pass the Foreign Investments Act of 1991 and thereby to adopt a new legal policy framework liberalizing entry of direct foreign investors, shortening the list of industries reserved for domestic firms and removing the ceiling on foreign share ownership in companies exporting more than 59 percent of production.

USAID also: (1) financed a study that led the GOP to accede to the 1971 Berne Convention on intellectual property rights (IPR) and that led to a Presidential initiative to change Philippine policy/ practice to enforce prosecution of IPR violations, (2) provided technical assistance that helped induce the legislature to extend the land lease period for foreigners from 50 to 75 years, and (3) supported the GOP initiative (through the Mindanao Growth Plan, beginning in 1991) that led to the East ASEAN Growth Agreement.

Further consequences of USAID assistance: The ASEAN Growth Agreement quickly brought (1994) Mindanaoan joint ventures in wireless communications, ice plant operation, and furniture manufacturing immediate increases in trade between Mindanao and Indonesia, Malaysia, and Brunei. Other consequences include:

- New bank legislation. Partly because of the success of foreign exchange and capital movement liberalization, the GOP legislated an opening to new foreign banks wherein 22 applied and 10 were authorized to begin doing business in the Philippines in 1995. The Bank of Tokyo, a full service bank, the first of the ten, began operations in April 1995.

- Increased direct foreign investment. Net direct foreign investment had been only $10 million a year during 1984 and 1985. It jumped to over $100 million in 1986, over $300 million in 1987, and above $900 in 1988. But it fell to the 500s each year 1989 through 1991 and plunged to $230 million in 1992 before recovering to $760 million in 1993.
- Approval of investment projects. For January-March 1994, the GOP Board of Investments approved $13 billion in projects, against $2.5 billion for January-March 1993, and well ahead of the full-year target of $10.4 billion. These projects included $1.64 billion in foreign capital, up from $0.28 billion in the first 3 months of 1993.
- Increased foreign investment in EPZs. Foreign investment in government-built export processing zones and in private industrial estates between January and October 1994 was $320 million, up 280 percent from $88 million in 1993's first 9 months.
- Increased equity. From January to September, 1994, $4.4 billion in equity was registered with the GOP, $560 million from the United States.
- Increased funding of infrastructure projects. The GOP has identified 82 priority infrastructure projects worth some $9 billion and is inviting private bidders under the new USAID-nourished BOT law in power, telecommunications, transportation, industrial estates, roads, railways, water systems, and tourism ventures.

4. Various provisions encouraged substitution of capital for labor

Tariff exemptions, investment credits, and subsidies as well as minimum wages led existing employers to choose capital-intensive production processes minimizing employment relative to output. Nominal interest ceilings and directed credit encouraged the subsidized beneficiaries to substitute capital for labor.

<u>USAID assistance with reforms</u>: To reduce the incentives to substitute capital for labor,

U..S. conditioned assistance supported GOP decisions that

- reduced by 22.3 percent (as against a target of 18-21 percent) the free trade valued added (FTVA) weighted average effective protection rate (EPR) for importables for the manufacturing sector, with the same indicator for the other sectors at least not increasing, and
- reduced by 52.9 percent (as against a target of at least 50 percent) the difference between the FTVA weighted EPR between importables of the manufacturing and of the agricultural sector.

5. Financial sector policies depressed savings and misdirected capital

Laws and regulations protected the monopoly powers of private banks allowing high overheads and big spreads between savings and lending interest rates. The low real interest rates discouraged the savings that would have increased investment and the demand for labor. Politics largely determined which businesses received credit; this misdirected investment provided less added demand for labor than would have come from market allocation of investment resources. But a principal reason for low national saving has been the government's negative savings practices.

<u>USAID assistance with reforms</u>: To change financial incentives to encourage increased national savings with corresponding increases in investment going to the most efficiently job-producing uses, USAID:

- provided technical assistance in analyzing the cost/performance character of Philippine banks which helped persuade the legislature to provide for the entry, in 1995, of 10 foreign banks. Their entry should lower the average costs of banking services and so raise the market level of savings rates, thereby increasing national savings and investment.

- provided technical assistance and training to the Bureau of the Treasury to equip its staff to manage the national debt. Good management on the part of the Treasury can provide an essential part of the foundation for a more efficient allocation of investment funds.
- financed a training program to prepare the Treasury to facilitate the development of the market in government securities.
- provided technical assistance from 1985-1990 through the Rural Financial Services Project. This led to Central Bank policy reforms, including the:
  - adoption of market interest rate policies by phasing out credit and interest subsidies for agricultural loan programs,
  - liberalization of bank branching in rural areas,
  - consolidation of 20 out of 40 separate loan funds
  - implementation of the rural bank rehabilitation program, and
  - provision of resources to the Philippine Deposit Insurance Corporation for carrying out effective bank examination and receivership/liquidation.

6. GOP regulations restricted growth of demand for rural labor

The GOP repressed the growth of demand for agricultural labor and for improvements in agricultural productivity by taxing farmers more heavily than other producers and by regulations that inhibited investment and innovation in agriculture. Regulations kept the corn price, 1990-93, 35 percent above the world price, thereby raising poultry and other livestock prices. Only the National Food Authority (the GOP food administration) has been allowed to import basic grains.

<u>USAID assistance with reforms</u>: To help get farm prices up to, and farm input prices down to international levels and to facilitate technological change and agricultural diversification, USAID used conditioned assistance to support GOP decisions to:

- end the high-cost monopolies of cargo handling in 2 of the larger ports (with over 300,000 MT/YR thruput) outside Manila,
- obtain removal of price ceilings on chicken, rice, and pork retail prices,
- undertake analyses of the effects of taxes/regulations on private agribusinesses including banana hectarage limitations and feeder cattle quotas, with subsequent disbursement dependent on GOP action on recommendations,
- reduce tariffs to 10 percent on defatted soybean meal for cattlefeed and to 3 percent on veterinary medicine, feeder and breeder cattle, and animal biologics,
- raise the 1992 GOP budget for agribusiness support services to 69 million pesos above the 1991 level, with that real level maintained through the 1993 and 1994 budgets.

USAID technical assistance and conditioned assistance have also:

- removed price controls from inter-island shipping, leading shippers to compete for agricultural products instead of avoiding them,
- helped produce the Seed Industry Development Act of 1992, and — just as important — implementation procedures freeing imports that may permit 90 percent of Filipino farm families to increase production by 50 percent when allowed access to good seeds,
- helped design legislation and marshall support for that legislation to reduce tariffs on food packaging materials from 40-50 percent to 20 percent, which would lower processed food prices, increase exports, and increase

demand for labor by farms and in agribusinesses,

- led to the beginning of containerized exports of mangoes to Hong Kong resulting from improved production and post-harvest practices with the expectation of substantial increases in exports to the U.S., Malaysia, and Taiwan,
- helped induce the revival of the Cattle Raisers' association, making it ready to implement training and policy-reform initiatives when the Supreme Court lifted the Land Reform threat that had removed the collateral value of land. The prospect is for a reversal of the past decade's 1.1 percent annual decline in the nation's cattle inventory,
- helped farm families to organize support to remove the Bureau of Plant Industry's barriers to the imports of seed potatoes required for output expansion.

Further consequences of USAID assistance:

- deregulation of rice prices, May 31, 1985,
- divestment of non-foodgrain activities from the National Food Authority (NFA), May 31,
- liberalization of the wheat and fertilizer sectors, 1985,
- divestment of the government divested from selected corporations under the Department of Agriculture, particularly the Philippine Cotton Corporation, the Philippine Dairy Corporation, and the NFA subsidiaries in Kadiwa, Tabangao, Digos and the Northern Philippines Grains Complex.

7. The tax system failed to fund infrastructure and human capital

The tax system was inequitable and inefficient in collecting funds due, thus failing to fund infrastructure and human capital investment at East Asian levels. A Philippine Institute for Development Studies (PIDS) study estimated that, in 1993, the BIR collected only about 40 percent of what should have been paid in personal and in corporate income taxes. Of an estimated 11.5 million potential taxpayers in 1990, only 6.4 million were registered with the BIR, and only 2.6 million paid tax.

USAID assistance with reforms: To help the GOP to collect a somewhat larger portion of GNP in taxes and to do so more equitably, USAID used conditioned assistance to encourage and support the GOP decision to establish a One-Stop Duty Drawback Center in 1992. VAT refund processing was transferred from the Bureau of Internal Revenue to this Center, which was made a permanent unit under the Department of Finance. This resulted in a reduction of processing time of duty drawback applications from an average of one to two years in 1991 to within 30 days in 1993 and a reduction of processing time of VAT refund applications from about one year in 1992 to within 60 days in 1994. This reform, of course, also facilitated exporting.

USAID also used technical assistance to:

- help the senior managers of the Bureau of Internal Revenue (BIR) reorganize staff and establish new procedures intended to reduce the inequities and the crimes of tax evasion,
- train more than 200 BIR staff, during 1993-94, to improve their ability to implement the new BIR procedures, and
- assist the Department of Finance staff to draft three 1995 tax bills that would, if passed, broaden the base of the corporate income tax. reduce corporate tax reductions, and simplify the personal income tax, all with the objective of higher yet equitable collections.

Further consequences of USAID assistance: In 1994, the BIR collected more than 12 percent more revenue than could be explained by increases in nominal income (from growth and inflation). The new BIR procedures and the newly trained BIR staff may have been responsible for most of this 12 percent-plus increase. Between 1989 and 1991, VAT-paying registrants increased by a cumulative total of 67,317 and VAT collections increased by 31 percent in 1989 over 1988.

8. Budgets underfunded infrastructure and human capital investment

The GOP has been unable to raise the level of investment in infrastructure and human capital to the levels of neighboring nations. Obviously, the attractiveness of investing and hiring in the Philippines depends in large part upon the extent and condition of public infrastructure and the health and education of the labor force. Additionally the dispersion or concentration of private investment depends on the concentration or dispersion of national infrastructure and educational and health facilities (which is also a question of the quality of dispersed public capital). In turn public investment and maintenance depend on the ability of the GOP to collect taxes.

USAID assistance with reforms: USAID technical assistance:

- led the Bureau of the Treasury to understand it could keep lower cash balances and thus reduce weekly borrowing (and its attendant costs) by 4.5 billion pesos,
- was instrumental in the drafting and subsequent adoption of the privatizing BOT law of 1990 promoting infrastructure investment. USAID funded pre-feasibility studies in power, transportation, ports, and telecommunications, and USAID TA developed the private-sector power supply model the National Power Corp. used in its BOT program,
- financed the Energy Sector Action Plan that increased private power generation and ended the frequent brownouts that injured business and households. USAID also financed the implementation guidance that resolved regulatory issues of interconnection and equal access and brought in new competitive telecommunications firms,
- financed educational seminars to teach policy makers about the possibilities of utilizing BOT legislation.

Further consequences of USAID assistance:

- Government capital expenditures rose from 4.7 percent of GNP in 1989-90 to 7.3 percent during 1991-93 to 9.3 percent in 1994,
- Government social service expenditures were 4.4 percent of GNP in 1989-90 and 4.3 percent in 1991-92 but rose to 5.4 percent during 1993-94.

VI. Hope for the future

Filipino post-independence experience is a history of failed economic reforms beginning with the Land Reform Act of 1955 and extending through the various trade liberalization initiatives introduced, with positive results, during 1978-1982 before crashing under the comprehensive foreign exchange and capital-market restrictions deemed necessary following the foreign-debt default of 1983. But since 1986 or, more precisely, since the inauguration of President Aquino's government, policy and institutional reforms have been cumulating. President Ramos' administration has added reforms while permitting little back-tracking.

Today, in mid-1995, the critical mass of policy, performance, and institutional changes may have become sufficient to nurture the growth in numbers of Filipino private employers sufficiently large to compel increases in real wages and, thereby, the kind of poverty reduction previously achieved elsewhere in East Asia and, earlier, in Europe, North America, and the Antipodies.

Caution even now is advisable. Policy reform success has involved a lot of successful skirmishes that have failed to add up to much. The World Bank's first Structural Adjustment Loan to the Philippines covered 18 months in 1980-81 and was by Bank standards, a success and was followed by SAL-II in 1992-93, also a success. Other bank reform successes and a series of IMF successful stand-by programs all passed without changing enough of the economy to get wages to begin to rise. USAID has reported policy reform successes over the past decade. All these successes were facts, but all together they were never, in the past, enough. Now — maybe.

VII. USAID's prominent role in responding to GOP reform initiative

From 1993 to 1994, the Mission provided technical assistance or other financial assistance to policy and institutional initiatives undertaken by:

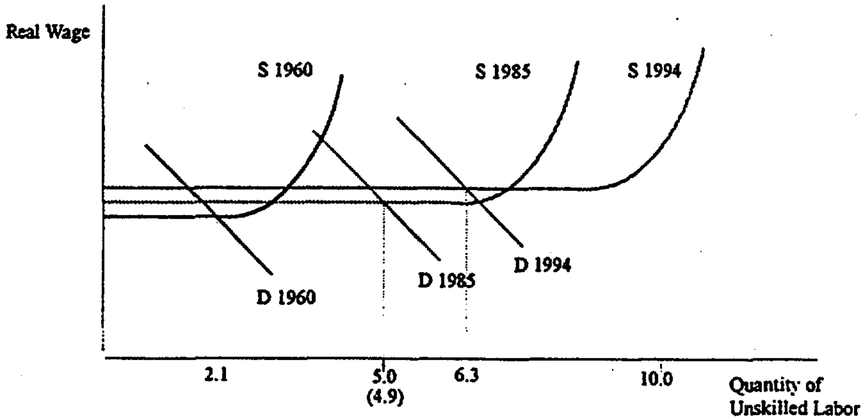
- The Central Bank
- The Bureau of Internal Revenue
- The Finance Ministry Office of Debt Management
- The Finance Ministry; Department of Finance, Bureau of the Treasury
- The Department of Interior and Local Government
- The Department of Environment and Natural Resources
- The Committee on Privatization
- The Department of Agriculture
- The National Economic Development Administration
- The Department of Trade and Industry
- The Philippine Institute for Development Studies

Using conditioned assistance, the Mission had the usual incentives to apply conditionality to areas where:

- individuals spearheading the reform process might have failed without USAID's conditioned assistance,
- policy reforms were likely to take place anyway. Getting involved in these areas provided the Mission with the opportunity to both share credit for these reforms and make genuine contributions to the quality of these reforms, and
- reforms were likely to remain unsupported within the government and undone without USAID support.

That was the case before the fall of international socialism and the outstanding successes of not only the original 4 tigers but of their rising rivals: Malaysia, Thailand, and Indonesia. USAID has recently played a new role as a genuine partner working with many government institutions cooperating in shared efforts to get both policies and institutions "right." Partnership instead of coercion and attention to the whole mass of remaining barriers to the growth of demand for wage labor that will eventually lift the burdens of poverty from the mass of the population.

Model Assumed for the Philippine Unskilled WAGE Labor Market



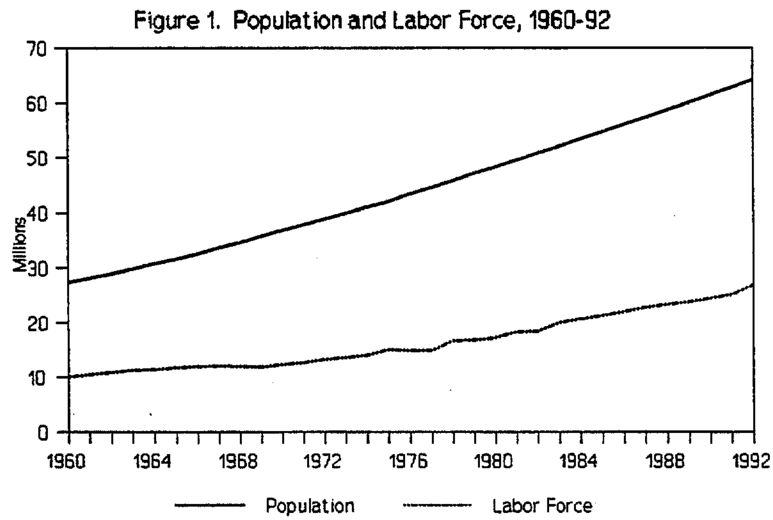
	Labor Force	Employment	Wage Employment	Unskilled Labor Force	Unskilled Wage Employment
1960	10.08	9.44	5.40	4.03	2.16
1985	21.33	19.80	12.20	8.53	4.88
1994	29.07	24.65	15.81	10.84	6.32

Wage Employment estimated as total minus 2/3 of agricultural employment minus 1/3 of services employment.

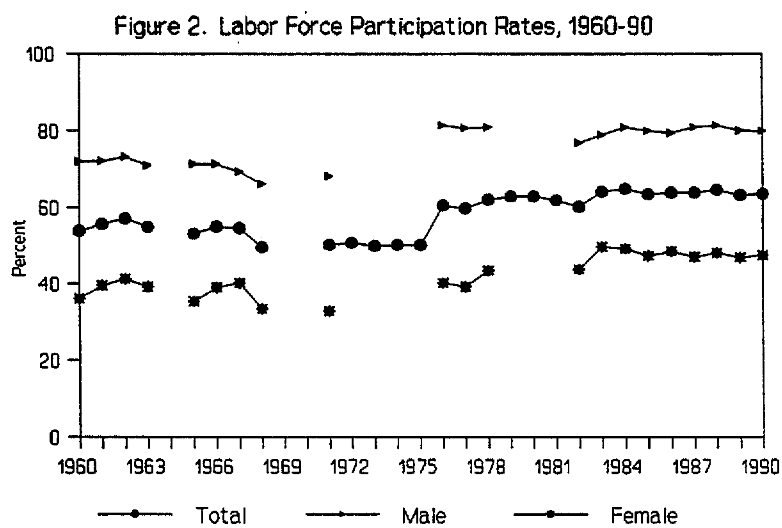
Assume:

- the supply curve moves up in subsistance agriculture as technological improvements (including IRT and birth control) spread to almost all people and

- demand will have to move out faster than supply before demand becomes the cause of rising wages for the unskilled poor.

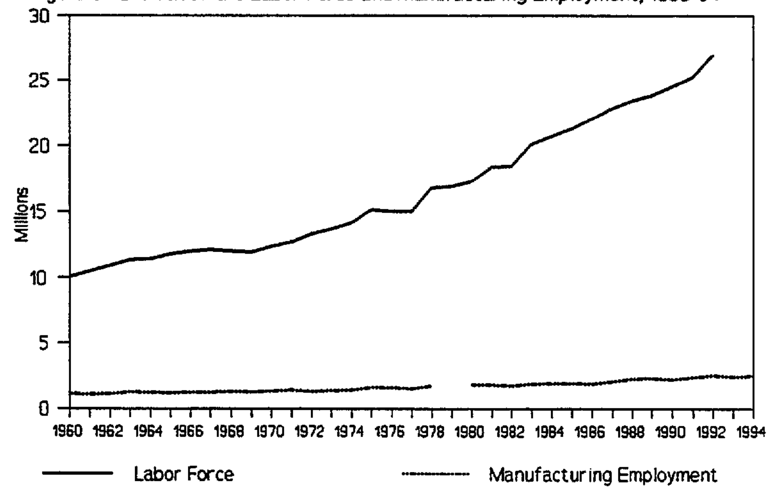


Sources: 1960-74 from World Bank, *The Philippines: Priorities and Prospects for Development*; 1975-81 from *Philippine Statistical Yearbook 1987*; 1981-92 from *Philippine Statistical Yearbook 1993*.



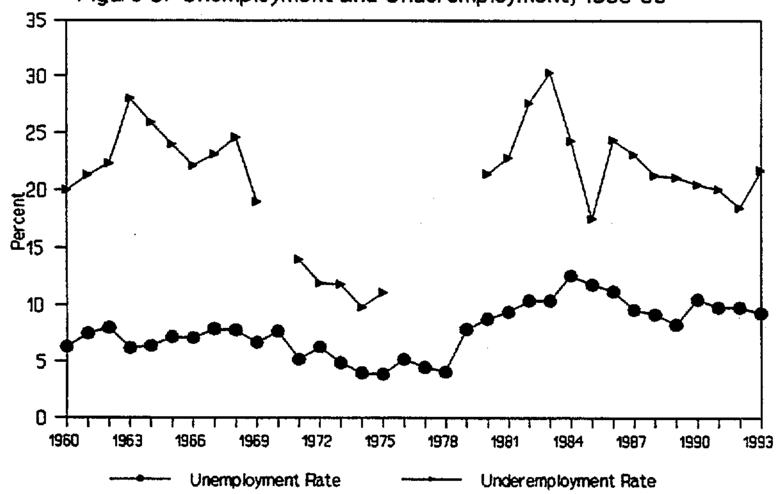
Sources: 1960-71 from International Labor Organization, *Sharing in Development*; 1976-80 from NEDA, *Social Development in the Philippines* (1982); 1981 from NEDA, *Economic and Social Indicators 1982*; 1982-90 from National Statistics Office, *Philippine Yearbook 1992*.

Figure 5. Growth of the Labor Force and Manufacturing Employment, 1960-94



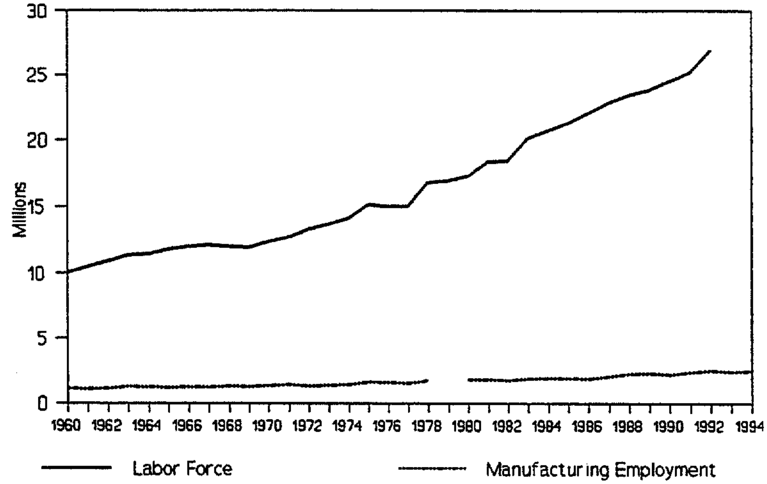
Sources: 1960-74 from World Bank, *The Philippines: Priorities and Prospects for Development*; 1975-81 from *Philippine Statistical Yearbook 1987*; 1981-94 from *Philippine Statistical Yearbook 1993* and NSO sources.

Figure 6. Unemployment and Underemployment, 1960-93



Sources: 1960-75 and 1987-92 from *Yearbook of Labor Statistics* 1992; 1976-78 from *Philippine Yearbook 1992*; 1980-86 from World Bank, *The Philippines: The Challenge of Poverty*.

Figure 5. Growth of the Labor Force and Manufacturing Employment, 1960-94



Sources: 1960-74 from World Bank, ***The Philippines: Priorities and Prospects for Development***; 1975-81 from ***Philippine Statistical Yearbook 1987***; 1981-94 from ***Philippine Statistical Yearbook 1993*** and NSO sources.

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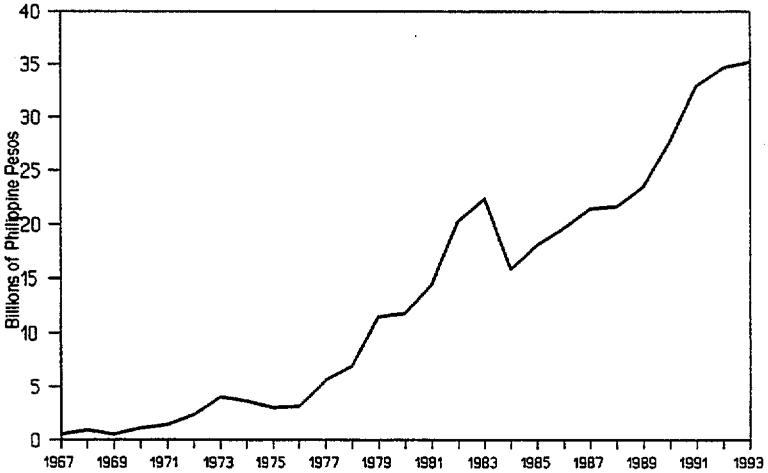
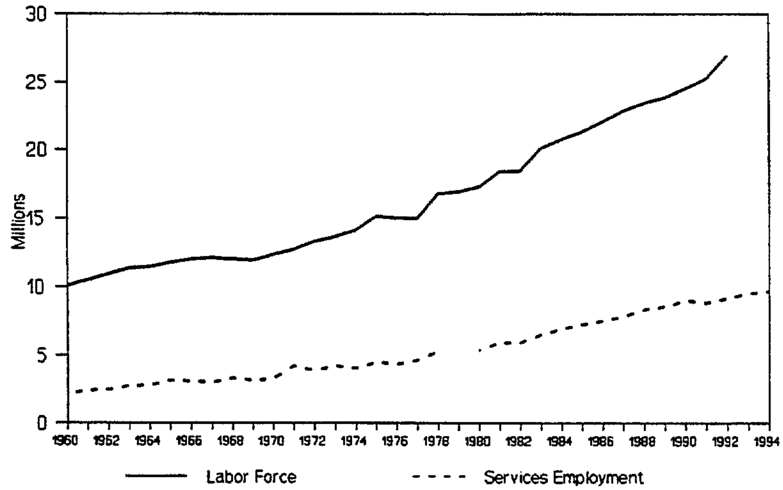
Sources: 1960-75 and 1987-92 from ***Yearbook of Labor Statistics*** 1992; 1976-78 from ***Philippine Yearbook 1992***; 1980-86 from World Bank, ***The Philippines: The Challenge of Poverty***.

Figure 7. Remittances, 1967-93
(In real terms, 1985 base)



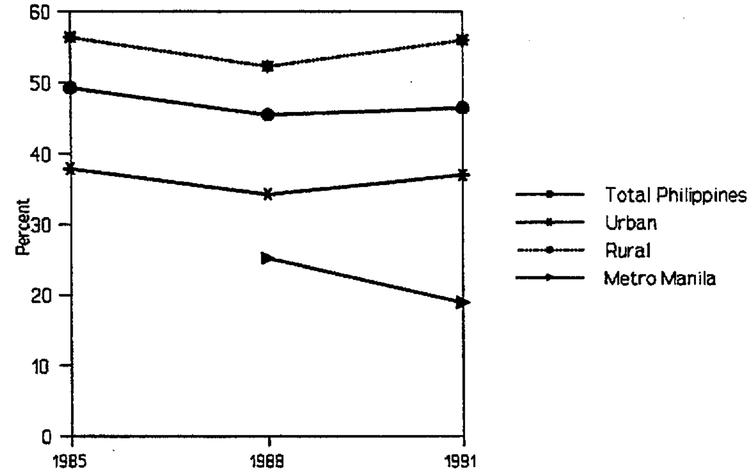
Sources: National Income Accounts, National Statistical Coordination Board.

Figure 8. Growth of the Labor Force and Services Employment, 1960-94



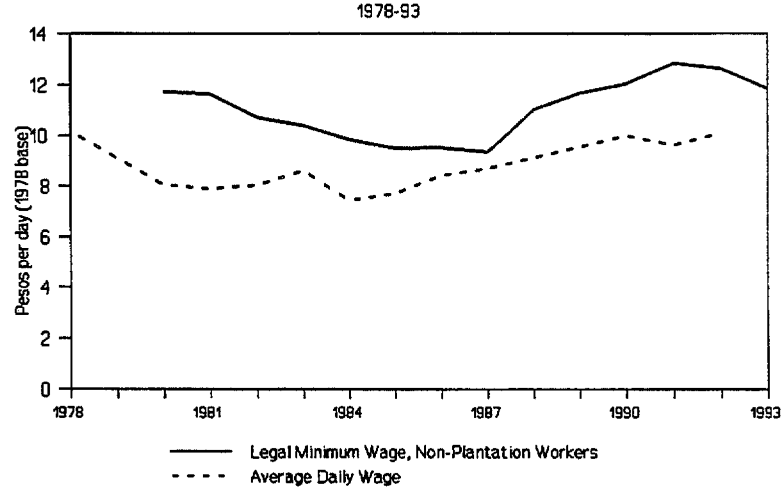
Sources: 1960-74 from World Bank, *The Philippines: Priorities and Prospects for Development*; 1975-81 from *Philippine Statistical Yearbook 1987*; 1981-94 from *Philippine Statistical Yearbook 1993* and NSO sources.

Figure 9. Poverty Incidence, 1985-91
(Percentage of Population)



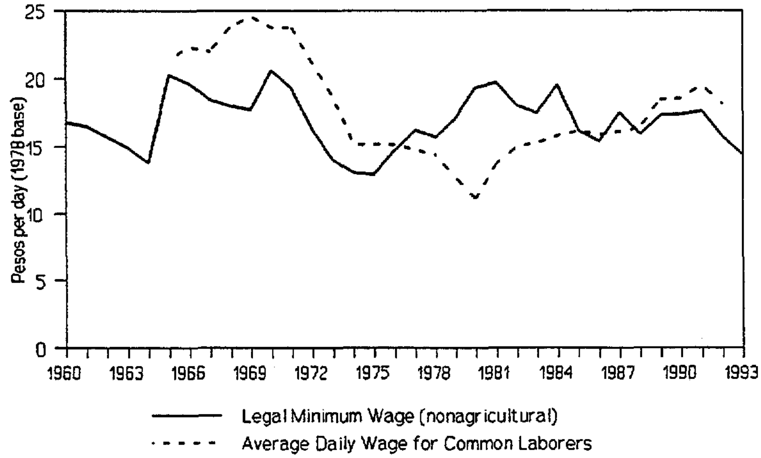
Sources: NSCB, ***Philippine Statistical Yearbook 1993***; Mangahas and Bautista, ***Review and Assessment of Rural Development Programs and Projects in the Philippines: Poverty Alleviation.***

Figure 10. Real Legal Minimum & Average Daily Wage Rates in Agriculture
1978-93



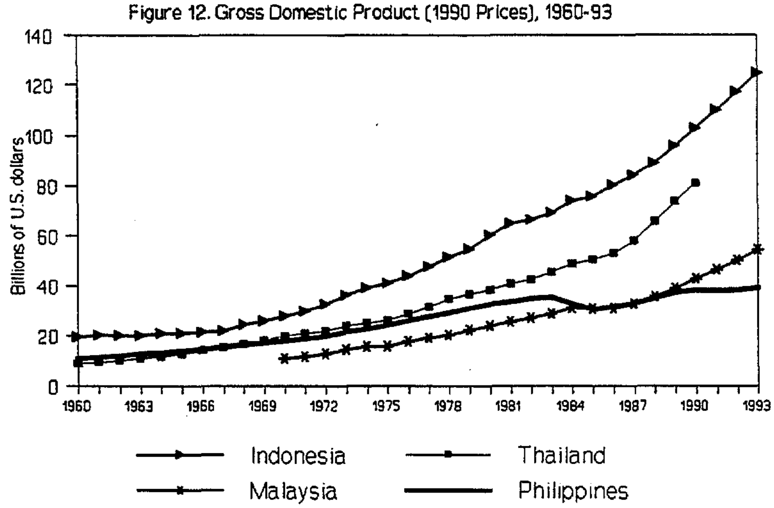
Source: Bureau of Agricultural Statistics.

Figure 11. Real Legal Minimum & Average Daily Wage Rates in Urban Areas
1960-93



Sources: 1964-80 from CBP; 1981-84 from World Bank, *The Philippines: An Opening for Sustained Growth,* 1993; 1985-87 from National Wages Council Survey; 1989-93 from Bureau of Labor and Employment Surveys.

Figure 12. Gross Domestic Product (1990 Prices), 1960-93



Note: Remittances are not included in the calculation of Gross Domestic Product.
Source: International Monetary Fund, *International Financial Statistics.*

TRADE, TRADE POLICY AND POVERTY ALLEVIATION

by

Chris Clague

IRIS and the University of Maryland

One of the things that distinguishes economists from other people is their enthusiasm for free trade. However, in recent years there has emerged a new branch of trade theory, incorporating economies of scale and noncompetitive and strategic behavior in which free trade is less than optimal from the point of view of a single country. This has strengthened the hand of believers in industrial policy. The globalization of the economy has many people worried about their jobs, and there is concern about the impact of expanded trade on the earnings of unskilled workers in the United States and other developed countries.

Our concern is with less developed countries. What are the recent developments in economic thinking about trade and trade policy, and in particular, what are the implications for how USAID economists might be conducting their business of helping these countries? One of the jobs of USAID economists is to persuade various people, from policy makers to the general public, of the virtues of economic policy reform.

As we all know there are the standard qualifications for free trade relating to terms of trade, national defense, infant industries, and so forth. There are market failures and hence there is the *potential* for a benevolent, competent government to improve resource allocation through manipulation of policy with respect to trade, direct foreign investment, and technology. There is persuasive evidence that the governments of "hard" states in East Asia have enhanced growth through some of their interventions, but the applicability of these policies to "soft" states is highly questionable. (Gunnar Myrdal in the late 1960s introduced the notion of "hard" states as states with strong bureaucracies that could enforce their directives, as opposed to "soft" states that lacked administrative capacity.)

Interesting questions relate to (a) how strongly economists should advocate for open trade policies, and (b) how trade policy reform comes about, or under what circumstances an advocate might be most effective. Both of these involve how much difference open trade policies make, both for growth and for poverty or inequality. The following issues can be considered in addressing these questions:

1. Effects of trade and trade policy on growth in LDCs
2. Effects of trade and trade policy on inequality and poverty
3. New ideas in trade and consequences for the case for free trade
4. Economic and political interactions in trade policy

Each of these topics is briefly described in the following paragraphs and additional details can be found in the readings listed at the end.

I. Effects of trade and trade policy on growth in LDCs

In the Slow growth model, in which the long term rate of growth depends only on technological progress reforms of trade policy were not permitted theoretically to have a permanent effect on the rate of growth. The new growth theory allows the rate of technological progress itself to depend on the openness of the economy. Moreover, if a country lies FAR inside its production possibility frontier, because for example of perverse policies imposed by narrow special interest groups, AND if open trade policies destroy or weaken the special interest coalitions, a country's growth rate can be raised for at least a considerable period of time by changes in trade and other policies.

In the 1970s and 1980s, economists found that in cross-country regressions of growth rates, measures of exports entered with positive coefficients (see the review by Edwards, 1993). Such regressions are open to various causal interpretations, however. (And they don't hold for all samples and periods in history). In the last ten years, there has been an explosion of cross-country and panel regressions of growth rates (stimulated by the availability of data as well as the interest generated by the new growth theory), and in some of these regressions measures of "outward orientation" have entered with positive coefficients. (An example is the paper by Dollar, 1992). Trade policy, however, continues to be very difficult to measure, and different measures are weakly correlated with one another. The trade policy measures that turn out to work in the regressions (in the sense of helping to explain growth rates) are also likely to correlate with other measures of economic policy, so that the results for any particular measure are sensitive to the other variables included in the regression. (This point is made forcefully in a study by Levine and Renelt, AER, 1992). The bottom line is that the cross-country regressions are certainly suggestive of a positive influence of outward orientation on growth, but they are not conclusive. (For somewhat contrasting views of the evidence by two essentially pro-free-trade economists, see the articles by Dornbusch and Rodrik in the *Journal of Economic* Perspectives, 1992).

II. Effects of trade and trade policy on inequality and poverty

Heckscher-Ohlin theory describes a close relationship between trade policy and factor prices. During the 1970s and 1980s, there has been a shift of attention among trade economists from the capital-labor version of the Heckscher-Ohlin theory toward broader conceptions of the relevant factors. With regard to North-South trade in manufactures, the most useful conception of factors relates to various levels of skill. Capital is often now regarded as a factor that is available in most countries for the same price (rates of return are not too different in rich and poor countries, and physical capital can be transported (equipment) or locally constructed).

Many studies have found that the trade in manufactures between the rich North and the poor South embodies an exchange of unskilled and skilled labor. Typically these studies either did not quantify the effects of this exchange on factor prices or concluded (in the case of studies of rich countries) that the effects were negligible. A recent study by Adrian Wood (1994) argues that prior estimates have systematically understated the magnitudes of the North South exchange of labor services through commodity trade and consequently that the effects of this trade on the relative wages of skilled and unskilled labor in both the North and the South have been underestimated. Burtless (1995) describes the Wood book and several other studies.

In the Heckscher Ohlin theory comparative advantage is determined by the factor endowments of countries and the factor requirements of commodities. Technology is assumed to be the same everywhere. Some recent thinking about comparative advantage has emphasized technological differences among countries as these differentially affect various commodities. The increasing interest in the institutions of property rights, contract enforcement mechanisms, and the bureaucracies supplying public goods has led to "institutional" theories of comparative advantage. Thus countries have strengths and weaknesses based on their culture and institutions, rather than their factor endowments. (This idea is discussed in Clague IRIS reprint #1.) To the extent that trade depends on non Heckscher Ohlin influences, the connection between trade policy and factor prices is less close.

III. New ideas in trade and consequences for the case for free trade

The 1970s witnessed a considerable increase in attention to nontraded goods in trade models and to the concept of the real exchange rate. Measures of trade policy include the variability of the real exchange rate, as well as the anti-export bias of trade policy. (These concepts are reviewed in Rodrik's essay, "The Rush to Free Trade...").

The availability of the Kravis Heston Summers data on purchasing power parities has kindled interest in the ratio of the PPP to the exchange rate (a concept closely related to the real exchange rate). This variable is one of the ones used by Dollar (1992) as a measure of outward orientation. Variants of this variable may be of use to USAID economists in their work. Many phenomena in international comparisons have been illuminated by the Kravis Heston Summers data, including the role of equipment investment in economic growth. DeLong and Summers (QJE 5/1991) have argued that equipment investment is a very important determinant of growth, and their empirical evidence rests squarely on the use of PPP data to correct equipment prices.

Imperfect competition models of international trade. Until the 1980s trade theory dealt almost exclusively with the case of perfect competition. During the 1980s economists began to incorporate models of monopolistic competition and oligopoly, internal economies of scale, and strategic behavior. The models of monopolistic competition, with scale economies and product differentiation responding to consumer preferences, reinforce the case for free trade, as the expanded market leads to larger plants and lower price cost margins. Some of the models of oligopoly with R&D have provided new theoretical arguments for government intervention. Baldwin (1992) reviews this literature, and this article together with the ones by Krugman and McCulloch in the AER May 1993, explain why economists' predilection in favor of free trade remains unshaken by these theoretical developments.

Neoclassical economists in the 1970s and 1980s attributed the success of the East Asian gang of four to their following of standard World Bank advice. A revisionist literature emerged in the 1980s, pointing out that in fact Korea, Taiwan, and Singapore have not followed World Bank prescriptions closely, especially in trade policy. These countries have intervened extensively in limiting imports, assigning particular products to particular firms, and directing credit in a highly discretionary way. The revisionists tend to argue that these interventions have enhanced growth by correcting market failures, which most economists would agree are pervasive in the industrialization of latecomers. (See the World Bank report on the East Asian Miracle (1993), and the critical review of it by Fishlow et al. (1994).) (For an interesting comparison of the effectiveness of export subsidization policies, see Rodrik, "Taking Trade Policy Seriously ", 1993.)

IV. Economic and political interactions in trade policy

USAID economists are undoubtedly familiar with the resistance of politicians (and non-economists generally) to the economists' recommendations for outward oriented trade policies. One of the reasons for this resistance is that trade policy has very strong redistributional effects. In LDCs trade reform has very seldom occurred during "normal times". Most trade policy reforms have occurred during economic crises or under the direction of a new government (or both) and most have been carried out rapidly. During normal times there is strong resistance to trade policy reforms, because vested interests have grown up around existing policies, including noncompetitive import competing industries, favored importers, and bureaucrats dispensing favors.

If the trade policy reform, and the other economic reform policies in the package, are successful, experience has shown that interests can grow up around exporting activities, and the outward oriented policies can be sustained. There also seems to have been some learning from the experience of other outward oriented countries. These issues are discussed in Rodrik, "Why the Rush to Free Trade..." (1994). On economic policy reform generally, see the works by Anne Krueger, Robert Bates, John Williamson cited in the session, "Does Economic Policy Reform Work?"

WHICH LABOR MARKET POLICIES WOULD BEST IMPROVE LABOR MARKET CONDITIONS FOR WORKERS?

by

Gary S. Fields

Professor of Industrial and Labor Relations and Economics Cornell University

Everyone working in the development field knows that the greatest economic growth successes are found in East Asia. Less well-known is the labor market side of the story. Put simply, the question is: How did the workers of East Asia fare in development terms compared with workers in other countries? The answer, as I shall show, is: "very well indeed."

This raises a related question: What labor market policies and institutions led to these favorable outcomes in East Asia, and how do they differ if at all from those followed in other countries. I shall show that while much of the developing world has tried to improve labor market conditions by directly pushing labor market conditions up, the approach followed in East Asia was a much more indirect one, relying on economic growth to pull conditions up.

A model is then presented showing how economic growth can lead to widespread labor market gains in all economic sectors. The talk concludes with some remarks on the questions of international labor standards.

I. Different labor market institutions

Labor market institutions are quite different in East Asia than in other developing regions:

Minimum wages aim to assure workers an "adequate" standard of living. Minimum wages exist throughout most of the developing world, but they are of little importance in East Asia. Korea introduced a minimum wage system only in 1988, and the minimum wage levels have been set so that it proves to be a binding constraint for only a small fraction of Korean workers. Taiwan has had a minimum wage for decades but no company has ever been fined for violating Taiwan's minimum wage law.

Trade unions are often encouraged by government policy as a means of entitling workers to a "just" share of the fruits of their labor. In Latin America and the Caribbean, studies show that unionized workers can be paid up to twice what comparable non-union workers receive. By contrast, in Korea, unions are repressed and the union wage differential is only about 3 percent.

Public sector pay policies often result in higher wages being paid to government workers relative to their private sector counterparts. Costa Rica is an example of this. As a result, "everybody" tries to work for the government in Costa Rica. In East Asia, the public sector pays what it has to to compete with the private sector — neither more nor less.

Multinational corporations often pay above market wages in sub-Saharan Africa and elsewhere. Although this is partly for efficiency wage reasons, it is also because some governments have "encouraged" them to do so by not so subtly threatening expulsion or expropriation if they do not. No such pay differential is reported in East Asia.

Finally, *labor codes* may regulate hiring and firing, impose payroll taxes on firms, and mandate that employers provide certain benefits to their workers. Panama had such a labor code and it was estimated to have raised labor costs by 90 percent. (It was finally abandoned as unsustainable.) Indian companies may not dismiss workers, and employment levels are said to be artificially high and economic efficiency artificially low, as a result. East Asian employers also face labor codes (for instance, severance payments must be made to laid-off workers) but the costs are very much lower.

These labor market interventions are well-meaning and do indeed benefit the workers who are fortunate enough to work in covered sectors of the economy. However, they appear to have had adverse employment and efficiency effects and to have contributed to the informalization of the economy, as employers evade the regulations by not engaging workers as regular employees or by not even appearing as official companies.

It is an empirical question as to which worked better: the direct approach to improving labor market conditions or the indirect approach. Let us turn now to two countries' experiences.

II. The case of Taiwan

Taiwan's economy is one of the fastest growing in the world. Real GDP grew by 9.7 percent in the 1970s, by 8.5 percent in the 1980s, and by 6.6 percent thus far in the 1990s. The nature of this growth has been aptly characterized as "export-push."

When exports constitute a major part of a country's growth experience, what happens to labor markets? There are some who maintain that the only way to succeed in today's global economy is to keep labor costs down. By this line of argument, once workers start enjoying improved labor market conditions, the increase in labor costs will stifle the very economic growth that has just gotten started, so labor costs must not be allowed to rise if growth is to proceed.

Three pieces of data should convince you otherwise. The first is the fact that by 1979, real earnings in Taiwan were four times higher than they had been in 1960. Labor earnings certainly were not curtailed in the first decades of export-push.

The second is a comparison between per-capita growth rates and the growth of real earnings. Between 1980 and 1990, Taiwan's GNP per capita grew by 88 percent in real terms. Labor earnings in Taiwan did not lag behind — average real earnings grew at an even higher rate (103 percent) than GNP did during that same period of time — indicating that Taiwan's workers benefited more than proportionately from their economy's economic growth.

Third, consider the basic labor market and income distribution statistics for the period 1980-1993 shown in Table 1. (A similar table reveals almost identical changes for the 1965-1979 period). Since 1980:

- Taiwan has maintained essentially full employment.
- The type of jobs that people are working in have improved: a smaller fraction of workers are in agriculture (a relatively low paying sector of the economy), a larger fraction are working as paid employees (as opposed to selfemployed or unpaid family workers), a larger fraction are working in the best occupations (professional, managerial, technical, and clerical personnel), and a smaller fraction are working with low levels of education (primary schooling or less).
- Real labor earnings doubled between 1980 and 1990 and rose by another 17 percent between 1990 and 1993, the latest year for which figures are available.
- By 1992, the poverty headcount ratio had fallen to one third of its 1980 level.
- Income inequality, as measured by the Gini coefficient, is as low in Taiwan as it is in any country in the world. (Inequality is, however, rising, apparently because of changes taking place outside place labor market.)

These data leave no doubt that the workers of Taiwan benefited and benefited handsomely from the economic growth that took place in their economy.

III. The case of Brazil

The Brazilian economy, like most others in Latin America, suffered mightily at the beginning of the 1980s. The economy recovered only partially in the following years, leading the 1980s to be regarded as a "lost decade" for Brazil.

- Table 2 presents data documenting what happened to Brazilian labor market conditions and income distribution. We find:
- The economic crisis was not manifested in widespread open unemployment; the unemployment rate never surpassed 5 percent.
- The main problem was falling labor earnings. Between 1981 and 1988, real labor earnings fell nearly in half, and by the end of the decade, they had only recovered to about two-thirds of their previous level.
- There were only modest improvements in the mix of jobs.
- Some statistics show that the poverty headcount ratio was higher at the end of the decade than it was at the beginning, while others show only a small reduction.
- Income inequality, already among the highest in the World, got even greater.

Sadly, Brazilian workers suffered when their economy did. There are souls who say that because the Brazilian economy is so inegalitarian, there is no point in pursuing economic growth because workers in general, and the poor in particular, will be left behind anyhow. The data show otherwise: Within the 1980s, economic growth improved labor market conditions and reduced poverty while economic recession did the opposite.

If something can be done in Brazil to reduce inequality, those at the bottom should be expected to gain more from the country's economic activity. But if, for political economy reasons, that proves impossible, it would still be better for the poor for the economy to grow than not to grow.

IV. Mechanisms for improving labor market conditions

How is it that, in the absence of strong wage-setting institutions such as effective minimum wages and powerful trade unions, labor market conditions get pulled up through economic growth? Figure 1 depicts an integrated multi-sector labor market model which, although oversimplified, proves to be an extremely useful analytical device.

Consider an economy in which the standard neoclassical labor market assumptions are fulfilled and the equilibrating forces posited by such models are free to operate. What are the predicted labor market effects of economic growth? The single most important one is that if the derived demand for labor or increases in one sector of the economy, it will result in an increase in wages not only in that sector but in all sectors of the economy.

The processes by which this comes out are the following. For ease of graphical analysis, it is assumed that the labor market consists of two sectors: ''manufacturing" and "agriculture." The initial demand for labor curve in the manufacturing sector is D_M; it is downward sloping relative to origin O_M. Similarly, the initial demand for labor curve in agriculture, D_A, is downward sloping relative to origin O_A. The labor market clears when the same wage is paid in the two sectors and the combined demand for labor by employers in the two sectors exactly equals the available labor supply which, for ease of graphical analysis, is assumed fixed and equal in amount to O_M O_A.

At the market-clearing wage, denoted by $W_M = W_A$ in the figure, O_ME workers will be employed in manufacturing and the remaining O_AT; workers will be employed in agriculture.

Suppose now that economic growth takes place in the manufacturing sector, so that more labor is demanded in that sector than before. The improved product market conditions are translated into a rightward shift of the demand for labor curve in manufacturing from D_M to D_M'. Following the same logic as in the preceding paragraphs, the model predicts that the labor market will equilibrate at a new, higher wage in *both* sectors of the economy ($W_M'=W_A'$) and with a reallocation of the labor force toward the growing manufacturing sector (EE' workers shift out of agriculture into manufacturing). Thus, according to the integrated labor market rondel, the wages in manufacturing and agriculture will be observed to grow at the same rate as each other regardless of the rate of employment growth or decline in the different sectors.

Empirical evidence for Taiwan strongly supports this prediction. Farm households' and non farm households' incomes have moved together. So too have the earnings of workers in different subsectors of manufacturing.

To sum up, the integrated multi-sector labor market model just presented helps us understand how it was that Taiwan's labor market transmitted the country's extraordinary economic growth to households. Essentially, there were three mechanisms:

1. The economic growth in certain manufacturing and service sectors raised the demand for labor and the real labor earnings of the workers *who already were in those sectors.*
2. The economic growth in certain manufacturing and service sectors enabled more jobs to be created at higher rates of pay for workers *who moved into those sectors from the declining sectors of the economy.*

3. In order to prevent all of the workers from leaving, employers in agriculture and other declining sectors raised the wages of the workers *who remained in the declining sector of the economy.*

The only important group that was left out were those who, for one reason or another, could not or would not move into the growing sectors.

What sets the preceding model apart from others analytically is that it takes the labor market conditions in one economic sector to be a function not only of labor supply and demand *in that sector* but rather by the growth of output and employment *in the economy as whole.* The parallel rates of growth of labor earnings across major economic sectors in Taiwan therefore comes as no surprise: they are exactly what the multi-sector labor market model would predict.

V. International labor standards

I would like to close by noting that there is some danger that the preceding comments may be misinterpreted. I am not calling for complete deregulation of labor markets as countries blindly pursue economic growth come what may. Some working conditions are abusive and need to be protected against. Anyhow, regardless of what I think, this is United States policy: both the Department of Labor (in the person of Secretary Reich) and the United States Trade Representative (in the person of Representative Kantor) are squarely behind international labor standards.

The new World Trade Organization delegated to the OECD the task of recommending whether trade penalties should be applied to countries that violate internationally agreed labor practices, including a clarification of what these internationally agreed labor practices might be. As an active participant in this process, I can report that the international trade union movement and other labor groups have aligned themselves behind a set of "core labor standards" that include:

- freedom of association and protection of the right to organize and bargain collectively,
- prohibition of forced or compulsory labor,
- equal remuneration for men and women workers and non discrimination in employment and occupation, and
- restrictions on child labor.

I have my own list of "basic human rights in the workplace":

- freedom from enslavement and indentured servitude,
- entitlement to full information about unsafe or unhealthy working conditions,
- freedom for children not to work long hours when their families' financial circumstances allow, and
- freedom of association and the right to organize and bargain collectively.

It is too early to tell what exactly will emerge from these discussions. I am confident, though, that a set of basic international labor standards will be in place before the end of the millennium.

TABLE 1

TAIWAN: LABOR MARKET CONDITIONS AND INCOME DISTRIBUTIONS, 1980-1993

	GROWTH	UNEMPLOYMENT	EMPLOYMENT COMPOSITION				EARNINGS	POVERTY	INEQUALITY
YEAR		UNEM	AG%	EMP%	PROF%	LOWED%	EARNINDX	POV	GINI
1980	2.8	1.2	19.5	64.4	21.6	51.3	100.0	47.4	0.277
1981	.4	1.4	18.8	64.3	22.1	49.6	102.2	49.5	0.281
1982	2.2	2.1	18.9	64.1	22.4	48.0	108.7	49.4	0.283
1983	7.3	2.7	18.6	63.8	22.6	46.7	114.0	44.7	0.287
1984	10.0	2.4	17.6	64.4	22.9	45.1	124.7	39.0	0.287
1985	4.3	2.9	17.5	64.1	23.4	43.5	130.3	38.0	0.290
1986	13.3	2.7	17.0	64.7	23.8	41.7	142.5	34.2	0.296
1987	11.6	2.0	15.3	66.7	24.9	39.8	155.7	29.5	0.299
1988	6.2	1.7	13.7	67.1	26.4	37.6	170.3	23.5	0.303
1989	5.9	1.6	12.9	67.4	27.6	35.8	186.5	19.9	0.303
1990	3.8	1.7	12.8	67.6	29.5	33.9	203.0	18.1	0.312
1991	6.6	1.5	13.0	67.1	30.3	32.6	217.4	14.4	0.308
1992	5.2	1.5	12.3	67.8	31.4	30.8	227.4	14.5	0.312
1993	5.9	1.5	11.5	68.7	33.9	28.8	238.2	n.a.	n.a.

VARIABLE DEFINITIONS AND SOURCES:
All data are taken from Fields (forthcoming). Original sources are:

GROWTH: Growth rate of real GDP per capita
Sources: Calculated from data in Republic of China, Statistical Yearbook of the Republic of China 1994. Table 98, p. 159 and Table 170, p. 296.

UNEM: Unemployment rate
Source: Republic of China, Statistical Yearbook of the Republic of China 1994. Table 27, p. 50.

AG%: Agricultural employment as a percentage of total employment.
Source: Republic of China, Statistical Yearbook of the Republic of China 1994. Table 30, p. 54.

EMP%: Employees as a percentage of total employment
Source: Republic of China, Statistical Yearbook of the Republic of China 1994. Table 32, p. 59.

PROF%: Professional , managerial, technical, and clerical personnel as a percentage of total employment
LEG: Legislators, government administrators, business executives, and managers
PROF: Professional
TECH: Technicians and associate professionals
CLERK: Clerks
Calculated from data in Republic of China, Statistical Yearbook of the Republic of China 1994. Table 31.

LOWED%: Percentage of employed persons with a primary education or less
ILLIT: Illiterate, as a percentage of employment
SELFED: Self-educated, as a percentage of employment
PRIMED: Primary school educated, as a percentage of employment
Source: Republic of China, Statistical Yearbook of the Republic of China 1994. Table 33, pp 60-61.

EARNINDX: Index of average real monthly earnings of employees in manufacturing, 1980=100
Source: Calculated from data in Republic of China, Statistical Yearbook of the Republic of China 1994. Table 35, p. 62.

POV: Estimated percentage of households with disposable incomes less than NT$200.000, in 1980 prices.
Sources: Republic of China, Report on the Survey of Personal Income Distribution in Taiwan Area of the Republic of China 1992. Table 7, p. 18 and Republic of China, Statistical Yearbook of the Republic of China 1994, Table 170, p. 296

GINI: Gini coefficient of household disposable income.
Source: : Republic of China, Report on the Survey of Personal Income Distribution in Taiwan Area of the Republic of China 1992, Table 4, p. 15.

TABLE 2

BRAZIL: LABOR MARKET CONDITIONS AND INCOME DISTRIBUTION, 1979-1990

GROWTH		UNEMPLOYMENT		EMPLOYMENT COMPOSITION			EARNINGS		POVERTY		INEQUALITY
YEAR	RATE	UNEM	AG%	EMP%	PROP%	LOWED%	EARNINDX	POV(2)	POV(2)	POV(3)	GINI
1979	4.2	2.8	32.5	62.3	20.7	85.0	76.3	0.343			
1980	4.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.				
1981	-6.6	4.3	29.3	64.2	19.2	82.9	100.0		0.22	0.334	0.56
1982	-1.7	3.9	29.5	63.1	19.0	62.8	87.7				0.57
1983	-5.6	4.9	27.1	65.0	19.0	81.8	60.3		0.28	0.417	0.58
1984	3.0	4.3	29.8	63.9	19.4	80.8	59.2				.58
1985	5.6	3.4	28.5	65.5	19.8	80.0	62.4			0.350	0.59
1986	5.3	2.4	25.9	66.1	20.7	79.0	80.1		0.12	0.240	0.58
1987	1.5	3.6	24.6	66.0	20.8	78.3	64.1			0.275	0.59
1988	-2.1	3.5	24.2	66.1	21.3	77.1	57.0		0.19	0.287	0.61
1989	1.2	3.0	23.2	66.0	22.4	76.9	68.3	0.403		0.298	0.63
1990	-6.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.			0.297	0.60

VARIABLE DEFINITIONS AND SOURCES:
All data are taken from Fields (forthcoming). Original sources are:

GROWTH RATE: Growth of real GDP per Capita
Source: IMF, International Financial Statistical Yearbook

UNEM: Unemployment rate
Source: Pesquita Nacional por Amostra de Domicilios various years

AG%: Agricultural employment as a percentage of total employment
Source: Pesquita Nacional por Amostra de Domicilios various years

EMP%: Employees as a percentage of total employment
Source: Pesquita Nacional por Amostra de Domicilios various years

PROP%: Professional, managerial, technical, and clerical personnel as a percentage of total employment
Source: Pesquita Nacional por Amostra de Domicilios various years

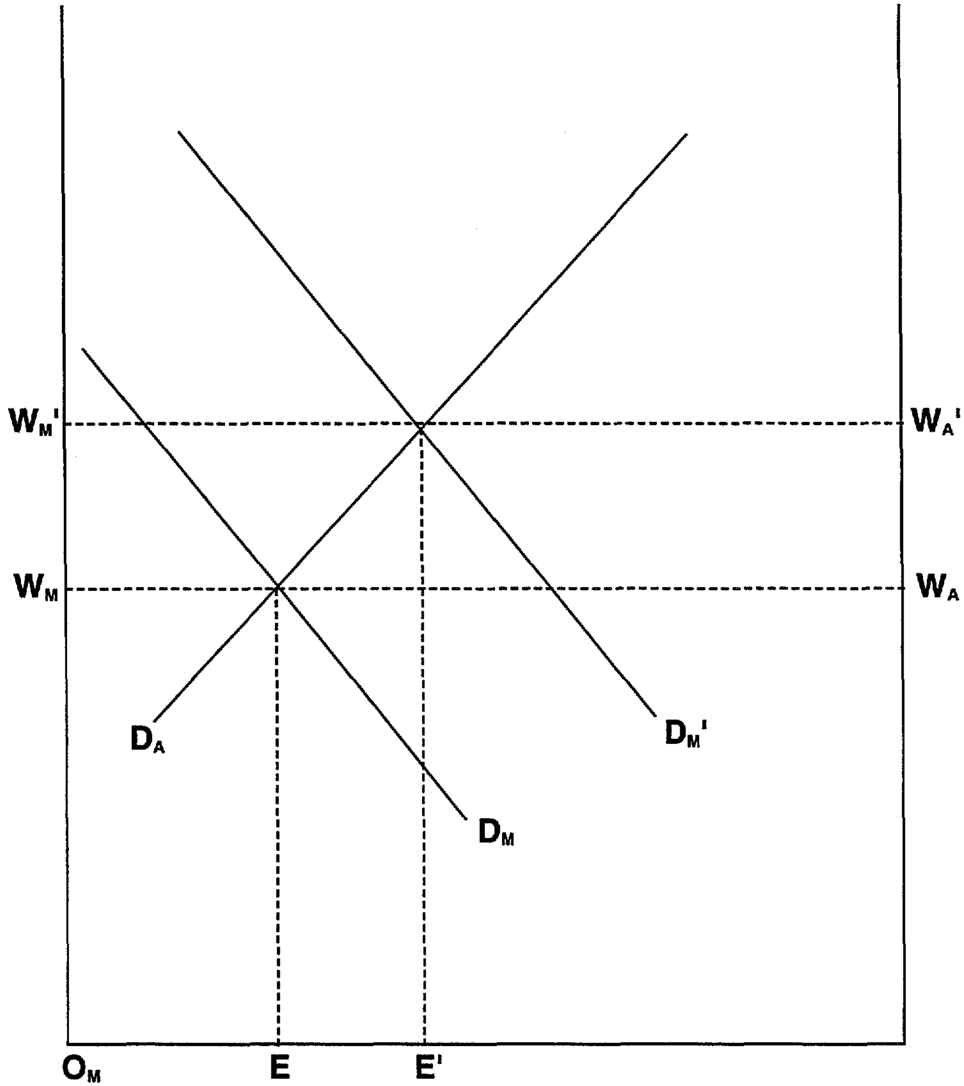
LOWED%: Percentage of employed persons with a primary education or less
Source: Pesquita Nacional por Amostra de Domicilios various years

EARNINDX: Index of real monthly earnings of employed people 1981=100
Source: Pesquita Nacional por Amostra de Domicilios various years

POV: Poverty headcount ratios
Source for POV (1): Psacharopoulos et al, 1993.
Source for POV (2): IDB, 1993.
Source for POV (3): Ramos

GINI: Gini coefficient of household income
Source: Barros et al, 1993.

Figure 1.



HONDURAS: Financial Sector Reform

by

Donald Harrison

USAID/M

The thrust of my remarks relates to financial sector reform in Honduras, where I spent the last three years of my life. It is always dangerous to start with a joke, but allow me to give it a try. I hope I do not offend any Virginians. How many people does it take to change a light bulb in the State of Virginia? Three. One to change the light bulb and two to remark on how good the old one was.

While reverence for tradition has its place, there is need for change in our client states, especially in their financial sectors. In Honduras, a process of financial sector reform has commenced but remains incomplete.

Under the Callejas administration, which took power in January 1990, the Honduran government embarked upon a comprehensive structural adjustment and stabilization program. A key aspect was financial sector reform. Positive developments include the decontrol of interest rates, the virtual elimination of directed Credit lines, and some movement toward rationalization of the State Agricultural Development Bank BANADESA.

On the other hand, financial sector legislation is still awaiting congressional approval; bank reserve requirements at 34k remain excessively high; and capital markets are undeveloped and thin.

The virtues of interest rate decontrol are evident. Interest rate decontrol provides access to credit to segments of the populace that were hitherto denied access. Neither USAID/Honduras nor any other entity that we know of has investigated the impact of interest rate decontrol on the poor in Honduras. Casual empiricism suggests that the non poor have been the primary beneficiaries. Medium size commercial traders, outsiders from politically powerful groups and the larger farmers appear to have benefitted the most.

The difficulties with directed credit lines also have been well documented. Government programs of directed credit at belowmarket interest rates targeted to priority groups and activities discourage deposit mobilization, thus decreasing funds available for private sector credit. Traditional directed credit programs also overlook two fundamental principles. One, increases in domestic credit not validated by an increase in the demand to hold domestic financial assets will leak out through the loss of foreign exchange reserves or through inflation. Two, targeted credit is incompatible with a market oriented economy in which private agents are free to select the activities most profitable to them. As long as targeted loans with subsidized interest rates exist, bankers will have incentives to lend to those who have the best collateral and the best connections, for instance, friends and relatives, rather than seek out new clients.

While the directed credit lines had been eliminated almost in their entirety, they keep on popping up. Last year, with the assumption to power of the new Reina administration and its sincere interest in helping out the rural poor, a $15 million Directed credit line was established to encourage basic grains production. A major brouhaha arose over the implementation of the credit line. The Central Bank accused several banks of diverting funds for other uses which was probably to some extent true. After one of the accused banks threatened to take the

Central Bank President to court for defamation of character, a public apology was arranged. Diversion of funds for other uses is always a problem with directed credit lines; the issue of fungibility also arises.

This year, two relatively small directed credit programs have emerged, including a $2 million guaranty fund and a $1.5 million food security fund. While the $15 million basic grains program was fully disbursed, this year's two new programs have yet to be. It will be interesting to see whether these two new programs will be implemented transparently.

A major thrust of the World Bank/Inter American Development Bank (IDB) supported Agricultural Sector Adjustment Program for Honduras has been the disincorporation of BANADESA, the State Agricultural Development Bank. The bulk of the technical assistance for the Agricultural Sector program has been supplied by USAID/Honduras under its policy analysis and implementation project. BANADESA is mired in financial difficulties owing (1) to a lack of attention to its financial viability by the Honduran authorities, (2) its vulnerability to political interference, (3) the image that it gave to private concerns that it did not care whether it was repaid, (4) an inappropriate interest rate structure and (5) an excessively large bureaucracy and high costs of operation. BANADESA has been kept afloat only by the injection of new resources. Established to channel funds to the poorest of the rural poor, it has never achieved significant coverage of the rural populace, instead furnishing the bulk of its money to those entities with political pull. Evidence of BANADESA financial difficulties is the level of loan delinquencies which amounted to 42 percent of its portfolio in 1992, 37k in 1993, and 40k in 1994. To secure this year the second stranches under its Agricultural Sector Program from both the World Bank and IDsw the GOH had to agree to restructure the lending operations of BANADESA to make them more consistent with the stated goal for the entity. Limits were imposed on the value of loans that could be provided. While the GOH would like to retain BANADESA, the medium term goal of the World Bank and IDB is its closure. There is urgent need to resolve once and for all its status. Failure to do so will encourage debtors not to repay loans and make it virtually impossible to clean up its portfolio.

Backed by USAID financing, noted economist Claudio Gonzalez Vega has been examining the issue of agricultural credit and BANADESA's role in its provision. According to the latest agricultural census, 6.7 percent of farmers have received loans from the formal financial sector. Vega's more narrow survey looking at agricultural credit in three better off localities within Honduras suggested that 11k of farmers had received loans from private banks or BANADESA in 1994. It is also clear according to Vega's work that access to formal credit is inversely related to farm size. While 14k of farmers with up to 5 acres of land had access to credit, 33k with farms between 12 and 25 acres are able to command loans. As in the case of loans, deposit services were similarly limited; only 12 percent of the farmers maintained deposits in banks and 6 percent in credit unions.

Over the past several years, the growth of agricultural credit has been slow in real terms, including 0.3 percent in 1993 and 1.9 percent in 1994. This is despite the significant stimulus provided to the agricultural sector by exchange rate liberalization and price decontrol under the country's ambitious economic reform program. Agricultural credit is growing slower than both the rate of growth of the agricultural sector and the rate of growth of overall credit within the country. A key contributing factor to the slow growth of credit to the agricultural sector has been the inability of BANADESA to maintain the real value of its portfolio. Its interest rate policies have neither covered the cost of operation nor protected the portfolio from inflation.

The relative importance of BANADESA in the provision of formal credit in the agricultural sector is declining vis a vis that of banks, credit unions, and non-governmental organizations. By 1994, BANADESA was serving 7 percent of total producers; banks were serving 8 percent; credit unions, 6 percent; and non-governmental organizations, 7 percent.

Despite the significant progress made by the credit unions in terms of coverage and financial viability owing primarily to USAID/Honduras work, the credit unions still suffer from deficiencies. They need (1) to cover a greater portion of costs in order to attend to the needs of their marginal clients, (2) to continue to improve their administrative practices, (3) to resolve potential conflicts of interest between net creditors and net debtors, and (4) to have in place a prudential oversight system that ensures the safety of deposits, thereby encouraging such deposits.

The non-governmental organizations in Honduras have significant problems. They have sub-standard internal control systems because they lack good management; they lack financial viability because their main concern is not the bottom line but rather the desire to assist the poor; and they have high costs of operations owing to the small size and number of loans in their portfolio. The end result is a high number of loan defaults, despite closer contact to their clients. They will not be successful institutionally until they submit themselves to financial discipline.

Informal markets are not an inconsequential source of credit to rural concerns in Honduras. While 26W of the producers in Vega's sample have access to formal commercial credit, 43t secured credit from rural money lenders. Only 7 percent, though, used money lenders as their primary source of credit. Another 25 percent secured credit from friends and neighbors. However, the most important source of money to producers is their own funds.

These informal markets also offer problems. The amounts of credit provided are small; the cost can be very high; and the maturities are short. Vega in his sample covering both formal and informal markets observed only three loans that were for more than one year. The small size of loans is an especially intractable problem because it increases average operating costs. While the informal markets provide a valuable service to poor clients, they are not sufficient to promote investment and rural development. They also do not offer deposit services.

There are, however, important savings in the rural areas that could be mobilized to provide credit. According to the individuals interviewed by Vega, 57 percent use domestic animals as a store of wealth; 40 percent have money under the mattress; and 59 percent accumulate grain inventories as a store of wealth.

One item that Vega found that discouraged the extension of credit is a judicial system that is practically non-operative. In Honduras, it is very difficult to seize assets in the event of a loan default. One banker with whom I spoke related that it took him over 11 years to seize the collateral of a borrower in default.

To improve the rural credit system, Vega recommends (1) continued GOH efforts to remove the anti agricultural and anti export biases in the economy, (2) avoidance of interest rate controls and directed lines of credit, (3) reduction in the high reserve requirement, (4) use of Central Bank rediscount rates that reflect the marginal cost of capturing additional resources, (5) increased prudential oversight that passage of the new financial legislation would provide, (6) judicial sector reform to encourage financial sector intermediaries to provide loans to individuals that heretofore did not have access, (7) an accord over the future of BANADESA, (8) introduction of well designed mechanisms to encourage the provision of rural credit by commercial banks, which have a comparative advantage as a Financial intermediary, (9) additional institutional strengthening assistance for the credit unions, and (10) and last caution in promoting the activities of non government organizations.

A very positive development in the financial system is USAID/Honduras' work with credit unions, although some difficulties persist. USAID/Honduras is promoting credit unions through institutional strengthening assistance to the country's Credit Union Federation, the umbrella credit union organization. That work is producing gains.

Over 1990-93, credit union assets grew 78 percent in real terms and membership growth was 18.7 percent annually. By 1993 there were 135,290 members, up from 80,890 in 1990. Credit unions' accounting and internal control policies are now generally quite good and getting better. Reserves in most credit unions now on a standard basis exceed 7 percent of assets. The portion of the loan portfolio which has a delinquent payment has declined from 20.28 to 15.1 percent over 1990-93. Bad debt provisions now cover most of the potential exposure from delinquent loans, 89 percent compared to 19 percent three years earlier. Finally, rates on savings deposits in credit unions are moving closer to the rate of inflation, thereby encouraging deposits.

In addition to the USAID institution strengthening assistance, contributing to the growth of credit unions in Honduras also have been improved economic policies, including (1) the liberalization of the foreign exchange system, (2) the removal or relaxation of interest rate ceilings on loans and deposits, and (3) the elimination of most subsidized credit lines. The credit unions also are growing in importance because they are serving the needs of their clientele. They are providing competitive access to both savings and credit services.

One of Vega's recommendations is reduction of the country's high reserve deposit requirement which now stands at 34 percent. In Honduras, reserve requirements can be met using cash in vaults, deposits held in the Central Bank, and especially designated government securities. In the past, these securities paid but 4 percent interest, serving as a means of financing the budget deficit. However, bonds issued to meet the 6 percentage point increase in the reserve requirement to 40 percent in June 1994 have paid market interest rates.

The problem is that the reserve requirement has served as a tax. Generally speaking, the rate of interest on the bonds purchased by the banks to satisfy the reserve requirements has been well below prevailing market rates of interest. The significant reserve requirement has contributed to a large gap between deposit and lending rates in the commercial banking system. With lending rates around 32 percent and deposit rates in the vicinity of 12 percent, the gap now stands at around 20 percent. The high reserve requirement means that less monies are available for lending reducing loans, and banks have a diminished incentive to bid for deposits, thereby constraining deposit creation.

Also contributing to the large gap between deposit and lending rates is a lack of competition between banks and difficulties in foreclosing against loan defaulters owing to the inoperative judicial system.

The 6 percentage point increase in the reserve requirement introduced in June 1994 was designed to offset the $65 million in monies printed by the Central Bank earlier in the year to cover unfinanced expenditures incurred by the previous administration. The previous administration had been guilty of election year politics. The increases in liquidity had placed pressure on the exchange rate, hiking import costs and inflation. Under the program with the IMF, the country reduced the reserve requirement from 40 to 34 percent over the first half of 1995 and was to reduce it further under the program to 27 percent by the end of 1995 with a goal of 15 percent in the following year. However, the Central Bank has arrested further reductions in the reserve requirement. The roughly $50 million in additional liquidity released by the reduction in the reserve requirement from 40 to 34 percent has been an important factor contributing to rapid monetary growth approaching 40k and fueling inflation — now in the neighborhood of 28 percent as opposed to only 6.5 percent two years earlier. The other factor promoting rapid monetary growth has been increases in coffee export proceeds, now estimated at $350 million for this year compared to $228 million last year. Coffee has overtaken bananas to become Honduras' most important export.

One intriguing question is that the reduction in the reserve requirement to 34 percent from 40 percent has not resulted in a narrowing of the differential between lending and deposit rates as sought by the IMF. If anything, the gap has increased slightly since the end of last year. Part of the explanation may be collusion among the banks.

Vega also noted the importance of enhanced prudential oversight that the approval of new banking system legislation would provide; enhanced prudential oversight would promote deposit safety, thereby encouraging deposit creation. New banking system legislation is now being considered by the Honduran Congress, and Congressional approval is the centerpiece of the reforms encouraged by USAID/Honduras' ESF program. This new legislation will:

- help eliminate the stranglehold that the "old boys" network had on credit within the country. Strict restrictions are imposed on any form of financing provided by credit institutions to insiders shareholders, directors and managers, their relatives or firms, and severe civil and criminal penalties are imposed on institutions and individuals for violations of the restrictions,
- legalize the country's market based interest rate system. In the absence of legislation, a new government administration could overturn the country's market based interest rate system,
- promote competition in the banking industry,
- strengthen prudential oversight and enhance public confidence in the commercial banking system, thereby helping to eliminate the possibility of bank failures and ensuing financial crises. In the past, the central bank bailed out individual banks when difficulties surfaced,
- make monetary policy more effective. Banks will no longer be able to use their holding companies to evade monetary policy measures; under the new legislation, holding companies will be accorded legal status and therefore will be required to ante up on the reserve deposit requirements like the banks and savings and loan associations currently are suppose to be doing, and
- help lower the cost of credit. For example, credit institutions will be entitled to more rapid judicial procedures to seize and liquidate collateral in case of default by borrowers, thereby permitting banks to lower the interest they charge on loans.

Actually, there are three separate pieces of legislation under consideration by Honduras' Congress, including one for financial institutions, another for the Commission for Banks and Insurance Companies, and still another for the Central Bank.

The new Central Bank decree would strengthen the conduct of monetary policy by increasing the penalties for evasion of the legal reserve requirement. Currently, the Central Bank can assess a penalty equivalent to 12 percent which with lending rates in the neighborhood of 32 percent hardly gives the banks an incentive to comply with the reserve requirement. Under the decree, the penalty would be assessed based on the market rate of interest.

What is holding up passage of all three decrees is the Commission for Banks and Insurance Companies which would provide for oversight of the entire financial system. There is a battle underway between the Central Bank President and the Coordinator of the Economic Cabinet — the country's economic Czar. The Coordinator does not have a portfolio of his own and happens to be the Vice President of Honduras' largest commercial bank. At issue is the make up of the Commission, its autonomy, and its financing. The Central Bank President would like a Commission that is primarily made up of Government entities, that is under Central Bank control, and that is financed by contributions from private sector financial intermediaries. On the other hand, the Coordinator and the private sector financial intermediaries are seeking a Commission that has private sector participation, is responsive to the private sector, and is financed by the Government.

The USAID Mission has been given assurances by Honduran authorities that all three decrees will be approved by Honduras' Congress in September 1995. Congressional approval would enable the Mission to give strong consideration to disbursement of its $5 million ESF program.

In summary, Honduras has come a long way but there is still work to be done to complete the financial sector reform process. In light of the incompleteness of the reform program, USAID/Honduras has yet to undertake an overall economic assessment of the financial sector reform process, especially its impact on the poor. USAID/Honduras, nonetheless, has underway a couple of studies that will assess the impact on the poor of the reforms that we have encouraged within the credit union movement. The Mission is anxiously awaiting the results of the studies which should be completed some time this fall.

GENDER BASED WAGE DIFFERENTIALS IN INDONESIA: A PRELIMINARY ANALYSIS[50]

by

Mary E. Norris[51]

USAID / Indonesia

I. Introduction

The prevalence and persistence of gender based wage disparities, while widely acknowledged, remains poorly understood. While considerable research has been devoted to explaining the sources of gender based wage differentials in the industrialized countries, only recently have researchers begun to examine the same sets of issues within developing countries.[52] Interest in the issue may correlate with a country's level of industrialization and the formalization of its economy as wage and salary work assume increasing importance with industrial development. Among those who have examined employment and wage

[50]Prepared for the USAID Economists' Training Workshop in Annapolis, Maryland, September, 1995.

[51]I am grateful to Vivi Alatas, Vickie Alexander, Robert Aten, Shafiq Dhanani, Kamala Lakhdhir, Peter Rosner, and William Wallace for their helpful inputs. Of course, I alone am responsible for the paper's shortcomings.

[52]See Linda Lean Lim, "The Feminization of Labour in the Asia Pacific Rim: From Contributing to Economic Dynamism to Bearing the Brunt of Structural Adjustment," in Ogawa et al. (eds.), *Human Resources in Development along the Asia Pacific Rim,* Oxford University Press, 1993. Also see *A Comprehensive Women's Employment Strategy for Indonesia,* ILO, Regional Office for Asia and the Pacific, Bangkok, 1993.

issues in the newly industrializing countries, there is a growing perception that industrialization has brought with it a "feminization" of employment which is associated with the relegation of women to inferior positions in domestic and international labor markets.[53]

From a welfare theoretic standpoint, the existence of unexplained wage disparities indicates the presence of economic distortions and their associated welfare losses. If the static welfare effects of such distortions have been under analyzed, then the dynamic consequences are even less well understood. Consequently, much more needs to be done to understand the sources of wage disparities within developing countries, recognizing that while certain universalities are apt to apply, country specific institutional arrangements and cultural constraints also are likely to result in different outcomes and different implications for policy response.

The purpose of this note is to present some evidence on gender based wage disparities in Indonesia, focusing primarily on earnings of wage and salary employees as provided in the National Labor Force Survey (Sakernas). The note then suggests some possible explanations for the pattern of wage disparities which the data exhibit. These explanations are only tentative and thus are intended to wet researchers' appetite to further explore the nature and source of wage disparities in Indonesia. The note concludes with a discussion of possible policy implications.

Table 1: Average Hourly Wage by Education (1993)

Education	**Female**	**Male**	**F/M**
No education	306	524	58%
Primary education	304	603	50%
Junior High education	459	909	51%
High School (General)	915	1089	84%
High School (Vocational)	1122	1239	91%
Diploma I/II	1296	1555	83%
Academy/Diploma III	1417	2002	71%
University	1654	2268	73%
Total	562	873	64%

Source: Sakernas, 1993.

II. What the data show

While we are interested in understanding the source of all earnings differentials between men and women, differentials which exist for the same skill level attract the greatest attention and concern of economists.[54] This is because the persistence of wage differentials for a given skill level is difficult to reconcile with a neoclassical labor market equilibrium wherein firms hire workers so as to maximize profits and workers sell their labor so as to maximize

[53] There is, of course, a substantial body of literature on the role of women in economic development [see the recent report prepared by Coopers & Lybrand for USAID, *Gender and Economic Participation: A Review of the Literature*]. While much of this literature addresses gender-based economic disparities, including earnings and income disparities, not many studies have focused on wage differentials.

[54] What we would really like to know is whether the wage differentials exist for the same *productivity* level. Skill is only a proxy for productivity since it only measures a worker's potential productivity regardless of his/her motivation and work effort.

utility. In effect, the presence of wage differentials for the same skill level implies that labor market institutions are accommodating "non-economic" motivations, e.g., discrimination and adverse self-selection.[55]

Unfortunately, measuring skill is wrought with difficulty. Typically, educational attainment and work experience are taken as proxies for skills In this note, we examine wage differentials across levels of education, recognizing that ideally, cross tabulations for age would also be examined. The data used here comes from the *National Labor Force Survey (Sakernas)* and in particular, draws upon one category of surveyed workers, those who are considered wage or salary employees.[56] It is important to note that these workers comprise only 31 percent of the total workforce in Indonesia, approximately 34 percent of the male labor force and 26 percent of the female workforce.[57] Hence, we cannot presume that the pattern of wage differentials which prevails among wage workers represents the pattern which obtains among informal sector workers. Table 1 presents data on the hourly earnings of male and female workers by education level attained.[58]

Table 2: Average Hourly Wage by Sector (1993)

Education	Female	Male	F/M
Agriculture	331	535	62%
Mining	528	1168	45%
Manufacturing	480	823	58%
Utilities	1189	1169	102%
Construction	722	716	101%
Trade & Hotels	616	758	81%
Transportation & Communication	991	968	102%
Finance	1148	1532	75%
Social Services	664	1074	62%
Other	424	989	43%
Total	562	873	64%

Source: Sakernas, 1993.

[55] Of course, the existence of wage differentials for the same skill level does not necessarily imply the existence of wage discrimination, i.e., different wages paid for identical work. This would only be the case if "skills" were perfectly correlated with a particular job and these jobs/skills could be clearly identified and measured. Instead, wage differentials for a given skill level are more likely to result from occupational discrimination or segmented labor markets whereby women are less likely to be hired (or seek employment of) a particular job than a man who possesses the same skill level.

[56] The Sakernas is a household labor force survey which collects data on five types of workers: 1) selfemployed; 2) self-employed assisted by temporary workers and/or family workers; 3) wage or salary employee; 4) employer; and 5) family worker. The earnings data presented here draws only on the third category of wage/salary workers. With regard to the data's reliability, it may be noted that the survey is a one page survey which focuses solely on labor force questions, and is conducted by direct hire employees of the Indonesian Central Bureau of Statistics, rather than by temporary employees. Hence, it is less suspectible to enumeration and interpretation errors than more comprehensive surveys (e.g., the Social and Economic Census). Nonetheless, researchers (including this one) have detected anomolies in the data which warrant some caution in relying on it exclusively. However, it is the only data source available which allows investigation of the questions at hand

[57] The single largest category of female workers is "unpaid family workers," which account for approximately 44 percent of the female labor force, compared to 13 percent of the male labor force.

[58] Data on hourly earnings were obtained by dividing monthly earnings by the average number of hours worked in a week. This figure is then divided by 30/7 (the number of weeks in a month). The Indonesian Labor Force Survey (Sakernas) asks salary/wage earners what their weekly earnings were in the previous week and the corresponding number of hours worked in that week. However, the published data gives average monthly earnings.

The data exhibit a rather curious relationship between skill level (education level) and the female male wage differential what we might characterize as a "snake" pattern. It is seen that for workers with no education, females earn approximately 58 percent of their male counterparts. The ratio then drops to only 50 percent for workers who have completed primary (basic) education, and increases by only one percentage point for workers who have graduated from junior high school.[59] Hence, workers whose education ranges from 1-9 years, the gender based wage disparity is alarmingly high. However, the wage disparity decreases significantly for workers who have received a high school education.[60] Female workers who have graduated from general high school can expect to receive 84 percent of what their male cohorts earn, while women who have graduated from vocational high school earn, on average, 91 percent of what their male cohorts receive. The ratio then dips some what for workers who have received one or two years of tertiary education (Diploma I/II). It declines further for workers who have received another year of tertiary education, and only rises slightly for workers who have received at least a bachelor's degree from a university. For all levels of education, women on average earn 64 percent of what men earn.

The data raise some interesting questions. Before turning to these questions, let us first look at how the average wage differential varies across sectors. Table 2 presents the average wage by sector and gender together with the associated female male wage ratio.

According to Table 2, it is seen that the lowest ratios (i.e., the widest gaps) obtain in the Mining and "Others" categories. However, as can be seen from Table 3, these sectors are not important in terms of employment. The next lowest ratio is in the manufacturing sector where women on average earn 58 percent of what men earn. In both the agricultural and social service sector, women's earnings are 62 percent of men's earnings. All three of these sectors are important in terms of employment: agriculture and manufacturing each account for 25 percent of total female wage employment, while social services accounts for 39 percent . Earnings disparities in these sectors thus contribute significantly to the overall wage gap.

Table 3: Employment by Sector (1993)

Sector	Female	Male	Total	Female Total
Agriculture	1924518	3030461	4954979	25%
Mining	31726	270770	302496	0%
Manufacturing	1980098	3129647	5109745	25%
Utilities	12949	133799	146748	0%
Construction	63076	2127874	2190950	1%
Trade & Hotels	562123	994411	1566534	7%
Transportation & Communication	61471	1080617	1142088	1%
Finance	120704	380732	521436	2%
Social Services	3048529	5456073	8504602	39%
Others	7394	19615	27009	0%
Total	7832588	16623999	24456587	100%

Source: Sakernas, 1993.

[59] There are actually two types of junior secondary education in Indonesia: general and vocational. However, I have only included general junior secondary education since only a small percentage of students have graduated from vocational junior secondary school.

[60] There are also two types of high school education in Indonesia. Unlike the case for junior secondary school, however, here graduates are fairly evenly distributed across the two types.

The highest ratios obtain in three sectors: utilities (electric, gas, and water), construction, and transportation and communication. Somewhat interestingly, in all of these sectors women on average earn more than their male counterparts. However, these three sectors combined only account for 1.8 percent of total female employment. The next highest ratio is found in the Trade and Hotel sector where women earn 81 percent of what men earn. As seen from Table 3, this is a moderately important sector in terms of women's wage employment. Women also fare relatively well in the Finance sector where they earn 75 percent of what their male cohorts earn, but this is not an important source of wage employment for women.

To better understand what the sources of the disparities are across education level, we need to examine the wage ratios by education and sector together with the corresponding employment data. These data are presented in Tables A.1 and A.2 in the Appendix. As seen from Table A.2, both women and men with no education are heavily concentrated in the agricultural sector, although agriculture comprises a larger source of women's wage employment than of men's employment (66 percent of women wage workers are employed in agriculture compared to 53 percent of men). For workers with no education, women's wages are 79 percent of men's wages in this sector. Hence, agriculture is serving to raise the overall female male wage ratio (which you recall is 58 percent for workers with no education). The other sectors which are important in terms of female employment (for workers with no education) are manufacturing and social services which together account for 30 percent of female employment. As can be seen from Table A.1, clearly it must be the large earnings gap in the social service sector which is dragging down the overall wage ratio. Here women earn only 41 percent of their male counterparts. In the next section, we offer a possible explanation for the low relative earnings of women in this sector at no or low levels of education.

Turning now to workers who have received a primary education, it is interesting to see how much less important agriculture is as a source of wage employment for these workers (see Table A.2). Agriculture accounts for 24 percent of female employment and 24 percent of male employment for workers with a primary education. The wage gap is higher, however, in agriculture at this level of education. Here women only earn 58 percent of what men earn in agriculture. [Note that this is still higher than the overall ratio.] Manufacturing, as a source of employment for women, is significantly higher than for women with no education. The social services sector also assumes greater importance at this level of education. While women appear to be concentrated in three sectors, men can add a fourth, the construction sector. Again, it is the wide wage gap in the social service sector which appears to contribute significantly to depression of the overall wage ratio among workers with a primary education: Here, women earn only 37 percent of their male counterparts' earnings. The wage ratio in manufacturing is about the same as for workers with no education (68 percent).

Employment patterns change dramatically among workers who have received a junior secondary education. Only 4 percent of wage earning females with this level of education are employed in agriculture (compared to 9 percent of males). The manufacturing sector employs fully half of all females with this level of education (compared to 27 percent of males). Women also increasingly enter the trade and hotels sector at this level of education while the social service sector remains an important sector as well. Interestingly, the lowest wage ratio for this level of education obtains in the manufacturing sector. According to the published Sakernas data, women only earn 35 percent of what their male cohorts earn in this sector.[61]

[61]Given the large drop in the manufacturing wage ratio (compared to workers with primary education only), and the huge increase in the ratio among workers with a general high school education, we have to suspect that these two statistics are anomalies in the data which require further investigation.

This wage gap is clearly the greatest contributor to the low overall wage ratio at this level of education. The wage ratio in trade is significantly higher than the overall wage ratio, while the wage ratio in social services is slightly higher than the overall average.

In the next section, we offer one possible explanation for the large wage gap in manufacturing at the junior secondary level of education, bearing in mind the anomalies discussed above and below. Looking at the next highest level of education (general senior high), quite puzzlingly, according to the published data, females who attain a general high school education and are employed in the manufacturing sector earn 20 percent more than their male counterparts. However, a vocational high school education only gets them 64 percent of men's wages in this sector. Clearly, these data require further examination to determine the source of the large variations. It is important to note here, however, that at this level of education, manufacturing assumes lesser importance as a source of employment, with social services and trade appearing to take up the slack. This is especially true for women who have attained a vocational high school education. Social service employment comprises 77 percent of such women's total wage employment (compared to 59 percent for men) As discussed below, the high participation of women in this sector helps explain the high wage ratio at this level of education.[62]

It is seen from Table A.1 that, compared to workers who have only a senior high school education, the wage ratio is lower for workers with at least two years of tertiary education. It declines further for workers with at least three years of tertiary education or a university degree. The overall decline in the wage ratio for workers with a Diploma III or university education appears to derive primarily from their lower participation in the social service sector.

III. Some possible explanations

Casual analysis suggests a few fairly obvious explanations for the gender based wage pattern. First, workers with no education or only a primary education, the low overall wage ratio is mainly attributable to the abysmally low ratio within the social service sector. While we do not have the decomposition, we suspect that it is the low earnings of housemaids who are included in this sector which accounts for the poor earnings of women in this sector. Men with similar education in this sector are more likely to be employed in public service jobs, e.g., construction, maintenance, etc., and those hired as household help (e.g., as guards) probably receive more than women working as housemaids.

Turning to the next highest level of education, recall that 50 percent of all women wage earners with a junior high education are employed in manufacturing. It is expected the majority of these women fare employed as production workers in industries which are primarily "manned" by women. These sectors include the footwear sector, textiles, and the food, beverage and tobacco sector where women comprise the majority of the workforce. According to anecdotal evidence collected by various labor researchers, quite often young women in these sectors are recruited in groups from their village by factory recruitment personnel. Evidence suggests that employers prefer to hire women for these jobs on account of their perception that women are more dextrous, more patient, less assertive and more deferential to authority than men.[63] For their part, young women from the village might be expected to be more inclined to migrate to the city for factory employment if they are accompanied by their female cohorts. Their parents may also be

[62] We should note another anomaly in the data, namely, the large relative wage ratio (153%) for vocational high school graduates working in the trade sector (for a regular wage). This also serves to increase the overall wage ratio at this level of education.

[63] See Mayling Oey, "Changing Work Patterns of Women in Indonesia during the 1970s: Causes and Consequences," in *Prisma* (Jakarta), Sept. 1985, pp. 1846, as cited in Mary C. White, "Improving the Welfare of Women Factory Workers: Lesson from Indonesia," *International Labour Review*, Vol. 129, 1990, No. 1.

more inclined to consent to their move under such conditions.

While we can only conjecture at this stage why women are targeted by employers and offered by themselves to work in female dominated factories, the likely result of such an employment pattern is that certain sectors become "sex-typed" and are likely to remain so under conditions of relative labor surplus. In addition, because women are probably much less prone to migrate to urban areas without a guaranteed job, and are less likely to seek initial urban employment in the informal sector, there are in effect fewer job opportunities for female workers with only a moderate level of education as compared to their male counterparts. Hence, the "crowding" of women into a few manufacturing sectors might well explain their lower absolute and relative wage.

It might be noted that the low relative wage for women with a junior high education is consistent with the evidence on the relationship between women's labor force participation and level of education. Studies have shown that the relationship between women's education and labor force participation exhibits a "U-shaped" pattern Whereby female labor force participation is fairly high at no or low levels of education, but then declines and is lowest for women with a junior Secondary education. Participation then picks up at higher levels of education with the highest participation rates recorded for women with a university degree.[63] The low market earnings received on average by women with a junior high education may not be sufficient to exceed the opportunity cost of their time spent at home.

At the senior high level, it seems apparent that the social service sector and women's high employment therein is what accounts for the high overall wage ratio. Of course, at this level of education, women are not employed as housemaids. Here, they are primarily civil servants especially primary school teachers. Indeed, while workers with a high school education comprise only about 12 percent of the workforce, nearly 60 percent of all civil servants have a high school education. Approximately 40 percent of civil service workers are female. The data in Table A.1 indicates that public sector employment practicies help to diminish the gender-based wage gap. Whether this means the government is not pursuing rational (i.e. "profit" maximizing) employment policies or that the private sector is the culprit is open for debate and further investigation.

The decline in the overall wage ratio at higher levels of education can be attributed to the lower percentage of women wage workers who are employed in the social service sector (compared to women with high school education) as well as to the fact that women are less likely to obtain a university degree in science and engineering compared to their male cohorts.

IV. Implications for policy and further study

To be sure, the above explanations suggested are far too tentative to warrant making any suggestions regarding the appropriate policy responses. However, if one were bold enough to do so anyway, what might one say? The immediate temptation is to argue that expanding female education is the key to reducing the gender based wage gap. However, there are other considerations that need to be borne in mind here. One consideration is the very high rates of unemployment which prevails among women with a high school education and above. In addition, open rates of unemployment for women are roughly twice that of men.

[64]See Diah Widarti, "The Determinants of Female Labor Force Participation: The Case of Married Women in Jakarta," paper prepared for USAID/Indonesia, 1995. This study focuses mainly on supply-side factors influencing the probability a married women will enter the labor force, and *interalia,* finds that for women with junior secondary education and above, factors e.g., husband's education, husband's occupation, and ethnicity (a proxy for social values) have an influence on women's decision to enter the labor force while these forces are not important for women with lower levels of education. The low expected wage for women with a junior secondary education could help to explain the higher propensity of these women to stay out of the labor force compared to more educated women.

Second, as high school and tertiary graduates continue to increase in Indonesia, there is an increasing likelihood that they may squeeze out workers with less education unless sufficient job opportunities are generated in occupations traditionally held by tertiary graduates.[65] While lower wages for tertiary graduates could narrow wage differentials across education, it could also depress wages among the less well educated.

Of course, the first best policy solution is to eliminate all forms of gender based labor market segmentation, but there is the obvious problem of implementing this solution There is an interesting question which can be posed, namely, whether a case can be made in favor of implementing a second best policy of raising wages in the female sectors where wages are depressed vis a vis the male dominated sectors. Of course, this policy response only makes sense if the wage differential can be attributed to labor market distortions (e.g., discrimination), and even then, the fact that the majority of Indonesian workers are employed in the informal sector weakens the case for such a policy response. While the discussion here suggests that the presence of gender based wage differentials is distortive, more research is needed before the nature and magnitude of these distortions can be known.

In conclusion, this paper was intended to shed some light on the nature and extent of gender-based wage disparities in Indonesia. It offered some possible explanations for the pattern of wage disparities which need to be further explored along with the attendant policy implications. Aside from noting the relative lack of knowledge and information on the subject of gender based differentials, the analysis done here also indicates the importance of improving the data sources on which such analyses depend.

[65]See Gavin Jones, "Expanding Education for Faster Growth," in Ogawa et al., op. cit., p. 254.

Table A.1: Average Hourly Wage by Education and Sector									
Sector	**No Education**			**Primary Education**			**Junior High Ed (general)**		
	Female	**Male**	**F/M**	**Female**	**Male**	**F/M**	**Female**	**Male**	**F/M**
Agriculture	325	410	79%	354	614	58%	420	560	75%
Mining	255	737	35%	537	643	84%	968	1096	88%
Manufacturing	318	475	67%	357	528	68%	447	1260	35%
Utilities	1087	1385	78%	500	864	58%	1111	943	118%
Construction	438	625	70%	576	622	93%	667	737	90%
Trade & Hotels	275	901	31%	297	525	56%	443	633	70%
Transportation & Communication	275	694	40%	425	638	67%	845	810	104%
Finance	–	916	–	610	682	89%	645	891	72%
Social Services	275	670	41%	238	641	37%	464	866	54%
Others	456	644	71%	358	726	49%	1167	468	249%
Total	306	524	58%	304	603	50%	459	909	51%

Source: Sakernas, Keadaan Pekerja, 1994.

Table A.1: Average Hourly Wage by Education and Sector (cont'd)						
Sector	**High School (general)**			**High School (vocational)**		
	Female	**Male**	**F/M**	**Female**	**Male**	**F/M**
Agriculture	505	706	72%	494	755	65%
Mining	1073	1838	58%	848	1964	43%
Manufacturing	1099	919	120%	608	956	64%
Utilities	1394	1194	117%	1260	1280	98%
Construction	797	911	88%	698	904	77%
Trade & Hotels	649	873	74%	1256	820	153%
Transportation & Communication	1172	1785	66%	931	1034	90%
Finance	1031	1247	83%	948	1247	76%
Social Services	939	1112	84%	1223	1457	84%
Others	–	989	–	442	1743	25%
Total	915	1089	84%	1122	1239	91%

Source: Sakernas, Keadaan Pekerja, 1994.

Table A.1: Average Hourly Wage by Education and Sector (cont'd)									
Sector	**Diploma I/II**			**Academy Diploma III**			**University**		
	Female	**Male**	**F/M**	**Female**	**Male**	**F/M**	**Female**	**Male**	**F/M**
Agriculture	1771	670	264%	188	1196	16%	1576	308	51%
Mining	1382	659	210%	–	2853	–	1769	3013	59%
Manufacturing	990	2203	45%	1595	2172	73%	1603	2413	66%
Utilities	–	–	–	1902	1447	131%	1537	2024	76%
Construction	889	2020	44%	1012	9086	33%	1896	2339	81%
Trade & Hotels	867	1291	67%	1275	1797	71%	1209	2601	46%
Transportation & Communication	2511	2341	107%	1828	2895	63%	1757	2107	834%
Finance	976	2147	45%	1831	2385	77%	1688	3748	45%
Social Services	1350	1479	91%	1351	1665	81%	1685	2103	84%
Others	632	–	–	–	583	–			
Total	1296	1555	83%	1417	2002	71%	1654	2268	73%

Source: Sakernas, Keadaan Pekerja, 1994.

Table A.2: Employees by Main Sector and Educational Attainment						
Sector	**No Education**		**Primary Education**		**Junior High**	
	Female	**Male**	**Female**	**Male**	**Female**	**Male**
Agriculture	66%	53%	24%	24%	4%	9%
Mining	1%	2%	0%	2%	0%	1%
Manufacturing	11%	12%	39%	21%	50%	27%
Utilities	0%	0%	0%	0%	0%	1%
Construction	1%	12%	1%	18% 6%	1%	13%
Trade & Hotels	2%	3%	5%	6%	14%	7%
Transportation & Communication	0%	3%	0%	7%	1%	10%
Finance	–	1%	0%	1%	1%	2%
Social Services	19%	15%	31%	22%	29%	30%
Others	0%	0%	0%	0%	0%	0%
Total	99%	100%	99%	100%	100%	100%
Total (number)	910760	753801	2276872	5363023	659853	2104239

Source: Laborers/Employ ees Situation in Indonesia, 1993, Sakernas

Table A.2: Employees by Main Sector and Educational Attainment (cont'd)						
Sector	High School (general)		High School Vocational)		Diploma I/II	
	Female	Male	Female	Male	Female	Male
Agriculture	1%	3%	1%	3%	0%	1%
Mining	0%	2%	0%	1%	1%	1%
Manufacturing	24%	20%	10%	17%	4%	6%
Utilities	1%	1%	0%	2%	–	–
Construction	1%	6%	1%	5%	1%	4%
Trade & Hotels	21%	12%	7%	4%	4%	3%
Transportation & Communication	3%	7%	1%	5%	1%	2%
Finance	6%	5%	3%	2%	3%	3%
Social Services	43%	43%	77%	59%	85%	79%
Others	–	0%	–	0%	1%	–
Total	100%	100%	100%	100%	100%	100%
Total (number)	860320	242527	1173867	2050271	104334	172693

Source: Laborers/Employ ees Situation in Indonesia, 1993, Sakernas

Table A.2: Employees by Main Sector and Educational Attainment (cont'd)						
Sector	Diploma II		University		Total	
	Female	Male	Female	Male	Female	Male
Agriculture	1%	1%	0%	1%	25%	18%
Mining	1%	2%	0%	1%	0%	2%
Manufacturing	9%	9%	7%	8%	25%	19%
Utilities	1%	1%	0%	1%	0%	1%
Construction	4%	5%	2%	5%	1%	13%
Trade & Hotels	7%	6%	5%	6%	7%	6%
Transportation & Communication	5%	6%	1%	2%	1%	7%
Finance	9%	9%	10%	7%	2%	2%
Social Services	63%	61%	73%	69%	39%	33%
Others	0%	0%	–	–	0%	0%
Total	100%	100%	100%	100%	100%	100%
Total (number)	570877	405226	209128	587625	7832588	16623999

Source: Laborers/Employ ees Situation in Indonesia, 1993, Sakernas

CAPITAL MARKETS AND POVERTY ALLEVIATION

by

Guy Pfefferman

International Finance Corporation

When I was asked to talk about this, my first reaction was to say no. I accepted because it seemed quite a challenge. When I asked colleagues for ideas, most of them recoiled; some said "you must be joking." Why not call the presentation: "Wall Street to Timbuktu?" Some of them, however thought the topic was important. I have reached the conclusion that the linkages between capital markets and poverty alleviation are indeed important, if somewhat unrecognized, and that the fact that aid agencies are trying to improve capital markets in developing and transition countries is quite proper for organizations whose overarching objective is the alleviation of poverty. In a nutshell, if one takes an overall view of an economy, it is apparent that capital markets, far from being a frivolous ornament, are indeed an essential part of the engine that generates development.

Capital markets can be understood in the narrower sense of securities markets or in a broader sense which embraces a country's entire financial infrastructure. In either case, we are talking about term financing. Likewise, poverty alleviation can be looked at in the aggregate or at the level of individuals and communities. These different facets suggest that I try to open several windows on the topic: first I will look at the scene through a telescope and talk about aggregate poverty alleviation, and, in turn, securities markets and financial institutions in the broader sense. Then, much more briefly, I will switch to a microscope and consider how individuals and communities might be affected by capital markets and financial institutions.

Let us begin with perhaps the toughest nut to crack, the task of relating stock markets in the narrow sense to the alleviation of poverty. How could the heart of the "casino economy" benefit the poor? Let me try out two propositions on you:

I. Stock markets are more important to the development process in poor than in industrial countries

This counterintuitive finding emerges rather robustly from research done at the International Finance Corporation (IFC). Under a World Bank research grant, we have compiled balance sheet and profit and loss accounts of up to the 100 largest manufacturing enterprises in each of ten developing countries: Brazil, Mexico, India, Pakistan, Turkey, Jordan, Zimbabwe, Malaysia, Korea and Thailand. In most cases, the data run from the early 1980s to 1992, and are being kept up to date. One of the main questions addressed in this research is how investment is being financed and, specifically, what is the relative contribution of retained earnings, stock issues and debt instruments. To our initial surprise we found that developing country corporations depend more on extra enterprise sources of investment financing than do firms in OECD countries. Stock issues, in particular, financed a larger share of corporate investment than in the United States and other major industrial economies. This was true not only in rapidly growing countries such as Korea, where investment needs clearly exceed what retained earnings can finance, but also in countries with less spectacular growth rates.

The implications are that the existence of well-functioning stock markets (and of efficient banking systems) are more important to growth and, hence, employment creation in developing countries than is often realized. The corollary is that an active secondary market in securities is essential to modern sector growth. This follows because there can be no sustained stock market development unless the public trades shares actively. The existence of reasonably well developed capital market institutions also provides the crucial conduit for international sources of finance. With proper safeguards, such as in Chile for example, medium and long-term private international capital flows clearly increase the capacity of local firms to invest and grow. This includes smaller companies. The initial public offerings market is growing rapidly in Chile and also in Egypt where, following IFC technical assistance and a new securities law, almost $300 million of new initial public offering (IPO) equity was raised in 18 months and where there are now about four IPOs per month. In Ghana, the country's key industry, gold mining, financed some of its recent investments through a combination of local and foreign equity.

Recent World Bank research shows an association between financial sector development and economic growth. Empirical evidence mustered by Ross Levine for 38 countries suggests that a strong association exists between stock market liquidity and the rate of long-term economic growth. By boosting investment quality, stock market liquidity increases the rate of return on corporate investment. In addition, banking development appears to have a separate but also positive association to growth. These findings confirm Joseph Schumpeter's 1911 insight that the services provided by financial intermediaries are essential for technological innovation and economic development.

Two strands of underlying assumptions must be made explicit at this point in the argument. First, what are the links to poverty alleviation ? My many years in the development field have convinced me strongly that there will be no widespread upward economic mobility without a dynamic economy. This is no crude "trickle down." In a large assortment of developing countries, Gary Fields could find only one instance where rapid growth had not been accompanied by improvement for the poor, that of the Philippines under Marcos. In all other cases growth and poverty alleviation went together. The functioning of the labor market is the driving force. Nothing new here. As demand for labor in the secondary and tertiary sectors draws people out of agriculture and other low-productivity areas their real incomes rise and many cross the poverty line. Later, as output and productivity growth are sustained, real wages in the advanced sector rise and terms of trade improve for consumers in the rural areas. This has been the case in all the successful East Asian economies. Conversely, I am not aware of an economy which stagnated over long periods and where the lot of the poor improved. I am not saying that micro efforts at poverty alleviation such as rural development projects cannot help, but they touch only a small fraction of the poor population and eventually will not be sustained in a stagnant economy.

The second assumption is that macroeconomic policies are reasonably adequate and stable. When serious macro imbalances exist, neither sustained growth nor poverty alleviation nor any other desirable social objective is likely to be achieved. The Mexican crises of 1982 and 1994 illustrate the devastating effects which macro imbalances can have on the poor. The first ushered in the "lost decade," the second has already destroyed hundreds of thousands of jobs as well as thousands of small and medium enterprises which, in any country, tend to be most vulnerable. To use a simpleminded image, electric power will not help so long as there are lots of naked crossed wires in your house, but is that an argument against electricity ?

Let me close this parenthesis about underlying assumptions and return to the links between capital markets and poverty alleviation. The points I made are that developing country firms need capital markets even more than do firms in the industrialized countries and that stock market development is positively associated with overall growth rates.

II. The reorientation of government resources in favor of the poor is greatly facilitated by the existence of an active securities market

I think that a consensus has solidified by now that the proper role of government is to do those things which the private sector cannot or will not do. This consensus has become more pragmatic than ideological. Scarcity of financial and human resources of most governments, and not only in developing countries, means that governments which are carrying on as usual are likely to be unable to finance sustained growth or to look after the needs of the poor. The private sector cannot provide national security, respect for the law, contract enforcement, or the necessary supervisory institutions. Nor will it provide infrastructure, including education and health, to the poor, especially in the rural areas; hence the consensus that development demands a redeployment of government resources away from commercial activities and subsidized services to middle classes, so that the poor can get a better deal. Well-functioning capital markets are close to being a *sine qua non* to redeployment in favor of the poor. Here are a few cases in point:

- Privatization. It is hard to see how governments can sell a significant amount of assets without a functional stock market. Indeed, a synergy exists between privatization and capital markets development because the sale of state assets provides a tremendous impetus to stock market activity. Quite apart from freeing government resources for redeployment to the poor, privatization has positive overall welfare effects, as illustrated in twelve case studies by the World Bank. Furthermore, mutual funds can make privatized assets available to small savers. Because they are listed and tradable or opened-ended, they are liquid and, therefore, convenient for households.

- Private infrastructure. Infrastructure investment also reinforces stock market development and vice-versa. In Argentina, infrastructure investments now represent a major share of capitalization. As loss-making and/or inefficient airlines, ports, power companies and so forth are privatized, governments can devote more resources, including infrastructure investment, to the poor. Furthermore, as the private sector invests in new infrastructure, this also contributes to overall growth. The elimination of long and pervasive power outages in the Philippines by means of private investment clearly benefits society, including the poor.

- Private pension funds. The lack of long-term savings instruments is holding back investment in developing countries. Private pension funds can help greatly to establish and develop a market for long-term domestic financial instruments. Chile has shown the way and several other countries are emulating its example. The Chilean system makes for a viable replacement of the pay-as-you-go systems which are no longer viable in many countries. It also makes for more equitable distribution of pension resources. In Brazil and Mexico there is resistance to adoption of a Chilean system because, under the existing systems, some groups get substantial pensions while many of the poor get nothing; reform would greatly improve the distribution. By making possible more investments in private infrastructure, among others, such savings contribute to long-term growth. Private pension funds can be designed to benefit the poor directly, when as in the case of Bolivia, all adults receive a share of privatized assets in the form of future pensions.

The overall importance of banks to the poor requires, I think, no elaboration. Just think of the most recent Mexican crisis to which the weakness of the banking system was a major contributing factor. Banks which are burdened with bad debt are clearly less likely to lend to small and medium enterprises or indeed directly to the poor than are healthier financial institutions. The Mexican crisis highlights the extreme importance of strong prudential regulations.

I now turn to the second part of the presentation which deals with micro aspects of the subject and is much briefer. The gist of it is that the development of capital markets and financial institutions can greatly facilitate upward economic mobility. Indeed, it is often the essential lubricant. The emphasis shifts away from securities markets to banks.

Clearly such institutions can play an important role, getting the poor out of the high rates charged by money-lenders some areas are so poor that they can't even support money lenders. Indeed, the development of micro-banks and the like is a standard activity on the part of development agencies. But I am not considering such institutions only as means to finance economic activities including investment.

The first point I would make here is that such credit institutions are unlikely to endure unless they are run without subsidy. If this view is correct, the Bolivian micro banks are a better bet than institutions such as the Grameen bank which one cannot expect to be readily duplicated. I believe that the argument is valid not only because banks require sustainable sources of funding rather than continuing dependence on the aid community, but also as far as the terms of lending to the poor are concerned. Owners and managers of such banks face an ageold ethical problem: should the poor pay market interest rates? Often such moral scruples lead to below-market loan pricing. This helps borrowers in the short term but may prevent the emergence of competitors, hence more pervasive development of lending to the poor. What I would call the social attitude to loan pricing neglects another crucial dimension of the link between poverty and finance, and that is the willingness and ability of the poor to save.

The idea that the poor don't save is a myth. India has a higher savings rate than the United States, as does China, Indonesia, Kenya, Honduras, Zimbabwe, Côte d'Ivoire, Sri Lanka, Philippines and Morocco, among other low-income countries. This is also a myth for poor households living in developing countries. What poor people lack are nearby institutions and credible instruments. Savings in mattress cash, gold, jewelry and real estate do not contribute as effectively to development as savings in financial instruments. Few rural banks exist and most of those that do serve as conduits for public funds rather than as capillaries capturing small savings. Sometimes communities organize their own institutions such as the *tontines* or savings clubs in West Africa. I am pointing here to the existence of a sizable, largely untapped savings potential which could contribute to investment and also provide many poor families with greater security. Besides rural savings banks, leasing companies can play a very useful role in financing small investments because they require no collateral other than the leased equipment. Such institutions will develop only if the word subsidy is stricken from the vocabulary of the however well-meaning designers of financial institutions. In conclusion, the road from Wall Street to Timbuktu may not be all that long. Capital and financial markets are an essential integral part of an economy, in the absence of which long-term growth and poverty alleviation are much harder to achieve. In the course of development, as societies move from barter to the ever-more-sophisticated use of currency, and as property rights move from communal to individual, transaction costs decline. The development of a capital market and of financial institutions is the institutional counterpart of this natural evolution. This is also true also for transition economies which, for decades, saw their development stunted in part by atrophied financial institutions.

THE DEVELOPMENT PROCESS AND DEVELOPMENT POLICY: WHAT HAVE WE LEARNED?

by

Gustav Ranis

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In assessing whether or not policy works, I think it is terribly important to be sensitive to typological differences among countries and most important — as well as most critical — to be clear about the time dimension. In this context it is relevant to note that much progress has been made, both analytically and in terms of policy prognosis, in shifting from cross sectional analysis, with every LDC representing a timeless observation point, to the recognition that differences in institutional and initial conditions, as well as in historical time, can make all the difference in how we assess a country's potential for policy change and how we go about assisting a country in the execution of such change. In other words, what I believe is essential is an evolutionary approach to analysis and policy making as a system moves from its agrarian origins to modern economic growth through various subphases. In this context, I find it useful to think of policies as obstructing, or accommodating this journey through the subphases in the spirit of Simon Kuznets. This is what makes it essential for the analyst and policy-maker to be extremely sensitive to differing initial conditions, as well as to the particular subphase a given country has reached before accommodating policy advice can be very useful.

Important dimensions of these initial conditions include the particular colonial legacy, in terms of the physical and human infrastructure left behind, the strength of the natural resource endowment relative to human capital, as well as the strength or weakness — and homogeneity — of the population. Favorable conditions provide the essence of organic nationalism as opposed to the government's need to resort to synthetic nationalism to try to tie disparate peoples and languages together. All this makes a good deal of difference to the burdens placed on a government trying to emerge out of its dualistic agrarian condition, and affects, as well, the character of the subsequent import substitution subphase. Nor is this irrelevant for today's developing world since many sub-Saharan African countries, as well as a few in Latin America, still find themselves essentially under conditions of agrarian dualism.

Import substitution usually starts during the late agrarian dualistic period, as comparative advantage and transport costs — especially when the domestic market is large — induces the construction of some urban industrial activity, often in competition with domestic rural industry and services of Z-goods. This, combined with mounting foreign exchange shortages, often leads, in an evolutionary sense, to import substitution which is then assisted by a well known policy syndrome pushing the system into an internally oriented and relatively inefficient subphase of development, characterized by the relative neglect of agriculture and human resources and the beginnings of the search for rents.

Unlike Chicago School adherents, who view this phase as a policy mistake from beginning to end, I would suggest that it is a necessary element in an evolutionary process during which colonial flows are restructured and infrastructural investment, along with import substituting industrial investment utilizing the sheer brute force of savings, often assisted by foreign aid, is the driving force. Analysts and policy makers have, however, an important option to be considered, which is to keep this period relatively brief and relatively mild in terms of the extent to which interest rates, exchange rates, agricultural neglect, protection, etc., are practiced. One can, for example, avoid completely destroying Z-goods, already under pressure during the agrarian period, and now threatened by "unfair" competition from favored import substituting urban industry. One can avoid undue deterioration of the agricultural sector's terms of trade: and one can, quite early, even during import substitution, keep financial market from being too repressed. One can also shift from quantitative restrictions to tariffs, even at this early subphase of development. And perhaps most importantly, one can already emphasize primary education in anticipation of the economy's future requirements on the human capital side.

It is well understood that once this early import substitution subphase reaches its inevitable end, society has a difficult economic and political-economic decision to make. Given the habits that have grown up inevitably, to some extent, in terms of rent-seeking behavior on the part of new industrialists, organized labor, and the civil service, it is, of course, easiest to maintain the import substitution syndrome by moving upstream, i.e., towards the production of consumer durables, capital goods, and the processing of raw materials at home. On the other hand, a minority of countries, i.e. the East Asians, faced with somewhat lower resistance from the vested interest groups, given their relatively poor natural resources endowment, were able to shift in an evolutionary fashion towards human capital displacing natural resources as the new vent for surplus.

In addition to macroeconomic stabilization on the fiscal, monetary and exchange rate side, specific structural policy changes, I believe, should clearly be under consideration during this more open economy-oriented export substitution subphase. This includes increased emphasis on human capital, especially primary education, since external competitiveness now becomes a critical phenomenon, even as the domestic economy continues to be substantially protected. It also means the possible deployment of export processing zones and import duty rebates as transition devices in achieving the objective without yet opening the entire economy up to international competition. It should also be noted here that agricultural mobilization in tandem with the new labor-intensive export orientation is critical and needs to be assisted by institutional investments such as farmers' associations, cooperative banks, agricultural research, extension, etc. It should be noted that in Taiwan, for example, the initial labor-intensive export push was initially not focused on apparel and textiles, but on agricultural products, in particular the exploitation of mushrooms and asparagus, labor-intensive crops, labor intensively produced and labor intensively processed and exported.

If the system moves vigorously through this early export substitution subphase, it will ultimately exhaust its unskilled labor vent for surplus and shift towards a higher skilled labor composition of production and exports. At this point, policy calls for increased emphasis on secondary education, i.e., a shift in compulsory education from six to nine years and from academic to vocational education at the secondary level (Taiwan, for example, was characterized by almost 60 percent of secondary education being in the vocational track during the 1970's). It also means more policy attention needs to be paid to R&D, preferably emphasizing so-called blue-collar innovations which can be encouraged by the adoption of the utility model of patenting, which has a lower threshold and greater accessibility to medium- and small-scale firms. At this point also, with capital requirements of industry rising, credit institutions and financial markets generally must be given more attention, all part of an evolutionary response to the changing requirements of the economy as human creativity and international competitiveness become more and more important. To the extent that medium- and small-scale firms can participate in R&D with the help of public sector institutions, the latter are forced to gradually increase the share in their budget deriving from private sector contracts, while R&D in larger firms can be encouraged by tax policy as an important ingredient in this subphase. The recent controversy surrounding the World Bank's East Asian Miracle study focused, among other things, on the role of directed credit mainly during this particular subphase. In my view, the most relevant period in Japan's development experience was entirely neglected in this study, i.e., the period between 1880 and 1930, when directed credit of the type practiced more extensively in Korea, and then in Taiwan, was not a major feature of Japanese financial markets. Industrial policy, which, even in the post-war period, i.e. in the heyday of MITI, is probably much exaggerated, remains a questionable tool at the micro level. This does not mean that some repression of credit markets is not acceptable, but it does mean that the ability to direct credit to particular industries and firms by planning commissions, finance ministries and development banks should continue to be questioned. The real secret to success during this late export substitution subphase is rapidly increasing entrepreneurial opportunities abroad and a slow but gradual dismantling of remaining restrictions, including protectionism, at home — now that entrepreneurs' competitive teeth have been sharpened abroad. It also means that the dynamic component of the domestic Z-goods activity, merging into the system's small- and medium-scale industries, can now be creatively linked up with larger scale urban industry in a complementary rather than competitive fashion.

Finally, as the system enters its ultimate transition subphase, i.e. what might be called a science and technology-dominated period, its dualistic characteristics have really disappeared. Agriculture has become mechanized and become just an appendage to the economy, while in the non-agricultural sector we find an increased complexity of both investment patterns in production and in export structure, implying an increased demand for human capital of the high-tech variety, along with R&D, requiring additional science and technology infrastructure. It also requires much more work on perfecting financial and foreign exchange markets so that foreign capital and technology can be deployed effectively in the contest with other countries either already in modern growth or en route, in a global product cycle context. Accommodating policies, in other words, have to focus now on the perfection of the financial markets to enable small- or medium-scale savers to be able to channel their resources into larger-scale projects as economies of scale become more pronounced within the industrial structure. Secondly, it requires continued resistance to monetary expansion on the part of government in the effort to promote growth, while moving towards more central bank independence. It is in this subphase that the gradual depoliticization of the economy in terms of the role of direct government interventions becomes a virtual necessity as a consequence of the enhanced complexity of industrial activity and should be added to the six famous Kuznets characteristics of modern economic growth. In other words, while policy early on already had to focus on fiscal and monetary stabilization and on an exchange rate maintained at a fairly realistic level, policy attention now needs to be focused less on agriculture or industry specific interventions, and more on institutional infrastructure. This is to assure that the various markets which need now to be increasingly relied upon have been substantially perfected by government action and, most importantly, that the system has an adequate supply of high level manpower emerging from its engineering and science-oriented institutions at home as well by drawing on brain drain ÈmigrÈs abroad, as the East Asians have done.

A word on what happens to the relationship between growth, income distribution, poverty reduction and human development in the course of this transition through the various subphases may be helpful. Here again it should be clear that if policies are accommodating in the sense of inducing the fullest participation of the human agents at as early a stage as possible, this simultaneously improves the distribution of income and reduces poverty. Growth is required to sustain improvements in poverty over time. The combination of a good distribution of income and poverty, in turn, through the government social expenditure pattern, along with household expenditure patterns, yields inputs into the improved basic bottom line of human development as summarized by life expectancy and infant mortality, etc. The relationship between human development and economic development is clearly a two-way street. The way income is generated and then deployed by public and private agents yields improvements in human development. Human development which represents the end product also is, in turn, an intermediate product in terms of combining with investment, institutions and the policy environment to yield growth of the right type in the reverse casual order. Such a general equilibrium relationship can be viewed as a virtuous or a vicious cycle depending on the strengths or weaknesses of various links and the way in which growth is generated through the various subphases as accommodated by policy change and the way in which these are then deployed to yield human resources feeding back into next year's pattern of growth.

A final word on my views on conditionality and the role of foreign capital, including foreign aid may be useful. I am a strong believer in the idea of "self-conditionality", i.e., that there is absolutely no substitute for a developing country itself determining what it needs to do in terms of policy change over a period of time, say 3 to 5 years, and then approaching the international community for assistance in achieving those goals. Obviously two conditions have to be met in this context. One is that the country indeed comes up with a good enough policy package of what it needs to do and may in fact require and seek outside help in putting such a package together. Second, there will, of course, be a need for some negotiation once the proposal is advanced by the recipient country. But the important thing is not that an official request is made or a letter of agreement is signed, but that the country itself is quite convinced at the outset of what it needs to do and that the conditionality which is then set is fully accepted as desirable and necessary by the recipient. In other words, the donors, while they can be expected to maintain traditional annual aid programs country by country, i.e., business as usual, should also be in a position to reserve some funds for ballooning assistance in cases where the country is the initiating party and the international community the passive party, waiting for such proposals for major policy change to emerge. If this is not done, and we continue with the current type of ritual dance under CG sponsorship that we've been prone to in recent years, the credibility of the whole process will continue to be seriously endangered.

Specifically, the problem is that natural resources and foreign capital, if not utilized in the aforementioned self-conditionality context, may likely have the opposite effect of what is intended, i.e., both can provide countries with the ability to continue pursuing present policies as they tend to take the pressure off and make painful reforms less likely in a political economy context. This has certainly been the case in the 1970's when OPEC dollars flowed freely into many LDC's and again in some cases in the 1980's with the help of public capital. In my view, and contrary to the Japanese position, there is really no such thing as not interfering in a country's decision making process because sending a check really means endorsing the current status quo, which may or may not be satisfactory. The critical policy issue therefore is how to get real agreement on what needs to be done, as well as with respect to the crucial implementation and follow-up stages — and not by pounding the table in one part of the year and pushing disbursements in another — but by being able to keep some of one's powder (i.e. resources) dry, exercise greater passivity but then hold people to conditions which were self-imposed and internalized at intermediate as well as high levels of policy-making.

THE EVOLUTION OF DEVELOPMENT ECONOMICS 1960-1995

by

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We have just finished revising the fourth edition our textbook, Gillis, Perkins, Roemer and Snodgrass, Economics of Development, for publication by W.W. Norton next spring. The first edition appeared in 1983. Our quadrennial review of the field of economic development offers a good perspective for reflection on the changes that have occurred in economic development, which is what the organizers of this conference have asked me to do.

It is not easy to summarize changes in this field in a short, after lunch talk. Economic development is a synthetic field, within which many different sub disciplines of economics are brought to bear on the economics of a particular group of economies. A development economist might be trained in monetary, fiscal, trade, labor, human capital, welfare, or any of a number of other subfields in economics. The ranks of development economists have been augmented in the past two decades by economists who have been trained principally in other specialities within economics, and other social scientists have also taken a more active interest in development. These migrants have brought new insights and precipitated some profound changes in development economics. On the whole, professionals interested in development are probably better trained in basic disciplines today than was true 30 years ago.

This synthetic, eclectic nature of development economics has an implication for anyone trying to survey changes in the field. To be fully informed, one would have to be an expert in perhaps eight or ten specialties. Very few of us are so comprehensively trained, and I am not one of them. So in this review I will have to cover several developments of which I am only a casual observer and in which many of you may be better informed.

A second major influence on development economics is simply the passage of time. We have accumulated a lot of experience in the past 30 years that was, obviously, not available to observers in 1960, and this experience has changed the way we see the world. Among the most profound influences, more or less in chronological order, have been the successes of the East and Southeast Asian countries, especially contrasted to the failures in Latin America and Africa; the external shocks of the oil and debt crises; the impact of the fall of communism; and the outcomes of an accumulating number of economic reform programs.

This accumulation of experience has even caused us to redefine the scope of "development." We once dealt with a more or less homogeneous group of developing economies. This group was never as uniform as we sometimes pretended, even within the major regions of the world. But as some have grown far faster than others, any pretense of homogeneity has to be discarded. The earliest development economists tried to restructure the developing countries in the image of the industrial countries.

But today we wonder whether the laggard developing countries can emulate the successful developers of East and now Southeast Asia. Moreover, to the original group of developing economies we have added transitional economies, in which we see some of the same problems but in a mix so different that many of the accepted prescriptions may not be effective.

To limit the scope of this talk and give it some focus, I will concentrate on changes in six areas: (1) the role of markets versus that of economic structure; (2) the operation of factor markets, particularly of labor markets; (3) the importance of short term macroeconomic stability; (4) environmental sustainability; (5) economic growth and poverty; and (6) politics as a concern in economic development.

I. Markets versus structure

Probably the most far reaching change in thinking about economic development since the 1960 has been the shift away from structural determinism towards market behavior as a starting point for both theory and practice. In 1960, and for several years thereafter, structuralists dominated the field. The two influential contributions of the 1 950s, Paul Rosenstein Rodan's notion of the big push[66] and Albert Hirschman's contrarian argument for *unbalanced growth,* were both based on structuralist assumptions and called for central economic planning to speed development. Growth theory emerged in the 1 940s as the one sector Harrod-Domar model in which the key relationship was the fixed relationship of the capital stock to output, the capital output ratio. The most sophisticated multi sector model was the Leontief input-output model with its fixed coefficients and lack of substitution among inputs.

In between these two was the model that was most influential for a decade or more among aid agencies, the *two-gap* model of Hollis Chenery, Dale Jorgensen and others. Those of you old enough to have used it will recall that the two inputs in the model, capital (really investment) and imports bore a fixed relation to output and that exports were determined outside the model. All of these approaches were very much in the spirit of Keynes: demand (in the form of growth targets) drove and supply followed. When I was at USAID in the late 1960s, I recall trying to explain the two gap model, in which I considered myself an expert, to a colleague who had been trained at Chicago. He was baffled by it: Keynesian systems and fixed coefficients were against his religion. At the time I considered him a Philistine, but after a while I began to see his point of view.

After all, the two-gap model takes the exchange rate right off the table as a tool in managing development: if export growth is determined by world markets, rather than by domestic supply conditions, there is no role for relative prices. Nothing symbolizes the changes in the field so much as this: think about economic development today without the exchange rate in a central role; or interest rates, for that matter, because they play no explicit part in the Harrod-Domar model.

[66]It is a fine irony that Rosenstein Rodan's articles on the big push were based on his observation of Eastern Europe just after the war. Then western development thinking and aid programs abandoned the communists bloc until, fifty years later, we are now back to substantial interest and aid programs in Eastern Europe.

Structuralism had far reaching implications. It linear models implied that only one constraint could be binding at any one time, which encouraged a series of shifting one factor explanations for development. First capital and then foreign exchange were the single factor explanations that on which the golden age of international aid programs was based, from the Marshall Plan through the 1960s. Structuralism also led to export pessimism, as expounded by Raul Prebisch, and the era of inwardlooking, import substituting development. Modernism in all its forms, including big scale agriculture and capital intensive industry, was another manifestation of structuralist thinking. And because existing economic structures were thought to resist change and slow development, structuralism gave intellectual support to state interventions in the economy. From the perspective of 1995, it seems hard to credit the importance that governments and aid agencies including USAID used to place on five year plans to guide development.

The attack on structuralism in its many guises probably began in the 1950s with Solow's neoclassical growth model, followed by Shultz's defense of the small farmer and his promotion of human capital as a factor contributing to economic growth in the early 1960s. Towards the end of that decade and into the 1970s, trade theorists including the Williams College faculty (financed by USAID), Bela Balassa, Jagdish Bhagwati and Anne Krueger (also financed by USAID), and the Oxford group under Ian Little, Tibor Scitovsky and Maurice Scott directed a withering fire at import substitution and established the outward looking strategy as the theoretical favorite, at least among U.S. and British economists.

Underlying all these contributions was the neoclassical notion that productive inputs could be substituted for each other to a point; that relative prices were the incentive signals that would guide profit seeking producers and utility maximizing consumers towards economically efficient outcomes; and, crucially, that markets, freed from government intervention, would be more effective in achieving development than inward looking, statist approaches.

The structural adjustment agenda followed by a little more than a decade the neoclassical attack on structuralism. Note that structuralism has not disappeared, and indeed neoclassical economics contains elements of it. But the presumption has been reversed. Today we think of market mechanisms as not only helpful to development, but as central to it. And where structural impediments to efficient markets exist, including externalities, the task is to remove them or to create new market institutions to overcome them. Government still has a major role in market focused development, but that role is to enhance markets rather than to interfere in their operation.

This reversal of the roles of government controls and market mechanisms has given rise to much of the reform agenda that has occupied development economics over the past decade. Trade reform, especially the deregulation of imports but also tariff reduction, has been a high priority since the mid 1970s. Privatization has been an important means of removing government from productive activities. Financial market development has been high on USAID's agenda because efficient credit markets are essential if market driven investments are to be the main engine of growth. Both of the latter two reforms became more urgent when the former communist states began moving towards market economies.

As markets became the central feature of development economics, our models have evolved to accommodate substitution and relative prices. The computable general equilibrium model is today's model of choice, one that can incorporate the structural features of its predecessors in a structure based on market behavior. Modern desk top computers can now run such sophisticated models with much greater convenience than the room sized behemoths of the 1960s that churned out Leontief models.

II. Factor markets

Perhaps the most influential early contribution to development theory was W. Arthur Lewis's notion of surplus labor, proposed in the 1950s. Surplus labor arises if the rural work force is large relative to the demand for labor in modern industry, so the supply of labor is perfectly elastic. This theory was elaborated in the mid 1960s by one of tomorrow's speakers, Gus Ranis, and John Fei, who suggested that surplus workers in agriculture would be paid a wage based on average rather than marginal revenue product, because their marginal revenue product was too low to sustain life. Put this together with an industrial wage based on a substantially higher marginal revenue product or on a legislated minimum wage and the familiar characteristics of developing country labor markets follow:

- surplus workers from agriculture can be withdrawn for industrial employment without a drop in food output, implying low or even zero marginal product;
- because labor rising population cannot raise food output, population growth further impoverishes the rural population,
- high wages in industry attract more workers than can be employed, leading to entrenched, structural urban unemployment, a phenomenon captured by the Harris-Todaro model of the 1970s;
- growth of industry leads to a worsening of the income distribution for a period; and
- savings are low in low income agriculture and higher in industry, so that unless industry can be pushed to rapid growth, the economy gets trapped in a low growth equilibrium.

The Lewis-Fei-Ranis model and its Harris-Todaro extension was based on market behavior. But it depended on institutional rigidities the payment of average wages in agriculture and of a legislated minimum wage in industry so was not strictly neoclassical. There were always neoclassical critics who argued that the marginal wage in agriculture was positive, so that higher demand for industrial labor would raise agricultural wages. Nevertheless, the surplus labor model seemed to describe reality in most developing countries during the 1960s.

Three developments of the 1970s changed the way we think of labor markets. First, the rapid growth of Taiwan and Korea showed that labor surplus could be eliminated rapidly, even in countries with poor agricultural bases. Second, anthropologists (Keith Hart, working in Ghana) and economists(an ILO mission to Kenya)
"discovered" the informal sector. This "missing link" in the two sector labor surplus model opened the possibility that rural workers flocking to the cities did not face unemployment, but rather moved into low wage work in simple manufacturing and, more likely, in retail trade and other services. The informal sector introduced a neoclassical continuity to the nearly dichotomous labor markets of the surplus labor model.

The third development was the introduction of a new theoretical concept from microeconomics asymmetric information to give a firmer theoretical structure to the Harris Todaro model. Joe Stiglitz, who introduced this notion to development, also used a concept that comes from the development literature, the effciency wage, to construct a more satisfactory explanation of industrial wages that are a multiple of the informal sector (or agricultural) wage. If we assume that higher wages can lead to higher productivity through better nutrition and improved living conditions, then firms might pay higher than market wages to increase productivity. However, managers have only a vague idea of how productive a worker might be, while the workers have a better idea of their own capabilities and only they know their own intentions. This asymmetric information can lead employers to attempt to cream the labor market by hiring new workers on a temporary basis, trying them out for a period, then keeping only the most productive ones. To do this they require a large pool of potential, i.e. under or unemployed, workers. Hence employers might willingly pay an above market wage both to have access to the best workers and to keep the unemployment pool large. This is a much more satisfactory explanation of labor markets than that of Harris and Todaro. Although rooted in neoclassical economics, it incorporates features that lead to the entrenched unemployment (or low wage, informal sector employment) that we observe in many developing countries.

Stiglitz also applied the notion of asymmetric information to credit markets to explain why bankers may willingly keep interest rates below market clearing levels. In this case, the asymmetry is in knowledge of the riskiness of a loan: borrowers have a better idea of their ability and intent to repay than do lenders. Stiglitz also applies the efficiency price concept, in this case to argue that at higher interest rates only those incurring higher risk can afford to borrow. Put these two notions together and you can see why bankers might choose to keep the pool of potential borrowers large by offering cheaper credit. Not only will they then have lower risk borrowers in the pool, but they can also be more selective in making loans. This argument has been used to justify the Korean and Taiwanese uses of moderately repressed interest rates and directed credit during the 1960s and 1970s, but has not been generally accepted as a prescription for other countries.

III. Macroeconomic stability

The development literature the early 1950s through the mid 1970s was virtually silent on issues of macroeconomic management, for at least two reasons. First, the structuralist bias virtually ruled out the principal instruments of macroeconomic control, the exchange rate, money supply, and budget balance. Second, economists were preoccupied with long term issues, especially the determinants of economic growth, perhaps in reaction to the previous focus on short term, Keynesian issues of the inter and immediate post war periods. When Ed Shaw headed the Harvard advisory group in Ghana in 1970, he and John Gurley were struggling to introduce monetary economics into the development field. We all got a big laugh from a tro tro, a forerunner of the minibus, painted with the legend, "Money matters," which was Ed's continual if unheeded theme. The World Bank did not touch macro issues in those days, not even devaluation.

Not everyone ignored macro management. USAID had invented program loans in the 1960s and had made the crawling peg the centerpiece of at least one development program in the late 1960s, that of Colombia. The Harvard group in Ghana was deeply involved in a devaluation of the cedi in 1971, possibly a forerunner of structural adjustment programs in Africa. (That devaluation was followed, less than two weeks later, by a military coup that set in motion a decade long decline of one of the richest economies in Africa.) And of course the IMF made the rounds of developing countries and preached its brand of monetary based economic management. But such efforts did not make much of an impression in the literature, or even on most development practitioners. Even when the neoclassical attack on import substitution gathered steam, the early works on export promotion dealt primarily with tariffs, NTBs, and the exchange rate, and hardly at all with monetary and fiscal policies.

By the early 1980s, however, both the rise and fall of oil prices and the emerging debt crisis made it clear that poor short term macroeconomic management could thwart economic growth, even (perhaps especially) in countries favored by high commodity prices. The last decade has been dominated by issues of stabilization and structural adjustment, both in theory and in practice. Recent econometric work by Stanley Fischer suggests that sound macroeconomic fundamentals low inflation, low budget deficits, and low black market exchange rate premia have been a necessary condition for rapid economic growth over the past 30 years, though not a sufficient condition. IMF programs are now prerequisites for aid from other donors. World Bank structural adjustment loans have received more attention than any other form of aid for the past ten years and bilateral agencies, including USAID, have considered it essential to participate in the macroeconomic policy dialogue. A World Bank study by Dani Kaufman and others has shown conclusively that the returns on Bank project loans are significantly higher in countries that also have a favorable macroeconomic environment. This macro first approach would appear to be the reverse of the structuralist school, which focused on large scale projects and might have argued that project loans are needed to change economic structures before traditional macroeconomic management could be effective.

Recent developments in international financial markets have made sound macroeconomic management even more essential. First, since the early 1980s there has been a shift of foreign funding for economic development away from both official aid and commercial bank loans towards private investment, but direct and portfolio investment. Second, the logic of market reforms and the greater dependence on foreign investment has dictated a much more open capital account for developing countries. Currency convertibility is becoming more the norm than the exception it used to be. Third, and partly as a consequence, international financial markets have become much better integrated, so that funds can be moved readily from one market to another. Macroeconomic imbalances can be exploited much more easily today than ten years ago, as the Mexican crisis demonstrated. In the new world of integrated financial markets, macroeconomic stability has itself become an integral part of any development strategy.

One other implication of integrated world financial markets might be worth a separate discussion: we have truly entered a world with one price for capital, with a highly elastic supply of funds to any one country. In this situation, a country is not free to set its interest rates at any level it chooses, nor is it free to tax capital at any level. With high capital mobility, the incidence of such policies is more likely to be on other factors of production, on land and especially on labor.

IV. Environmental sustainability

Rachel Carson published *Silent Spring* in the early 1960s, and the environmental movement gathered steam slowly thereafter. But environmentalism hardly touched the developing world or the development profession until the 1980s. The concept of sustainable development is a recent invention, but now is at least a part of, if not yet a motivating factor behind, most development programs.

Not only has sustainable development become a popular concept in recent years, but our notions of how to achieve it are also being transformed, perhaps belatedly, very much along the lines of the structuralist market transformation of development economics. Environmental degradation is largely the result of market failure, specifically the inability of markets to handle the external costs of exploiting common property resources. A natural reaction to market failure is government regulation, and regulation has been the dominant approach to imposing environmental values in the industrial world. Lawyers and regulators have been the main players.

But economists are reconsidering this approach. First, not all environmental degradation is due to Market failure; much of it can be traced to mistaken government policies such as subsidized production of goods that use natural resources or pollute the environment. Second, even if regulation is necessary and can be successful in industrial countries, it seems fanciful to suggest that most developing country governments have the capacity to enforce environmental regulations effectively. After all, government failure has been a constant theme in developing countries.

Third, economists have been inventive in showing that market means can often be more effective than regulation in correcting market failures. Property rights can be awarded to private agents who will then, as profit or utility maximizers, act to exploit common resources optimally for society. This can be done by conferring monopoly control over common resources to private agents who are allowed to maximize their rents; or by creating rights of access fishing or forestry licenses, rights to emit a certain level of pollution to private producers who in turn are allowed to sell these on the market. Property rights do not avoid the need for regulation, but reduce its scope and impact in ways that may make it feasible for more developing countries to manage their resources, including the environment, sustainably.

V. Growth and poverty

I confess to being astounded that we even have to debate the question of whether economic growth reduces poverty, but in fact this has been a contested issue since the beginning of development economics. Most of the debate has centered, not on poverty, but on income distribution. One implication of Lewis's labor surplus model is that income distribution will first worsen, then improve, as the modern sector grows and absorbs workers from low wage agriculture. And of course the Kuznets curve showing that middle income countries have less equal income distributions than poorer or richer countries has been taken as empirical proof that income growth worsens income distribution. But more recently the issue has become poverty as stabilization and structural adjustment have come under attack because of their supposed impact on the poor.

Thirty years of development have taught us a few things about poverty and income distribution. One of them is that the worsening of income distribution is not a necessary phenomenon. Kuznets' observations depend heavily on the circumstance that many of the middle income countries happen to be in Latin America, where income distribution is less equal than on other continents. Put in regional dummies, and the inverted U is much weaker. Moreover, time series data on income distribution, though rare, show all three possible patterns: rising, unchanging, and falling inequality with growth. Finally, cross country regressions show a strong inverse correlation between either the income of the poor or the incidence of poverty and the level of per capita income. The most important reason why people are poor is that they live in poor countries. Raising average national income, whatever happens to income distribution, reduces poverty. And if econometric results do not convince, there is an increasing number of cases in which rapid income growth has reduced the incidence of poverty. My favorite is Indonesia, one of the world's largest and poorest countries in 1970s, where income growth of 4 percent per capita has reduced the incidence of poverty from over 60 to under 15 percent of the population in 25 years.

The harder case to answer is that directed at stabilization and structural adjustment. As already noted, stabilization appears to be a precondition for rapid growth and structural adjustment is today's consensus strategy for moving from stabilization to growth. Yet these approaches are under fire because they are supposed to make the poor worse off. This argument can be refuted, but it requires a counterfactual or "what if" proposition. It is illegitimate to compare the position of the poor after economic reform with their position before reform, because the conditions that make reforms necessary are also likely, if unchecked, to harm the poor. Rather, it is necessary to compare the position with reform against the position after reform would have taken place but did not. The latter cannot be observed, of course, although economists, some sponsored by USAID, have made valiant efforts to construct such scenarios through CGE models. Selling counterfactuals to the public, especially to groups opposed to structural adjustment, is no easy task. But it is important to try, because sound economic policies may be in jeopardy, and the position of the world's poor seriously compromised, if we fail.

VI. Politics in economic development

In the 1970s, the market minded economists who were arguing for a shift to the outward looking strategy had little patience for an exploration of the politics of economic reform. Anne Krueger was less guilty of political naivete than most of us; her article on rent seeking appeared as early as 1974. Yet in the 1980s even she was still referring to "political will" as all that stood between advice on and implementation of the outward looking reform agenda. In part this naivete reflected the uphill struggle that economists were having to get their reform agenda accepted by practitioners even in principle: there was little energy left for consideration of the subtleties of governance and politics. In part this apparent dismissal of political economy reflected our comparative advantage as economists. And in part it reflected disinterest by political scientists in development and in economic reform.

None of these conditions prevails any longer. The case for more liberal economies has prevailed and we now have lots of examples of implementation of stabilization and structural adjustment, enough to suggest the importance of political issues in designing economic reforms. Economists began in the 1980s to consider the political economy of reform in more systematic ways and some have joined forces with political scientists, more of whom now study development and economic reform. Consequently, the literature on reform has been substantially enriched over the past decade. We now have a large and growing literature by political scientists on the political conditions that are favorable to implementing reforms and by economists on the sequencing of reforms, both a political and an economic issue. One of the more lively debates in recent years has been on the trade offs between shock treatment versus gradualism, which turns to a substantial extent on the political window of opportunity. It is now possible to cite at least a few hypotheses, all rooted in experience rather than in a prior theorizing, about political situations in which reforms can and cannot be readily carried out. The concept of credibility, at heart another political issue, now infuses our thinking about stabilization and structural adjustment. USAID commissioned a study of the impact of reform on the poor in Africa and economists regularly make assessments about the impact of outward looking polices on various income and thus political groups. Studies have begun to appear on the interaction between forms of governance a continuum running from democracy to totalitarianism and economic development, one in which democracies come out better than had been believed before. These studies are in their infancy, but it has become clear that economists can no longer think of economic growth and reform without considering the political conditions that will make it implementable and, in the long run, sustainable.

VII. Conclusion

The intellectual development of our field has proceeded much like Al Hirschman's process of unbalanced growth The profession becomes convinced and gets excited about a particular departure from past practice, whether it be the addition of foreign exchange as a factor of production, greater attention to poverty or basic human needs, the importance of stabilization and structural reform, the notion of sustainability, or the importance of educating women. Once on the agenda, that new departure is worked intensively by aid agencies and advisers until we begin to accumulate some experience. Gradually the euphoria wears off, sometimes because real progress has been made and the problem seems less acute, more often because frustration and fatigue set in. For whatever reason, a new approach becomes fashionable, many of the profession embrace it, and the cycle begins anew.

This rhythm of intellectual change is healthy, because each of the new approaches is based on a core of truth that adds something to our understanding of development. But at times we seem to careen from one fashion to another, and sometimes back, seeming to focus on only one problem and solution at a time. It behooves us to keep in mind the discarded or deemphasized approaches so that we do not repeat the mistakes of decades ago. It seems to me that, after almost four decades, the field of economic development has reached some core truths that ought to be preserved as we move on to new problems and new solutions. One of these is the importance of economic growth in achieving most of the aims of poor societies. A second is the efficacy of the market as the principal tool in achieving, not only rapid economic growth, but many of the other aims of development. There is much more to development than this, of course. But as we move into environmental sustainability, democratization, a poverty focused development, as we should, it is essential not to lose cite of these core truths.

What might be the next changes in development economics? Looking towards Beijing, it seems likely that women's issues or gender economics will finally have an impact on mainstream development economics. To some extent it already has: the World Bank and others have become enthusiastic about women's education as the most powerful tool in achieving reduced population growth, healthier children, and, perhaps, even more rapid economic growth.

A second change, already begun, is likely to be in the way we measure GNP per capita. The purchasing power parity approach, pioneered by Summers and Heston, has already changed our view of the relative wealth and poverty of nations. Environmentalists have promoted natural resource accounting and a new concept called adjusted net national product that measures the production available for consumption after allowing for both depreciation of man made capital and degradation of natural capital. Such fundamental changes, combined with the emphasis on gender, cannot help but lead to further corrections to GNP accounts, of which the most notable would be accounting for unpaid household work. You probably have other candidates.

EVALUATING FINANCIAL SECTOR DEVELOPMENT LINKAGES TO ECONOMIC GROWTH

by

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USAID development programs are increasingly designed to address poverty alleviation through promotion of non farm sector growth. As economists we provide leadership in analytically identifying programs that most efficiently promote broad based economic growth.

[67]A draft discussion paper prepared for USAID Training Workshop for Economists, Annapolis, Maryland, September 13-15, 1995 in Annapolis, Maryland.

USAID economists within a Program Office are often also responsible for cost effectively estimating program impacts on rural incomes in a transparent and rigorous manner. The difficulty in linking program outputs, such as increased availability of financial services, to people level impacts, such as rural income growth, is increasingly a constraint in reporting and justifying specific development program choices.

Rural financial sector development is expected to provide new employment opportunities primarily to households able to take advantage of income earning opportunities in the non-farm sector. In addition, households located in rural markets well endowed with natural resources and manmade infrastructure are expected to benefit the most from financial liberalization since banks prefer to locate new offices in these types of markets. Since access to credit is a more important issue than price of credit for micro enterprises, financial liberalization is expected to have the most positive effect on the investment rates and capital productivity of firms in well endowed market areas. In summary, financial market development is expected to disproportionately benefit non farm businesses producing nontradable products in well endowed market areas that most likely already have a larger than average non farm business sector.

This paper outlines key issues in evaluating the impact of financial sector development on employment and income generation in rural Africa. There are two general approaches to estimation of impacts. The first is development of a model of a local economy with parameters to be changed as a result of program interventions. Estimates of change in one parameter caused by the interventions can be used to estimate changes in income and employment. This will be outlined in this paper. The second approach is generation of statistical data for a set of local market areas that will allow analysis of employment and income differences between markets with and without development interventions. This second approach is reviewed in Rogers, Shaffer, and Pulver [1988 and 1990], though the data requirements for this approach are excessive in a developing country context. In conclusion this paper proposes that impact evaluation should focus on tracking changes in the production of non tradable goods and services within identifiable local geographic market areas using a combination of these two approaches.

I. Financial sector development and non-farm employment creation

Rural employment generation due to financial market development is expected to Charger in the non farm sector than in the farm sector. This is expected for three reasons: first, new tradable agricultural production stimulates non tradable production, second, non-farm businesses appear be more constrained than agricultural producers by weak financial markets, and third,the ratio of new investment to new employment appears higher in the non-farm sector.

Each dollar of new tradable farm income generates between twenty and eighty cents of new income in the non tradable, mostly non farm, sector of the local economy through a multiplier effect [Rogers,1993]. Since wages are equivalent at the margin in different sectors, this linkage alone can generate significant non tradable sector employment through new local demand for startup and expansion of businesses.

Credit has not been the major constraint to agricultural development it was often presumed to be [USAID, p48]. This may be because agricultural producers of tradable goods are more able to obtain cash from non financial market sources in the form of advance purchase of crops or credit with variable (even negative) interest rates related to farm production outcomes. In contrast many businesses potentially producing non tradables are constrained from starting up by lack of local savings mechanism or from expanding due to lack of credit availability. What is critically important is that development of financial markets can increase the size of the local non tradable sector supported by the local production of tradable products. This means that each unit of new as well as existing tradable farm income can support additional non tradable sector income. Even in markets not experiencing net growth in agricultural production or declines in agricultural employment, financial market development can lead to significant growth in non tradable sector income and employment.

Finally, there is evidence suggesting that investment in existing agricultural production is a substitute for farm labor and investment in non farm businesses is a complement to labor. If this is the case, even though both farm and non farm output increase as a result of financial sector development this means employment in the non farm sector will grow more quickly. This is supported by recent micro economic analysis indicating financial liberalization has a positive effect on the investment rates and capital productivity of small firms [USAID, p49]. Binswanger and Khandker found that a ten percent increase in the number of rural commercial bank branches in India was associated with a 2.9 percent increase in non agricultural employment and a 0.7 percent decline in agricultural employment, in spite of increased aggregate crop output of 0.2 percent.

II. Financial market analysis should be based on geographic markets

As economists we know we need to simultaneously focus analysis on supply and demand for a well defined product in a well defined market. A well defined market has both product and geographic boundaries. The banking business is local in nature due to the importance of geographic convenience. However, the existence of a "local geographic capital market" in contrast to fully integrated "national market" is largely due to the unequal marginal cost of and access to information among markets.

Legal restrictions and differences in access to information cause debt capital markets (dominated by commercial banks) to be largely independent of local equity capital markets (dominated by groups of friends and relatives) for small businesses and specialized venture capital firms for large businesses. Debt capital is generally provided with a collateral guarantee which substitutes for information on the business and borrower. Equity capital is not provided with a collateral guarantee; thus it requires additional information on the borrower, such as is frequently available only to close friends and relatives.

A business that is not well known to local lenders and that cannot provide adequate collateral as a substitute for lender's information may be unable to obtain credit. The lack of this type of additional information is one important reason that commercial lenders do not provide unsecured loans which friends and relatives may be willing to provide. However, in a market with extremely good information flows, equity capital can substitute for debt capital even at a local level. Udry [p23] describes the rural credit market in northern Nigeria in which there is only minimal use of collateral or other contractual mechanisms to alleviate the usual difficulties posed by information access. He concludes that these are not necessary because credit flows through paths that take advantage of the extremely free availability of information at the village level.

The existence of distinguishable geographic credit markets does not imply market imperfections. However, financial institutions serving distinct markets may inadequately assess the creditworthiness of new businesses, service sector firms without tangible collateral, very small businesses, and very rapidly growing firms. The result is that geographic areas characterized by these types of businesses may represent a financing gap. There may be significant gaps in financing by economic sector, length of loan, availability of equity capital, size of business, or geographic location. Access to credit is even more important than price of credit for micro enterprises in the non farm sector [USAID, p49].

Analysis of debt capital markets in rural Wisconsin has shown that identifiable "local" markets exist. Lenders recognize local community boundaries and this spatial grouping results in distinct difference among local debt capital markets. Demand and supply characteristics of local capital markets appear to be highly correlated and both should be included many analysis with and across local geographic capital markets. However, the most appropriate geographic unit of analysis for combining supply and demand side characteristics depends on the type of analysis being conducted [Rogers, Shaffer, and Pulver, 1988].

Important geographic market heterogeneity can occur among community markets that are smaller than the local administrative areas for which data is easily available. If a local administrative area is an inappropriate unit of analysis, the samples and data aggregations used could be misleading for policy analysis. When administrative areas are used as proxies for capital markets, community market heterogeneity may be averaged out through aggregation, causing areas to appear similar. When this happens, local capital markets are judged to be homogeneous and local price variation among local capital markets, which reflects imperfections, is overlooked. Observed equal market prices across aggregated markets can be consistent with important price differentials among smaller market units. The conclusion that there is no price variation across markets has been used as evidence of a "competitive" market for financial market structure policy analysis.

Employment and economic growth opportunities could be lost due to inappropriate policy analysis. Efforts to increase location-specific employment and income generation in agriculture, manufacturing, and service activities require an increased focus on sub national rather than purely national economic development. If local geographic markets continue to exist in a developed economy such as the U.S. then the need to structure financial meet analysis around relevant geographic markets in developing countries is even more important.

III. Impact analysis of financial sector development requires a model

Analysis of the impacts of financial sector development on rural incomes requires a clear model for comparing the "with" and "without" financial development scenarios. To be most useful the model should emphasize potential impacts on the non farm sector within a geographically defined market. In addition the model should be a simple framework that is conceptually complete enough to enable comparisons among different choices of local economic growth strategies.

A model for conceptualizing impacts of development programs on economic growth can define total income in a local economy as a function of six parameters:[68]

Y = regional income =

$$[T*V_1 + T*V_2 + R]/[1-B*V_3]$$

where

T = total value of local output of tradable products, defined as those products for which local supply responds to changes in non local demand or increases in local demand can be met by imports or imports of close price substitutes.

[68]This is a simplified version based on Rogers, Glenn "Modeling the impact of land tenure on local income generation in rural Mauritania" in Risk and Tenure in Arid Lands: The Political Ecology of Development in the Senegal River Basin, edited by Tad Park, University of Arizona Press: Tucon 1993: 125-144.

V_1 = direct local household income per dollar of T

V_2 = non tradable income per dollar of T generated by direct and indirect production linkages, with non tradables being defined as products for which local demand cannot be met by imports, or by imports of close substitutes.

R = net value of household income from outside the region, including remittances, pensions, taxes, or household income resulting from net investment flows or factor income from non local investments by local residents.

B = average propensity to consume non tradables out of household income

This parameter is determined by and systematically varies from 0.2 to 0.75 as a function of per-capita income, household size, prices, and other characteristics of the local economy. Delgado, et al [IFPRI, 1995] estimated this to be 0.71 in Burkina Faso (1985), 0.47 in Niger (1989), 0.50 in Senegal (1989), and 0.76 in Zambia (1986). In rural Mauritania in 1985 this was between 0.30 and 0.40.

V_3 = direct and indirect local value added per dollar of household consumption expenditure on non tradables which is likely to be over 0.80.

This basic model with these six parameters can now be used to estimate the change in local income as any individual parameter changes. Alternatively, the model can be used to define other parameters of interest. In the following section these six parameters will be linked to five potential development strategies used to promote local economic growth.

IV. Strategies for promoting local economic growth

Financial sector development is usually justified in order to promote economic development through a variety of mechanisms. These can include facilitating investment and transfer payments from non local sources, starting new firms, increasing efficiency of existing firms, or increasing the capture of consumer expenditures locally. These five strategies identified by Glen Pulver at the University of Wisconsin Madison to promote local economic growth are discussed below and linked to parameters in the model presented in the previous section:

1. Attract non-local investors to increase production of tradables locally:

Promoting the production of tradable goods locally, for export or import substitution, are important traditional ways of increasing local economic growth. In terms of the model just presented this growth strategy increases R in the short term during the investment and construction phase and may reduce R in the longer term as non local factor payments increase. This strategy is intended to lead to a sustainable higher T based on new production.

2. Increase net transfer payments to and investments in the local economy from broader government and local individuals working outside:

Reducing the net outflow of taxes paid to non local government and increasing remittances of non local residents with ties to the community will increase local income. In agricultural crop marketing the implicit taxes paid by residents of producing areas can be an extremely high proportion of potential local income. In West Africa remittances from workers outside, pensions, salaries of staff in health clinics or schools, and non local property income can be over half of total income in a rural community.

This strategy is focused on increasing R through increasing net remittances, reducing net tax outflows, or increasing the return on non local investments of local residents. Financial sector development may increase transfer payments by making the payment system easier. Alternatively financial systems may allow agricultural producers to sell their crops at a higher price by allowing them sufficient financing for storage.

3. Startup new firms locally for both tradables and non tradables:

It is generally agreed that diversifying the agricultural export base and diversifying the economy across sectors is central to long run growth strategies in Africa. Reducing the barriers to entry for new firms and helping to assure concentrations of threshold demand levels in particular geographic locations are two ways to promote local economic growth through start-up of new firms. It is important to remember that new income earning opportunities can exist locally in the production of tradable goods, such as mining or horticultural crops, as well as in non tradable services such as health care and education.

Until there is a critical level of local demand for a particular good or service it will not be produced locally. Minimum demand thresholds are critical constraints in many sparsely populated and low income rural areas. As local economies grow in size and/or per capita income levels there is an endless sequence of new business opportunities for products not currently being produced locally. The lack of a savings mechanism to allow accumulation of assets for starting a new business is often a critical constraint on new business startups.

In terms of the model presented this growth strategy has three objectives: (1) increase T directly through increased local production of tradables either for export or import substitution, (2) increase V_1 by having new firms be more efficient than existing firms, and (3) increase V_2 and B through making new non tradable goods and services available locally for consumers and producers of tradables.

4. Increase the efficiency of existing local firms:

Increasing the efficiency of existing firms is a third way to generate more local income. Fewer resources used in the local production of goods and services means higher profits per unit of production and increased possibilities for export. Often it is possible to increase the efficiency of existing firms by improving the efficiency of firms that provide business services, such as financial institutions, or transport services. Reduction of transactions costs is an important area for improving efficiency.

This growth strategy can increase V_1 when efficiency is increased in the tradables sector ,or V_2 for business services, and V_3 when efficiency is increased in the non tradable consumer sector. In a second round of effects these changes can increase T through improving competitiveness of local production for export or import substitution.

5. Increase the local capture of consumer expenditures:

A final way to generate local income is to increase the capture of consumer expenditures locally. This can be based on import substitution that shifts local resident retail consumer expenditures from goods or services produced in another market to the local market. Alternatively this can increase local expenditures of non local residents through attracting consumers into the local market for private expenditures on health care, educational services, tourism, other specialized services such as banking.

This growth strategy is focused on increasing V_3 through capturing a higher percentage of resident and non resident expenditures within the local economy. Improvements in the quality of local retail and service sectors can increase the local purchases of goods and services that may have previously been purchased outside the local economy. Educational, health, tourism, and financial services are significant areas where a local community can attract the expenditures of non local residents.

V. Conclusion

Given the accelerating trend toward decentralized governance and developmental decision making, analysis of local economies will be increasingly important. The geographic targeting of programs, either explicitly for poverty alleviation or implicitly through sectoral targeting of geographically concentrated production activities, will also make these analytical approaches increasingly relevant for comparative analysis of sub national areas.

This paper made four key points related to impact analysis of financial sector development:

1. Financial Sector development is expected to lead to larger employment generation in the non farm sector than in the farm sector, so impact on employment should be tracked in the non farm sector.
2. Analysis of the adequacy of financial markets and impacts of financial market development should be based on both the supply and demand sides of the market in well defined geographic and product markets. Analysis that ignores the question of geographic access to financial services will not provide the most useful policy analysis.
3. Analysis of the impacts of financial sector development requires a clear model for comparing the with and without financial development scenarios. A model
4. Financial sector development is critical to ensuring that other economic growth initiatives, such as export promotion or micro enterprise support, result in broad based economic growth.

One test of operational usefulness of this modeling approach for USAID program design and evaluation is whether it helps us more clearly focus analysis of program impacts on local income generation in a with versus without framework. A second test of usefulness is whether it helps us measure fewer key parameters and focus on a minimum set of parameters in primary data collection or use of secondary data.

POLICY REFORM AND THE TRANSITION FROM COMMAND TO MARKET ECONOMY: A CONCEPTUAL OVERVIEW

by

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I. Introduction

The unprecedented political and economic transformations that are being enacted in Europe, the former Soviet Union, China and elsewhere have monumentally important implications for the entire world. Within economics, the importance of the process is evidenced by the attention it has attracted from many of the leading luminaries of our profession. Yet despite its world historic significance, most of the scholarly work on the subject addresses specific aspects of the transition process (e.g. social cost of adjustment, stabilization policy, transport) or the experience of specific countries or regions. (Examples of excellent studies of both kinds are included in both volumes of Blanchard, Froot and Sachs, 1994). Some efforts have taken a general equilibrium-like approach (Pogodzinski and Antes, 1992), Others, (e.g. Olson. 1994, Clague, 1994, Williamson, 1993) have zeroed in on the political and institutional factors influencing the incentives that determine the pace and form of the transition. This work is particularly promising because its focuses on the conditions that provide incentives to authorities to create an environment that promotes a profitable private market system. Nevertheless, there is so far, relatively little work toward the development of a general theory of the transition itself.

A general theory would be useful to governments involved in the arduous work of transition (which is, at least in the early stages, a public sector-intensive process) in planning the work that must be done in order to make the transition successful. Of course, countries involved today in the transition vary greatly in the degree of progress they have made, in the characteristics of the systems from which they started (which determines the distance they must travel to complete transition), and the breadth of support in their communities for the transition. Despite these differences, we contend that the properties of the systems at the end of the transition journey are sufficiently similar that general principles can be advanced that help form the agenda of work to be accomplished in order to make the transit.*

This paper does not create a general theory of economic transition. It does, however, focus on the transition process itself. It envisions that process as one involving a profound change in the relative roles of the private and public sector, and necessitating a broad and deep change in the economic landscape, or structure. These changes occur in two directions. First, looking ahead to the issue of how resources will be allocated in the future, a new, reasonably effective, system of private market - determined relative prices is needed. This call for major legal, regulatory, policy and institutional changes. Second, looking back at the investment decisions made in the command economy, it is virtually certain that (most?) will be found to have been "wrong" when considered through the lens of a market-directed economy. The main manifestations of the "mistakes" of the past will be found in the following elements of structure: (1) product mix; (2) scale of production facilities; (3) factor proportions: (4) location of productive activity: and (5) size, services and organization of the public sector. The two classes of change probably can, and should, be pursued simultaneously, particularly as the correction of most of the past mistakes will be made by way of private rather than public decisions.

II. Looking ahead: legal, policy and institutional changes

Legal, policy and institutional changes required by the transition fall in one of two categories. First are those that provide and oversee rules of the game that are general. These include laws and institutions relating to: property rights; adjudication of economic conflicts; contract integrity and enforceability; fraud, embezzlement and other property crimes; and anti-competitive practices. The second category deals with specific sectors, markets and segments of economic policy.

2.1 *Changes That Transcend Markets and Sectors*. The legal, policy and institutional changes necessary to the transition are, of course, necessary because of the change in the roles of the public and private sectors implied by the transition. In the command economy the public sector directs resources among alternative uses by command. In the market economy, the public sector directly determines output and input decisions over a relatively narrow range of goods, generally those classified ad "public goods." Thus the public sector withdraws from its role of deciding directly the allocation of resources with respect to most "private goods." Having withdrawn, however, it gains the responsibility for creating a environment that induces private entities to engage in specialization, trade

*This paper draws heavily on the author's experience as Director on Economics in the United States Agency for International Development, Bureau for Europe and the NIS (ENI). Nevertheless, the views and opinions expressed are the author's alone. USAID is not implicated.

and exchange with each other, and to save and invest, lend and borrow, outside their immediate circle of personal acquaintances, friends and relatives. The community believes (so the private market story goes) in the social gains from these kinds of voluntary and self-serving economic interactions, so long as there are enforceable and adjudicable "rules of the game" that proscribe anti-social behavior (e.g. price fixing, market sharing, fraud, and theft). But, for this idealized scenario to have any practical relevance, there must be mechanisms to collect information on the tastes and preferences, risk aversion, propensities to consume, save, work and enjoy leisure, of millions of actors, and to transform the information into a set of output prices, input prices, interest rates, exchange rates, profit rates and incomes. Thus the public sector must create a body of laws and regulations that make such private transactions secure and must establish the institutions required to enforce the laws and adjudicate disputes.

2.2 *Changes Related to Specific Sectors or Markets*. Macroeconomic policy influences transactions in the fiscal, financial and foreign sectors of the economy. The changes in policy in each area, and in how it is implemented upon transition, are of sufficient importance to merit separate treatment.

The Fiscal Sector. Transition to a market economy has been characterized above as a major shift in the roles of the public and private sectors. Specifically: (a) the public sector's direct determination of the allocation of resources is reduced to embrace a limited share of total production, mainly, "public goods"; (b) ownership of productive enterprises is transferred to private sector; (c) this privatization process deprives the public sector of its main source of revenue; (d) enterprises, once privatized, cease providing social services to the communities in which they are located, other than those services that are a "normal" part of employee compensation; (e) many of the social services are largely of the kind that would be provided, in a market economy, by sub-national levels of government (e.g. steam, water and sewerage, welfare, education, public health and housing, police and fire protection), and will be demanded of those governments in transitioning countries. Thus it is likely (though by no means certain without much more empirical work) that the transition implies a net loss of financing, and hence larger deficits, for the central government. If this is so, it reinforces the urgency of perfecting the public fisc at the earliest possible stage of the transition process. It has been argued previously (and persuasively) by Ron McKinnon (1992) that this should be the top priority. While other conclusions reached by McKinnon on the optimum order of liberalization have been the subject of spirited dispute, I think there is a close to a consensus on this one.

The priority given by many to fiscal sector reform is based primarily on the potential of fiscal deficits to aggravate inflationary pressures. However, there are other reasons of similar importance. As noted above, privatization is likely to result in a curtailment of social services previously provided by enterprises. With its revenue sources drying up, the central government is not likely to take on responsibility (or, if it already has responsibility, to honor it) for these services. Thus the demands will fall in sub-national authorities. As experience in the former Soviet Union makes clear, devolution of expenditure responsibility to lower levels of government, without corresponding revenue allocations, can lead to terminally destabilizing socio-political reactions. Thus the entire area of intergovernmental fiscal relations is one that is opened by the transition process. In the view of this observer, it is at least equal in importance to the inflationary risk of increasing central government deficits.

I will not even bother to argue the importance of tax policy to the structure of the economy. However, if foreign sector taxes are included in our definition of the tax system, as they should be, I think we have all seen enough distortionary mischief wrought by ill-advised tax structure to agree that it is an area of policy that demands early attention. My own very strong held view is that fiscal reform projects deserve the highest priority, and should: (1) always include both the revenue and expenditure sides of the fisc; (2) include all elements of the tax system; and (3) should include both tax policy and tax administration. If forced to choose the order of reform of policy and administration, I would, without hesitation, choose policy.[69]

The Financial Sector. Within the financial sector, I include both commercial banking and the markets and institutions that make up the capital market. And, within the category of "banking", it is important to consider both "public bood", namely the national payments mechanism, and the essentially private good it produces, namely financial intermediation. The banking system as a whole, including the central bank, is the nucleus of the institutional framework for the conduct of macroeconomic, or stabilization, policy. Lest someone complain that is too monetarist a view, I would hasten to agree that the statement assumes that fiscal deficits result in price inflation when they result in excessive monetary expansion relative to the demand for money. It is also acknowledged that this is almost always the case, empirically, though it is not obvious that it must be the case.

2.3 Banking The functions of the banking system as the national payments mechanism and as a locus of financial intermediation are not crisply separate. The connection is that the system will not be used to effect payments unless it is perceived to be a relatively riskless abode for liquid wealth. Thus the well understood transactions cost economies from having a generally accepted medium of exchange, would be lost. In many post-command economy states, the banks' portfolios continue to show loans to insolvent state enterprises at their face value. Between the insolvency of the debtors and the effects of price inflation on the real value of the assets, there are often substantial imbalances between the assets and liabilities. Private wealth owners are not likely to wish to place funds in such banks.

An important question is what to do with such banks? There are a number of known solutions, and no one of them is necessarily the ideal in every situation. However there are some guiding principles that I believe any proposed solution should incorporate. First, the general interest in probably served by protecting the depositors, whether the banks are private or public. That does not, by the way, necessarily imply that the banks should save. Second, if depositors must be protected by way of "bail out", those should not be financed by taxpayers. Rather the central bank should bail them out, but in a manner that does not imply large increases in high powered money. This should be manageable, though there may be cases to the contrary. In any case, once the old problem is solved, it is important that the institutions and policies required for private market-compatible bank supervision and regulation are there to take over vigilance of the banking system.

As in other areas of economic policy and regulation, simple is probably beautiful. The greater the number of rules a banking institution has to follow in making its lending decisions, the greater is the likelihood that the outcomes will depart from efficiency. The foundations of a sound banking system are as follows: Transparency in lending operations; standardized accounting standards and financial disclosure requirements for enterprises, including banks; regular supervisory monitoring of aggregate and sectoral loan performance; capital adequacy and loan loss provisioning policies that reach international standards. Availability of deposit insurance, financed fully the banks and their customers, is

[69]However, for an argument that the distinction between tax policy and tax administration is, at times, artificial, see Tanzi and Pellecchio, 1994.

a way to diminish significantly the moral hazard associated with under funded, publicly "backed" insurance.

Monetary policy, of course, is transmitted through the banking system. Its principal instruments-reserve requirements, discounting and purchase and sale of financial assets (primarily claims against government)-should be reserved for exercising control over the level and growth rate of the means of payment, and perhaps, in the short run, interest rates. Its purpose is to control the rate at which aggregate spending grows by increasing and decreasing the relative profitability of investing borrowed funds. These instruments of policy should be targeted on the relevant policy variables, and not used to provide preferential access to credit for favored borrowers (as is the case when it is required (or permitted) that a proportion of banks' legally required reserves take the form of interest bearing government securities while the reserve deposits receive no interest).

2.4 Financial and Capital Markets Significant economic restructuring requires extraordinary amount of investment. Whereas an established economic system might be able to just sustain a given level of production by investing about 10 percent of annual GDP to replace capital consumed in the production process, transitioning former command economies require much more. Ironically, particularly in the early stages of the transition, when the need for investment is greatest, income is likely to be falling and domestic saving falls along with it. Moreover, if financial sector stability is not maintained, existing liquid wealth is likely to flee to more secure ground . Thus the domestic financial sector must seek to attract foreign savings to finance the exceptional investment requirement.

Basically, the non-bank financial markets have three jobs to perform in a market economy:

(1) Provide an attractive abode for the savings of a wide variety of domestic and foreign savers with diverse risk, return and liquidity requirements, and a source of financing for the establishment or expansion of productive capacity; (2) allocate savings among competing investors based on the most productive deployment; (3) provide instruments for managing and hedging normal market risks. More succinctly, the financial markets' job is to stimulate and intermediate savings and investment.

The greatest difficulty in establishing effective financial markets in formerly planned economies is likely to be the lack of a cultural tradition of trust in individuals who don't know each other. Combining that with a lack of the legal and institutional apparatus needed to establish confidence, makes it extremely difficult to establish such markets. The gap between the present state of financial intermediation and western norms varies greatly from one country to another. In some republics, the gap is so large that it will probably be years before there can be any realistic expectation that it will be closed. The idea of a rapid transformation from a society in which households do not even use checking accounts and can't imagine a bank loan, to one with broad and active equity markets, future markets, residual and so on, is just not credible. Thus the work that must be undertaken to begin the process of establishing a full menu of financial instruments and institutions is the work of establishing the legal and policy framework.

Much of this framework is of the kind discussed earlier that transcends markets and sectors. However, there is also legal infrastructure that is unique to financial markets. Law governing collateral and its disposition in case of default is particularly important. The tax treatment of both financial assets and the income therefrom is another important legal matter, primarily because it can exert significant, and undue, influence on the relative uses of equity and debt financing.

Financial and capital markets are highly complex and complicated. This is attributable to both the electronic information technology it employs and the bewildering array of financial assets and liabilities, their maturities, the precedence of claims associated with them, and their legal standing. Thus a specialized regulatory structure, such as the United States' Securities and Exchange Commission, with regulations to assure transparency and honest dealing with transactors, is essential.

In summary, financial markets are indispensable to an efficient market economy. The task of creating an appropriate legal and institutional environment to foster development of these markets should take high priority. However, the recommendation here is that the process begin by focusing on the environment for the simplest intermediary structures such as banks, and the mechanisms to facilitate the privatization of state enterprises.

The Foreign Trade and Exchange Sector. As emphasized earlier, the transition to a market economy almost certainly necessitates a combination of domestic and foreign savings. However, the development of a sizable and reliable flow of foreign exchange earnings is also needed as the inputs into the productive process are likely to include a significant share of imports. In addition to the direct gains from trade, opening the economy to imports can reduce the cost and increase the quality of consumer and producer goods available, and by doing so, provide an incentive to domestic producers to become more efficient.

Trade and exchange sector reforms during the transition have as their fundamental objective the removal of barriers to both exports and imports, and the facilitation of international capital flows. To the extent that it is politically or economically necessary to provide protection to domestic productive sectors, it is probably true that tariff protection is to be preferred to non-price restrictions or exchange controls. I argue this not so much because of the arguments of the competitive economic model that quantitative restrictions involve welfare losses, although I admit to being partial to that view. Rather, it is based on the advantage I perceive in simplicity. It is easier to implement a tariff effectively and requires far less information than would be required to feel confident that any particular set of administrative restrictions implied welfare gains or neutrality.

With respect to the exchange regime, there is a recent surge of controversy over what kind of system is more appropriate for transitioning economies. It is my perception that a neo-Keynsian view that favors fixed nominal exchange rates is in the ascendancy. My understanding of the issues is that the advocates of fixed rates believe that, with fixed rates, a program of fiscal and monetary austerity, coupled with guaranteed convertibility, will elicit foreign and domestic investment more quickly than would a program with the same monetary and fiscal discipline, but with floating nominal exchange rates. The fixed rates, presumably, remove monetary policy from the realm of discretionary policy, and that contributes to the confidence of foreign and domestic investors.

Of course, a floating rate system would remove exchange rate settings from the realm of discretionary policy, which could also inspire confidence. Moreover, while under a fixed rate system, that central bank loses its ability to control the money supply except for very brief periods, it does not lose its ability to extend credit. Thus the central bank only need to *try* to expand the money supply, even though it may not be able to do so, to undermine a stabilization program. Which system truly works better? I believe this is an empirical question on which the evidence is still coming in. Nevertheless, there does not seem to be any disagreement on the desirability of stable real and nominal exchange rates, regardless of which policy combination is employed to achieve them.

Exchange controls on capital account (especially on foreign borrowing), according to some authors, should be retained until such time as domestic price stability is established and domestic financial markets are fully liberalized (see, for example, McKinnon, 1992). Without getting into the issues of the timing of capital account liberalization, it is surely one of the characteristics of a completed transition. It is one of economics' main paradoxes that if a nation wants capital to stay in the country or come into the country, it must permit it to leave the country.

III. Dimensions of structural change

At the outset, I suggested a classification scheme for the main dimensions of the structural economic change involved in the transition to a market economy. The categories included product mix, scale of production facilities, factor proportions, location of production facilities and the size, services and organization of government. At this point, I will go a step further and speculate on how these dimensions might be influenced by the kind of economic system in place. These are just impressions, but they lend themselves to empirical testing which should endow them with some merit.

3.1 *Product Mix*. This dimension of structure, particularly for former command economies, includes the mix of public and private goods and the mix of tradable and non-tradable goods. It is clear that the public sector will produce relatively less and the private sector relatively more following the transition. However, as noted in an earlier section, the transition also involves an exchange of production responsibilities as enterprises production of social services for the entire communities in which they are located, and governments begin to provide at least some of the same services. The acquisition by the relevant governments of the institutional capacity to deliver these services is an important part of the transition.

In general, it should be expected that the production of tradeable goods will expand as the transition proceeds to open the foreign sector. However, the very definitions of tradeable and non-tradeable goods may change as the opening process proceeds. In the former Soviet Union, for example, the supplier-producer-distributor-consumer networke of the old system have broken down. Part of the pain of adjustment comes from the fact that, when subjected to market tests of efficiency, many of the goods that flowed between republics before, can no longer be sold outside.

3.2 *Scale of Production Facilities*. Competition is often considered wastefully duplicative in command economies. This would seem to imply a bias toward large-scale production facilities. Casual observation suggests that this is characteristic of command economies, but examining the proposition empirically, and extracting its policy implications, if any, could provide interesting insights.

3.3 *Factor Proportions*. A bias toward large scale production might imply a simultaneous bias in favor of capital intensity. The latter appears to have been reinforced by a penchant for high technology, particularly in military related industries. However, planned economies also are often characterized by redundant labor, whatever the technology. It would be interesting to attempt to quantify the efficiency or welfare implication of the factor proportion outcomes of the planning process. Are inefficient factor proportions endemic to command economies?

3.4 *The Location of Production Facilities*. Central planning authorities often plan facility location based on plan objectives with respect to the geographic distribution of populations. In Egypt, for example, enterprises have been directed to locations distant from the cities in order to attract residents and thereby relieve pressure on the municipal infrastructure. In Chile in the 1960s, production facilities were erected in locations remote from the concentrations of consumers (i.e., the central valley around Santiago), to provide employment for small concentrations of populations. Can the costs of these locational distortions, if indeed they exist, be confirmed and measured? Again, it could offer an interesting and manageable research agenda.

Perhaps more important is the question of the influence of transition on the location of productive activity among nations. If many nations are simultaneously "opening" and "liberalizing" their economies, there is reason to expect that some will gain real income while others will lose. Which ones? (See Krugman and Venables, 1995).

3.5 *The Size, Outputs and Organization of the Public Sector.* This dimension of structural change associated with the transition, as has already been indicated, is among the most politically important. In most cases, this kind of transition has been associated with a political shift toward more democratic governance. As this political change occurs, it is accompanied by a search for more effective means of incorporating individuals into the political process. An important part of this is the establishment of mechanisms through which their preferences with respect to public services can be expressed. Moreover, as a significant proportion of public services are more appropriately produced by sub-national governments than by central governments, the roles of the various levels of government may change dramatically. However, for truly democratic participation to occur, individuals must be able to participate in the selection of public services they receive and in the decisions as to how to finance them. Formal systems of intergovernmental fiscal relations are required for this purpose. Thus the public and private sectors meet head on in this dimension of structural change. The importance of getting th legal, policy and institutional support for this change in place would be difficult to exaggerate.

IV. Thoughts on the role of foreign assistance

Foreign assistance has been available to Central and Eastern Europe and the Former Soviet Union from a variety of international and bilateral development organizations and financial institutions. Realistically, however, the resources they have to offer represent a miniscule proportion of the resources required to undertake such comprehensive restructuring. How can the resources be put to best use? This observer's bias is in favor of emphasizing the development of policy making and implementing institutions. When a country has the institutional capacity to evaluate its own economic performance, formulate alternative policy programs to solve the problems, support attainment of the goals and implement the policy program, its prospects are bright. Obviously it helps if it can also get its hands on additional resources to speed the transition to a market-led and sustainable growth path. However, all that is needed is a glimpse at the population numbers of the countries now embarked on a transition to see that concessional foreign assistance will not be large. Hence the conclusion that donors can be most helpful bringing their experience with policy for market-directed economies to bear on the problems faced by the countries in transition.

To be most helpful, donors seeking to assist with the transition should recognize that their technical expertise is only one of the ingredients needed for a successful technical assistance effort in economic restructuring. In a stabilization program, for example, there are always a variety of settings of the instruments of macroeconomic policy that will reach a given objective. Which combination is ideal depends on cultural, historical and psychological phenomena about which foreigners are likely to know very little. Policy reform projects, to be successful, need to be projects that the "beneficiaries" want to carry out because they believe they will help to achieve their national and personal goals.

Finally, I would like to urge that technical assistance projects that end with the presentation to the host government of a document on policy and institutional development are likely to represent wasted money. Rather, valuable technical assistance provided by resident teams of specialists working with host-country counterparts in both the design and the implementation of the projects are more likely to have lasting effects. When such assistance has been successful, there is a seamlesss continuation of the work it has been carrying out, and it is completely directed by the host country counterparts.

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