

BWI STRUCTURAL ADJUSTMENT PROGRAMS AND INCOME POVERTY

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There has been a long-standing criticism from the Left of BWI SAPs as is proportionately hurting the poor:

- When the BWIs arrive in southern countries, corporate profits go up, but so do poverty and suffering. Decades of promises that just a little more "short-term" pain will bring long-term gain have exposed the BWIs as false prophets whose mission is to protect those who already control too much wealth and power.
- A report published by the World Development Movement (WDM) shows that the IMF's new Poverty Reduction Strategies are acting as barriers to policies benefiting the world's poorest peoples.
- Many developing countries suffered – sustained increases in prosperity, accompanied by dramatic increases in inequality and child poverty – under the auspices of the BWIs' adjustment programmes.
- In country after country, SAPs have reversed the development successes of the 1960s and 1970s withmillions sliding into poverty every year. Even the World Bank has had to accept that SAPs have failed the poor, with a special burden falling on women and children. Yet together with the IMF it still demands that developing countries persist with SAPs.

Easterly (April 2001) examines the record of SAPs. He stresses the importance of distinguishing "structural adjustment lending" from "structural adjustment policies". He notes the "considerable international evidence that structural adjustment policies, like macroeconomic stabilisation, financial development, openness to trade, and removal of price distortions, improve growth potential – and thus strengthen poverty reduction". For example, he cites Easterly and Levine (2001), "Its Not Factor Accumulation: Stylized Facts and Growth Models" *World Bank Economic Review*, and providing a

demonstration that good policies matter for growth!

He however points out that "*the success of adjustment loans at changing policies is very mixed*". He avers to the general historical record that foreign aid and adjustment lending has not discriminated much between good and bad policies. Indeed in the World Bank (1998) *Assessing Aid: What Works, What Doesn't and Why*, OUP notes on pp.48 that "there is a long legacy of failed adjustment lending where there was no strong domestic constituency for reform".

Easterly notes that the results may not be so surprising in view of the recent vintage of concern for poverty in BWI adjustment packages, well after the poverty spells of the last two decades. In other words, for most of the period, BWI "adjustment lending was not designed to reduce poverty directly and so it is not surprising they were not effective at doing so". The results may well be confirming that adjustment loans are not a very effective vehicle for reducing poverty and the BWIs and governments "would do better by directing resources towards programs that directly target poverty – income subsidies for the poor, infrastructure targeted towards poor areas, improved access to credit (possibly through microcredit schemes), subsidies for inputs to subsistence production and improved access to market information (such as through IT) for the poor".

He laments that adjustment lending has been so continuous for some economies that it is hard to speak of it as purely a transitional phenomenon. This continual dependence on the IFIs, requiring in some cases relief from past IFI loans (Ghana in 2001 is requesting through the HIPC Initiative relief from ERP loans), is itself cause for concern. If adjustment loans had to be repeated 10 times or more, this clearly does not speak well for the effectiveness of the treatment, he concludes.

Furthermore, from a political economy point of view, the finding that AL lowers the sensitivity of poverty to the aggregate growth rate of the economy "could be dangerous". This is "because it gives the poor less of a stake in overall good economic performance which might increase support of the poor for populist experiments at redistributing income".

Lipton and Ravallion (1995) "Poverty and Policy" in Jere Behrman and T.N. Srinvasan (editors), Handbook of Development Economics, Vol. 3B, Chapter 41 p.2601, stress that there is considerable heterogeneity within the urban informal sector, with an individual's poverty depending more on individual attributes like human capital than on any economy-wide labour market distortion leading to the creation of an informal sector. Other distortions may exclude the poor from taking advantage of reforms under SAP, like lack of access to credit.

Van de Walle (2000) "Are Returns to Investment Lower for the Poor? Human and Physical Capital Interactions in Rural Vietnam." *World Bank Policy Research Working Paper 2425*, shows evidence of lower returns to formal sector investments (irrigation is her specific example) for the less educated.

Lundberg and Squire (2000) "The Simultaneous Evolution of Growth and Inequality" *World Bank mimeo* cited by Easterly find that the bottom quintile are the only quintile out to benefit from trade openness. The poor may be geographically isolated from the formal economy, which may be exacerbated by poor infrastructure.

Whatever the distorting or initial endowment at work, the individuals who are poor may be ill-placed to take advantage of new opportunities created by SAPs, just as they may suffer less from the destruction of old opportunities enjoyed by protected sectors prior to SAP.

The effects of BWI SAPs on policies, as mandated from the top, are usually limited to highly visible macroeconomic indicators – the fiscal balance and devaluation (expenditure-reducing and expenditure-switching policies). Again, these seem more likely to affect the formal rather than the informal sector in economies growing under homegrown reform programs, where government ownership create stronger motivation for genuine change. For example, China over the last two decades had only 3 ALs in the 80s and none in the 90s and is a good example of the type of homegrown reform that includes a more sweeping transformation of incentives affecting formal and informal sectors.

Easterly's main finding is that BWIs AL lowers the growth elasticity of poverty, that is the amount of change in poverty rates for a given amount of growth. Economic expansions benefit the poor less under SAP, but at the same time economic contraction hurt the poor less. Possible explanations of this finding include:

- BWI conditionality may be less austere when lending occurs during an economic contraction, while conditionality may require more micro adjustment during an expansion.
- If macro adjustment disproportionately hurt the poor – say because fiscal discipline, for example, is implemented through increasing regressive taxes like sales taxes or decreasing progressive spending like transfers – then we get the result that AL lowers the elasticity of poverty.
- BWI conditionality may itself cause an expansion or contraction in aggregate output – depending on the composition of the SAP – but not affects the poor very much. For example, the poor may mainly derive their income from informal sector and subsistence activities, which are not affected much by fiscal policy changes or adjustments in other

macro policies. SAP packages usually imply some previously favoured formal sector activities may contract while other formal sector activities newly formed can expand. The net effect may be overall contraction or expansion, depending on the initial sizes of the declining and expanding sectors and the specific policy measures in the SAP. However, if the poor are not tightly linked to either the expanding or contracting formal sector, the amount of parity change for a given amount of output change may not be very high under SAP. An expansion or contraction in the absence of AL, on the other hand, may reflect economy-wide factors that lift or sink all boats.

Beyond the important distinction between structural adjustment policies ALs with their own special features which may or may not promote and which moreover, are found to lower the growth elasticity of poverty, there is the fact that growth and welfare are not the same thing. The main problems with economic growth as measure of welfare include the following:

- the empirically identifiable effect of policies at the rate of growth – especially over short intervals – could be different from their effects on levels of income (see Easterly February 2001);
- levels of per capita income may not be good indicators of welfare because they do not capture the distribution of income or the levels of access to primary good and basic capabilities; and
- high growth rates of the economy could be associated with suboptimally low levels of current consumption.

As Rodrik cautions, the welfare implications of empirical results regarding the link between trade policy and growth – be they positive or negative – must be treated with great caution. Trade policies can be positive effects on welfare without affecting the rate of economic growth. Conversely, even if policies that restrict international trade were to reduce economic growth, it does not follow that they would necessarily reduce the level of welfare. Negative coefficients on policy variables in growth regressions (leaving the mis-specification problems discussed in Easterly February 2001 aside) are commonly interpreted as indicating that the policies in question are normatively undesirable. Strictly speaking, such inferences are invalid.

Widening income gaps "are helping to feed a backlash against globalisation around the world". These widening income gaps are particularly noticeable outside the United States where middle classes tend to be much smaller and where antimonopoly and other income-equalizing laws are less stringent. This is one of the central economic dilemmas of the globalisation system: the Golden Straitjacket, the Electronic Herd, free markets and free trade produce far greater (world incomes). That is a fact. But that income is highly unequally distributed (among countries and within countries) and the whole

let-her-rip capitalism that comes with it is enormously socially disruptive.

Admittedly, this cannot be a good case to stick with a closed, regulated, bureaucratically run economy. In a globalised world economy, this would impoverish society as a whole which could be even more socially disruptive – without generating any of the resources which could, at least in principle, be used to ameliorate the conditions of those left behind.

There was indeed little in the way of income gaps in Fidel Castro's socialist Cuba in the 1990s (when poverty was deepening in SAP economies). But "the society as a whole became so poor that Cuba in the mid-1990s became the sex tourism capital of the western hemisphere as thousands of Cuban families had to assign a wife or daughter to take up prostitution to earn hard currency to survive (Thomas Friedman. Lexus, p. 318).

In the long run, these income gaps, if they continue to widen, could turn out to be globalisation's Achilles heels. There is something inherently unstable about a world that is being knitted together tighter and tighter by technology, markets and telecommunication, while splitting apart wider and wider socially and economically, Friedman concludes.

One of the most serious by-products of plugging into the globalisation system is clearly this phenomenon of increasing inequality. Friedman's Lexus provides evidence that the two decades of the 80s and 90s were not lost only to SAP countries as may be inferred from Easterly (2001). Friedman observes that: during the 1980s and 1990s, as globalisation replaced the Cold War system, income gaps between the haves and have-nots with industrialised countries widened noticeably, after several decades in which that gap had remained relatively stable (pp.307).

Reasons typically given by economists for widening income gaps include:

- massive demographic shifts from rural to urban areas;
- rapid technological changes that increasingly reward knowledge or skilled workers over the less skilled;
- the decline of unions;
- the shift in manufacturing from high to low wage location; and
- rising immigration from less developed, low-wage economies.

While all these factors matter, in the context of the globalised world economy of the 80s and 90s Friedman considers the phenomenon of "winner take all" to be most relevant and important. The phenomenon refers to the fact that "the winners in any field today can cash in because they can sell into this massive global marketplace, while those who are just a little less talented, or not skilled at all, are limited to selling in just their local market (and even that

cannot be taken for granted) and therefore tend to make a lot, lot less".

He cites the book *The Winner-Take-All Society* in which the authors, economists Robert H. Frank and Philip J. Cook, point out that globalization "has played an important role in the expansion of inequality" by creating a winner-take-all market for the globe. And with trade barriers and tariffs being reduced or eliminated all over the earth, travel costs being slashed, internal markets being deregulated and information now being freely and cheaply disseminated across borders, a unified globe market is being created in many industries and professions.

"In the global village", write Frank and Cook, "the top players – those who can deliver the best product – can earn enormous profits", while those with only marginally inferior skills will often do much less well, and those with low or no skills will do very poorly. Therefore the gap between first place and second place grows larger, and the gap between first place and last place becomes staggering. Those near the top get a disproportionate share. The more that different markets get globalised and become winner-take-all markets, the more inequality expands between countries as well as within countries. These inequalities are becoming the most disturbing social by-products of the system.

According to the 1999 UN Human Development Report, the fifth of the world's people living in the highest-income countries has 86% of world GDP, 82% of world export markets, 68% of FDI and 74% of world telephone lines. The bottom fifth, in the poorest countries, has about 1% in each of these sectors. Not surprisingly, the wealthiest fifth consume 45% of all meat and fish, while the poorest fifth consume less than 5%. And the gap has been widening.

A host of consumption options have been opened for many consumers – but many are left out in the cold through lack of income. And as pressures for competitive spending mount, "keeping up with the Jones" has shifted from striving to match the consumption of a next-door neighbour to pursuing the lifestyle of the rich and famous depicted in movies and television shows.

Examples of wide income disparities abroad even in the developing world – Brazil, Egypt – where 500,000 live inside tombs in the "City of the Dead": five square miles of cemeteries in the heart of the Egyptian capital. In contrast, ten miles away is the newest gated golf course community called Katamy Heights. Here, price per person for golf, including transfers to/from Katamy Heights golf course: \$165 per capita annual income in Egypt in 1998 was \$1410 – good for about nine rounds of golf.

Thailand is a country sharply split between an urbanised, export-oriented working and entrepreneurial class, living in the financial and manufacturing

centre of the country and enjoying many benefits from globalisation; and an impoverished, inward-looking rural sector which, though indirectly affected by globalization, has little understanding of it and sees little benefit from it. The Thai baht crash of 1997 brought home the stark lesson how this gap between the globalized and the non-globalized in a society, if untended, can widen to a point where people who speak the same language cannot understand each other anymore, let alone feel a common bond.

Easterly (February 2001) examined the phenomenon of developing countries' stagnation in spite of the sea-change of policy reforms under the guidance and with massive resources from the BWIs. He noted that the improvements in policy variables in growth regressions marking the market-friendly economic policies by developing countries beginning around 1980. Development consensus shifted away from state planning towards markets, away from import substitution towards outward orientation, away from state controls of prices and interest rates toward "getting the prices right".

The World Bank began "adjustment lending" in 1980, which was lending conditional on implementing the new consensus on economic policies. The IMF expanded its portfolio of conditional lending at about the same time. The two institutions made 958 ALs to developing countries over 1980 – 98. Reflecting poor growth performance despite policy instruments, Paul Krugman (1995): "Dutch Tulips and Emerging Markets" *Foreign Affairs*, Vol. 744, pp. 23-44 noted that "*the real economic performance of countries that had adopted Washington consensus policies was distinctly disappointing*".

Growth projections through the 1980–98 period under review, expectedly forecast a return to the halcyon days of the 1960s and 1970s. For example, the 1983 World Development Report of the World Bank projected a "central case" of 3.3 per cent annual per capita growth in the developing countries from 1982 to 1995. The pessimistic scenario was a "low case" annual per capita growth rate of 2.7 per cent over 1982 – 95.

Growth regressions have had considerable success explaining cross-country variation in growth rates, "and thus might potentially be of use in explaining the cross-time variation as well" Easterly (February 2001) emphasis added. The key right-hand side variables of choice include:

- initial income, primary and secondary enrollment, political instability, and deviations from PPP: Barro (1991) "Economic Growth in Cross Section of Countries" *Quarterly Journal of Economics*, Vol. 106,2, pp. 407 – 443.
- Fertility and life expectancy (as additional initial conditions). Barro (1998) Determinants of Economic Growth: A Cross-Country Empirical Study. Cambridge MA: MIT Press.

- Macroeconomic variables like budget deficit, black market premium, and inflation rate. Fischer (1993) "The Role of Macroeconomic Factors in Growth", Journal of Monetary Economics, Vol. XXXII, pp. 485 – 511.
- Financial development (measured typically by M2/GDP) Levine, Loayza, and Beck (1999) "Financial Intermediation and Growth: Causality and Causes", World Bank Policy Research Working Paper 2059.
- Real exchange rate overvaluation as proxy for outward orientation: Dollar (1992) "Outward-oriented Developing Economies Really Do Grow More Rapidly: Evidence from 95 LDCs, 1976 – 1985" Economic Development and Cultural Change Vol. 40, No. 3, pp. 523 – 544.
- Infrastructure development (telephone lines per capita) Easterly and Levine (1997) "Africa's Growth Tragedy: Policies and Ethnic Divisions" Quarterly Journal of Economics, November.
- Well developed institutions Knack and Keefer (1995) "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures" Economics and Politics, Vol. 7, No. 3, pp. 207 – 227.
- Initial inequality Alesina and Rodrik (1994) "Distributive Politics and Economic Growth" Quarterly Journal of Economics, Vol. 109, No. 2, pp. 465 – 490; Forbes (2000) "A Reassessment of the Relationship Between Inequality and Growth" AER; Deininger and Olinto (2000), "Asset Distribution, Inequality and Growth", World Bank Policy Research Working Paper No. 2375.
- Dependence on natural resource exports – a political economy variable said to deprive countries of the externalities to manufacturing activities and lead to a frenzy of rent seeking: Sachs and Warner (1995) "Natural Resource Abundance and Economic Growth" NBER Working Paper 5398; Gylfason (2000), "Natural Resources, Education, and Economic Development", Centre for Economic Policy Research Working Paper No. 2594, October.

Beano and Easterly (1998) "Inflation Crises and Long-run Growth" Journal of Monetary Economics 4, pp. 3-26 found no robust evidence of a negative correlation between inflation and growth below 40 per cent per annum. In fact they found that the cross section relationship between growth and inflation is zero on average. They explained this by the pattern of sharp output declines associated with "inflation crises" with output reverting to trend after the end of the inflation crises. Barro (1998) finds a lower breakpoint of 15 per cent per annum, below which there is no significant correlation between growth and inflation.

In the 1980 – 1998 period, the median per capita growth of developing countries in the Easterly study (February 2001), was 0.0 per cent. The median

is chosen because it weights all countries equally, which is appropriate if we treat each country as an observation of a given set of country policies and characteristics. The median was 0.0 per cent for both the 80s and 90s taken separately. The weighted average growth rate showed less of a decline from the 1960 – 79 period, "because of accelerated growth in India and China in 1980 – 98. It is also noted that the 1980 – 98 figures included the ex-Communist countries of Central Asia and Europe that had strong output declines. Excluding these countries, however, still leaves the median per capita growth for the 1980 – 98 period still at 0.3 per cent.

The two "main possible logical explanations for the failure of growth regressions to explain the cross-decade slowdown" given by Easterly were:

- They are mis-specified, regressing stationary growth rates on non-stationary policies and initial conditions, along the lines of the Jones (1995) "Time Series Tests of Endogenous Growth Models" *Quarterly Journal of Economics*, Vol. 110, pp. 495-525 critique: coefficients estimated on the basis of cross-section variation field time series properties of the linear combination of growth determinants that are incompatible with the stationarity of growth. While you may grow faster than your neighbour if your secondary enrollment is higher, your own growth does not necessarily increase as you (and everyone else's) secondary enrollment ratios rise. This first hypothesis, which Easterly could not rule out in his empirical study "calls into question many empirical studies of growth".
- Some factor other than country characteristics led to the disappearance of growth. Easterly provides "suggestive evidence of 'another factor' – the not so surprising or unknown slowdown in growth in the industrial economies". This slowdown may have had a big effect on growth in the developing world. A secondary factor also emanating from industrial countries was the rise in world interest rates that increased the debt burden of developing countries. Easterly, however, is "unable to demonstrate a clear mechanism" by which these external shocks translated into lower growth for the developing world. "A variable that interacts OECD growth with the share of OECD trade in the country is insignificant, for example".

The possible role of the industrial countries slowdown and of hikes in real world interest rates suggest that external factors need to be given more attention relative to national economic policies. Easterly, Kremer, Pritchett, and Summers (1993), "Good Policy or Good Luck? Country Growth Performance and Temporary Shocks" *Journal of Monetary Economics* 32, December, pp. 459 – 483, made an earlier argument for the importance of random shocks relative to national economic policies, based on the weak cross-period persistence of growth rates contrasted with the strong persistence of policies. Pritchett (1958) "Patterns of Economic Growth: Hills, Plateaus,

Mountains, and Plains" *Policy Research Working Paper*, November 1947 also on "plains", but again his emphasis is on cross-country variation rather than the aggregate performance of developing countries over time.

Rodrik (1994) "Where Did All the Growth Go? External Shocks, Social Conflict, and Growth Collapses" *Journal of Economic Growth* Vol. 4.4, pp. 385 – 412, examines the question "where did all the growth go?" His findings are that:

- i. countries that lacked a social consensus (proxied by ethrolinguistic fragmentation) and
- ii. had poor institutions (which together with fragmentation he summarized as "social conflict") suffered a strong negative impact from TOT losses.

It is important to note, however, that Rodrik's regression does not explain the mean growth itself since regressions explain variation around the mean rather than the mean itself. Even countries with zero social conflict on his measures had a significant decline in growth. Thus Easterly differs from Rodrik in his investigation of the mean cross-time pattern of growth as opposed to the cross-country variation of growth changes as emphasized by Rodrik.

Poverty is multidimensional. A number of the right-hand side variables of growth regressions examined here are in themselves indicative of alleviation of poverty in dimensions other than income. Easterly's results can therefore be interpreted as affirmation that income poverty is neither necessary nor sufficient for other dimensions of poverty. Moreover, the various dimensions are not necessarily correlated.

A fundamental economic assumption is that the satisfaction of individual preferences gives rise to individual well-being. Economists take this assumption as a matter of faith, and it underlies most if not all of economic theory. Politicians, and indeed the general public for that matter, routinely compare countries on the basis of GDP per capita and often evaluate our own economy and society on the basis of household disposable income and the distribution of income. However, many of the important aspects of well-being are left out by such simplifications.

In fact, economists have long recognised that GDP per capita is not a reliable measure of either individual or social well-being, because market values do not encompass all the important economic values (such as environmental protection) and because market values that do exist might suffer from distortions that mask underlying economic values (as in the exercise of monopoly power in the market). More generally, it is clear that many important aspects of well-being could be left out by a simple measure of

welfare.

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