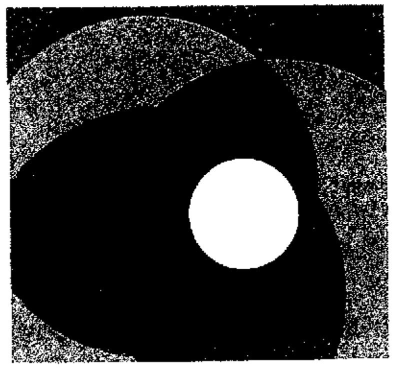

Fund-Supported Adjustment Programs and the Poor

Not adjusting is costliest for the poor. Adjustment has costs, too, but the poor can and should be protected

Peter Heller

Economic adjustment is a process of adapting an economy to live within its means. Whether or not it is supported by Fund resources, it cannot be achieved costlessly. There will be temporary, adverse effects. However, the effects of economic adjustment policies and programs on the living standards of the poor are an important concern. The poor should be safeguarded, where possible, from the adverse effects these programs can have in the short run.

Fund-supported adjustment programs have often been misunderstood and have been criticized for seeking excessive reductions in aggregate demand, resulting in unwarranted contractions of output and employment opportunities, and declines in the living standards of people in poverty. Some commentators have suggested that more explicit account be taken of the effects of programs on the living standards of different socioeconomic groups in the countries undertaking these programs. Others have suggested that macroeconomic adjustment programs be designed to mitigate the adverse distributional implications of external shocks, and to improve the welfare of poverty groups.

See Peter Heller, Lans Bovenberg, Thanos Catsambas, Ke-young Chu, and Parthasarathi Shome, The Implications of Fund-Supported Adjustment Programs for Poverty: Experiences in Selected Countries, *IMF Occasional Paper No. 58, May 1988.*

The principal mandate of the Fund is to help its member countries to maintain, or restore, internal and external financial balance. It seeks to assist countries to achieve this balance in ways that are compatible with the achievement of sustainable economic growth, yet do not intrude on a country's prerogative to make its own social choices in the process of its economic adjustment, growth, and development. The Fund has always recognized that adjustment policies have implications for income distribution, and that these are important considerations for any country in the formulation of its adjustment policies.

Nonetheless, three points have become increasingly clear since the early 1980s: First, that the relationship between external and domestic policies, including policies that affect the distribution of income, is central to all discussions on the use of Fund resources. Second, that in the alleviation of poverty, the processes of adjustment and growth are intertwined. Orderly adjustment and growth are vital to any effort to reduce the incidence of poverty. Because of this the World Bank and the Fund coordinate their efforts in assisting countries in the design of structural adjustment programs. The third point is that, as the Fund's Managing Director stated recently, "Adjustment does not have to lower basic human standards. . . . The more adjustment efforts give proper weight to social realities—especially the implications for the poorest—the more successful they are likely to be."

Poverty study

To obtain a balanced and comprehensive appraisal of how the poor fare in the context of Fund-supported adjustment programs the Fund recently undertook a series of studies of nine programs in seven countries: Chile, the Dominican Republic, Ghana, Kenya, the Philippines, Sri Lanka, and Thailand (see box).

The programs. All the sample programs entered into force in 1983; eight were stand-by programs for periods of 1–2 years and one (in the Dominican Republic) was under the Extended Fund facility. They lasted between five months and two years; three programs (with the Dominican Republic, the Philippines, and Sri Lanka) did not run their full course, because program policies were not fully implemented.

The programs were all introduced after a prolonged world recession had caused a substantial deterioration in the external terms of trade of the program countries. Conditions were aggravated in some cases by bad weather or domestic civil disturbances and in all cases by the effects of expansionary financial policies or a misaligned domestic price structure, or both. As a consequence, the seven economies not only had severe domestic and external imbalances, high unemployment, or domestic inflation, but also low economic growth. Except in Thailand, programs were designed and executed in a crisis environment. (Thailand's program was a response more to a potential problem than to an actual crisis.)

Most of the programs contained:

- fiscal policies to reduce government deficits. Measures were taken to broaden the domestic tax base, reduce tax evasion, and reduce government spending, while increasing its efficiency through changes in the composition of expenditures;
- monetary and credit policies to restrain domestic credit expansion so as to stabilize prices and reduce external imbalances;
- exchange rate policies, combined with domestic pricing policies, to encourage the rational use of foreign exchange, as well as provide adequate incentives to exporters;
- labor market policies to restrain real wages in the organized sector, and increase the flexibility of wages and labor markets.

Although the programs thus had strong elements of macroeconomic policy management, such policies were in most cases complemented by structural measures to increase capacity utilization and expand productive capacity. For example, credit restraint and fiscal consolidation were complemented by pricing policies to promote production, particularly of goods for export, as in Ghana and Sri Lanka. Some programs, particularly those of Chile, the Dominican Republic, and Ghana, were specifically aimed at increasing domestic investment rates. The structural adjustment measures taken contributed in large part to the achievement of macroeconomic equilibrium in these countries.

In some countries, the authorities took steps to protect some of the poor who suffered immediate adverse effects from unfavorable external shocks or from policy measures aimed at restructuring production. For example, Sri Lanka and Chile used food rationing schemes to reach the poor; Chile maintained an emergency employment scheme, and Chile and Kenya took steps to change the composition of social expenditures toward those benefiting the poor.

Approach. During the process of adjustment from an unsustainable economic situation, it is inevitable that some socioeconomic groups lose and others gain, particularly when adjustment is aimed at a shift in sectoral resource allocation. The study broadly characterized the impact of adjustment policy measures on different poverty groups, in their capacities as consumers of goods and services, as owners of assets, and as factors of production. Based largely on information provided by the World Bank, the poor were identified on the basis of, for example, the type of their production activities, their consumption patterns, holdings of land and other assets, and degree of access to government services and to formal markets. Though it analyzed effects on the incomes of specific groups, the study did not explicitly analyze shifts that may have resulted in the overall distribution of income.

The study looked both at the short-term, aggregate demand implications and the longer-term, supply-side effects of the adjustment process. The principal focus was to compare the economic status of poverty groups as a result of the measures with their economic status before the measures were implemented. Inferences were also drawn, however, on what might have happened without a Fund-supported program.

How the poor fare without adjustment. Given an external financing constraint, the alternative to an orderly stabilization program is often disorderly adjustment through rapid inflation and the continuation of unsustainable economic imbalances. The latter are typically suppressed through direct government controls and result in significant black markets for goods and currencies.

In such situations, the poor suffer badly. First, they lack the capacity of wealthier groups to shift or lessen the burden of the implicit and explicit taxes associated with unsustainable policies. Second, if wages in the formal sector remain unsustainably high, or if net capital inflows fall in response to unsustainable policies, the poor are the first to be laid off or to suffer a decline in earnings in the informal sector. Third, political interventions that become necessary in the absence of orderly adjustment tend to favor politically powerful groups. They divert resources into rent-seeking activities and support rents based on political privilege rather than on economic performance.

Fourth, the poor are often the hardest hit by inflation or by the high prices that prevail on black markets. Thus while price liberalization may result in large increases in officially measured prices, the actual prices paid by the poor may, in fact, not increase very much. In Ghana, for example, extensive price controls had shifted transactions away from official toward parallel markets where poor consumers, lacking access to goods at official prices, may have paid much higher market-clearing prices. By facilitating an increase in supply, the removal of most price controls improved the access to goods of both the rural and urban poor. Increases in official prices for agricultural goods also directly benefited poor producers of these goods, though in some cases smallholders may already have been selling their products through informal markets.

Findings

By promoting growth and efficient resource allocation, adjustment programs on the whole play a constructive role in safeguarding the long-term interests of the poor. In many cases, the poor benefit in the short run from both individual policy measures and the combined impact of all the measures in the adjustment program. However, some of the macroeconomic policies that aim at restructuring production may aggravate the plight of some vulnerable groups in the short run. Efforts to consider explicitly the impact of alternative measures on income levels, and the use of specific compensatory or targeted policies, may offer scope for protecting vulnerable groups during the process of adjustment.

The effects of adjustment programs on poverty depend strongly on country circumstances—in particular the structure of poverty and the mix of policies adopted:

Tax measures in the programs studied were designed to broaden the tax base and to increase the revenue collected from tax evaders and avoiders—who are typically relatively wealthy professionals, businessmen, and other self-employed groups. Efforts to raise revenue included indirect taxes such as excises on tobacco and alcohol, other sales taxes, or import duties. While some of these measures might have been regressive, they were often accompanied by compensatory measures (e.g., exemptions for certain goods) to offset possible adverse effects on the poor. In general, increases in taxation appeared to affect middle-income or wealthier groups rather than the poor.

Exchange rate policies. Most adjustment programs seek to improve the external balance through a real depreciation of the exchange rate. Devaluation in Kenya and Ghana seems to have benefited the dominant poverty groups in the short run. In Ghana, the most important poverty groups are landless agricultural workers and rural smallholders. These groups produce export crops, especially cocoa. The devaluation of the exchange rate helped poor smallholders, mainly by reducing their need to engage in smuggling and other costly trading of inputs and consumer goods in parallel markets, and by stimulating an increase in output. Landless laborers benefited from expanded rural employment as production for export increased. In Kenya and the Philippines, many of the poorest farmers did not appear to have been helped by devaluation in the short run, because they could not quickly raise output in response to higher prices. The reasons for this included bottlenecks caused by inadequate or insufficiently maintained infrastructure, and the concentration of many poorer farmers on nontradable foodstuffs for the domestic market or on subsistence agriculture.

In Chile, the Dominican Republic, and the

Philippines, where a large share of the poor are landless farm laborers, devaluation tended to widen the inequalities in the rural sector, where the distribution of land ownership is highly concentrated. Landowners seem to have absorbed most of the immediate benefits. Rural laborers had to pay higher prices for the food they bought in the market. Also, devaluation had adverse short-run effects on the production of nontradable goods and on sectors that relied heavily on imported intermediate inputs in the urban sector. This may have led to an increase in the rural labor supply and downward pressure on rural wages.

The effects of a ***reduction in capital expenditures*** will depend on where the cuts are made and on how efficiently investments are targeted to the poor. Sri Lanka made sharp cuts in overall capital expenditures, but its investments in health projects, which benefited the poor, continued to rise. In Chile and the Dominican Republic, the programs allowed public investment to rise relative to GDP; investments included labor-intensive projects in public housing, as well as infrastructure projects. In other cases, cuts have hurt the poor: in the short run, by reducing the opportunities to work as unskilled day laborers; in the long run, by reducing the services provided by the social and economic infrastructure.

Cuts in ***health and education expenditures*** adversely affected poverty groups in some countries, particularly the Philippines. However, recent empirical studies suggest that social services generally have been relatively protected from expenditure cutbacks. In Chile, Ghana, and Kenya, social expenditure was reallocated in favor of poverty groups.

Fund-supported programs often reduce ***price subsidies***. Although price subsidies symbolize a government's commitment to protecting the poor, most studies have found that untargeted, open-ended price subsidies are a relatively inefficient way of reaching the most needy; middle- and upper-income groups, who are politically more articulate, often appropriate a large share of the benefits. However, if no compensatory measures are taken, reducing subsidies on goods consumed mainly by the poor may seriously hurt poverty groups, especially in the short run. An efficient way of protecting the most vulnerable groups is through targeting. The challenge is to target the benefits of programs accurately without incurring excessive administrative costs.

In Sri Lanka, the authorities drastically reduced the subsidies on imported petroleum, which had been contributing to unsustainable external deficits. The price of kerosene—the main petroleum product used by the poor—rose by more than other petroleum products, having been more heavily subsidized before the program started. To protect the real income levels of the poor, the Government implemented a kerosene stamp program explicitly targeted to the poor.

When examined narrowly, ***restrictive monetary policies*** may appear to affect employment opportunities and earnings for urban poverty groups adversely in the short run (as has happened in the Philippines). Credit restraint may curtail employment and real output in the short run, especially if nominal wages and prices are rigid. However, in most stabilization packages, efforts to constrain credit have concentrated on the public sector and have sought to limit the adverse effects on the private sector. Moreover, credit restraint is typically combined with financial reform and with supply-side measures aimed at maintaining or raising real activity during the adjustment period and improving the trade-off between inflation and employment.

In the ***labor market***, typical adjustment measures seek to restrain the growth of wages and diminish the role of indexation. While in the short run, these measures may impose hardship on middle-income workers in the formal sector, by lowering real wage rates, they may also create job opportunities for lower-income workers. Wage restraint was an important element in the programs of Chile, Kenya, and Sri Lanka. In Sri Lanka, higher than anticipated inflation caused minimum wages to decline in real terms, though more so in industry and commerce than in agriculture, which employs the poorest workers. In the medium run, flexible wage policies may serve to offset the negative employment effects of a fall in domestic absorption or adverse external shocks.

The fact that the effects of adjustment programs on poverty depend so much on the particular circumstances means in principle that the designers of adjustment policy packages have substantial scope for controlling or offsetting the effects on poverty. It suggests the importance, for policy analysis, of developing a "profile of poverty" in [illegible] country. This requires an initial characterization of the different groups of the poor, identifying the relative magnitudes of the different groups and the salient characteristics of their economic situation, such as the locus of their production activities, their consumption patterns, holdings of land and other assets, access to government services and to formal markets, and so forth.

Role of supply-side policies. The structural measures that were taken in the programs studied played a vital role in assisting the poor to raise their productive capacity over the medium and long term:

- financial reform generally increased the supply of loanable funds available to the poor by reducing the role of rationing in allocating credit and by raising foreign and domestic saving, as in Chile, Ghana, and Kenya. Some programs supported an increase in credit to agriculture, as in the Dominican Republic and Sri Lanka;
- in Ghana and, to a lesser extent, the Philippines, depreciating the exchange rate made exports more competitive and encouraged the flow of resources into export sectors, thus enhancing the income prospects of the rural poor engaged in these sectors;
- removing price controls contributed to a more efficient resource allocation and a reduction of rents based on political privilege, particularly in Ghana and the Philippines;
- emphasizing labor-intensive elements of the public investment program, as in Chile and the Dominican Republic, increased employment opportunities among the poor, while strengthening the public infrastructural base;
- targeting public expenditures more directly to public services that efficiently benefit the poor protected the real consumption of the poor, as in Chile, Ghana, and Kenya.

Compensatory measures. For those poverty groups that cannot be drawn into the restructuring of production in the short run, other compensatory measures may be the only effective means of adjustment assistance. As was described above, some of the countries took steps to protect the poor, through targeted rationing schemes for food and other basic commodities, employment schemes, and changes in the composition of social expenditure, particularly in health and education.

Difficulties confront any effort to shelter the poor from the possible adverse impact of adjustment, let alone to alleviate poverty, in most developing countries. Since the adoption of effective compensatory programs requires good data on the characteristics of

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the poor, time, and probably experimentation, the best way to protect the poor is by designing and developing policies and institutions not under the pressure of a crisis but through a deliberate, long-term plan.

Fund approaches

As mentioned earlier, any adjustment program—that is, any program that seeks a better balance between the supply and use of resources—has certain costs. This is so irrespective of whether the program is supported by the Fund. In the case of Fund-supported programs, the results of the study suggest that many of the poor do, indeed, benefit from adjustment, both in the short and medium term, but that there is room in the design of programs to enhance these beneficial effects. Some groups of the poor may be adversely affected by program measures, particularly in the short run. In highlighting the importance of efforts to limit the adverse impact of adjustment, four aspects of existing Fund policies should be mentioned.

First, perhaps the most important way the Fund can help the poor over the medium to long run is to carry out its principal mandate—for supporting orderly balance of payments adjustment—as well as possible. The costs to the poor of disorderly adjustment are high and onerous. The increasing emphasis in Fund-supported programs on growth and structural adjustment is also relevant in this regard, as policies supportive of these priorities will eventually help to expand employment opportunities for the poor and also increase the government's fiscal capacity to finance investments and targeted programs for people who remain outside the growth process.

Second, the Fund supports efforts by countries to assess the impact of policies and the development process on poverty and the distribution of income. As the Managing Director has affirmed, "Fund missions are willing—when preparing standby programs and when so requested by a member country—to consider with the authorities the implications of alternative approaches to adjustment for the distribution of income, with a view, in particular, to sheltering the poorest." The issue of the distributional effects of particular measures has often been raised in the context of program negotiations, providing an opportunity for a more general discussion of distributional issues.

Third, the policy framework papers that are prepared for each arrangement under the Structural Adjustment Facility (SAF), and the associated Board papers, include a section jointly prepared with the authorities and the World Bank on the social impact of SAF programs over the medium term. When available, social indicators are included in Fund staff reports for Article IV consultations with member countries.

Fourth, the Fund actively participates in discussions on poverty issues with UN agencies, nongovernmental organizations, labor groups, and academics. It has also helped to develop active programs to address poverty in the context of adjustment, as illustrated by Ghana's recent PAMSCAD program of short-term community-initiated employment projects. When World Bank adjustment programs accompany Fund-supported programs, the Bank often addresses social sector and other poverty issues.

The Fund's sensitivity to poverty issues will continue to be reflected in efforts to appraise the implications for poverty of program measures in the course of its missions to member countries, and to initiate discussions on distributional issues during Article IV consultations. ■

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