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Policy-based Lending and Poverty Reduction: An Overview of Processes, Assessment, and Options

**Richard Bolt
Manabu Fujimura**

January 2002

ERD Working Paper No. 2

**POLICY-BASED LENDING AND POVERTY REDUCTION:
AN OVERVIEW OF PROCESSES, ASSESSMENT, AND OPTIONS**

**Richard Bolt
Manabu Fujimura**

January 2002

Richard Bolt and Manabu Fujimura are Economists at the Project Economic Evaluation Division, Economics and Resource Development Center, Asian Development Bank. The authors wish to thank David Edwards, former Assistant Chief Economist, EDEV, who provided overall guidance and support. Nigel Rayner, Tumurdavaa Bayarsaihan, and Vo Van Cuong contributed to Appendix 1. Section II.B benefited from a report by George Abonyi. The paper also benefited from helpful comments by Charles Adams, Christopher Edmonds, Eunkyung Kwon, Gustav Papanek, and John Weiss. Anneli Lagman and Virginita Capulong assisted with the literature search and compilation of supporting documents. Regina Sibal assisted with report presentation. The views and opinions expressed in the paper are those of the authors and not of ADB.

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Foreword

The ERD Working Paper Series is a forum for ongoing and recently completed research and policy studies undertaken in the Asian Development Bank or on its behalf. The Series is a quick-disseminating, informal publication meant to stimulate discussion and elicit feedback. Papers published under this Series could subsequently be revised for publication as articles in professional journals or chapters in books.

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Abbreviations

ADB	–	Asian Development Bank
ADBI	–	Asian Development Bank Institute
BOT	–	Build-operate-transfer
CDF	–	Comprehensive Development Framework
CGE	–	Computable general equilibrium
CWIQ	–	Core Welfare Indicators Questionnaire
DFI	–	Development finance institution
DFID	–	Department for International Development
DMC	–	Developing member country
DPO	–	Development Policy Office (of ADB), currently SPD
EDEV	–	Project Economic Evaluation Division (of ADB)
EDRC	–	Economics and Development Resource Center (of ADB)
FDI	–	foreign direct investment
FSM	–	Federated States of Micronesia
GDP	–	Gross domestic product
GP	–	Guidelines on Operational Procedures (of ADB)
ICB	–	International competitive bidding
ICT	–	Information and communication technology
IMF	–	International Monetary Fund
LHS	–	left hand side
LSMS	–	Living standards measurement survey
MDB	–	Multilateral development bank
NARC	–	National agricultural research center
NBER	–	National Bureau of Economic Research, USA
NGO	–	Nongovernment organization
OED	–	Operations Evaluation Department (of ADB)
PBL	–	Policy-based loan; policy-based lending
PHC	–	Primary health care
PIA	–	Poverty impact assessment
PPTA	–	Project/program preparatory technical assistance
PRS	–	Poverty Reduction Strategy
PSD	–	Private Sector Development
RA	–	Rapid appraisal
RETA	–	Regional technical assistance
RHS	–	right hand side
RRP	–	Report and Recommendation of the President
SDP	–	Sector Development Program
SME	–	Small- and medium-size enterprise
SOCDD	–	Social Development Division (of ADB)
SOE	–	State-owned enterprise
SPD	–	Strategy and Policy Department (of ADB)
SPPR	–	Poverty Reduction Unit (of ADB)
TA	–	Technical assistance
WB	–	World Bank
WDR	–	World Development Report

I. INTRODUCTION AND OVERVIEW

A. Introduction

The Asian Development Bank (ADB) has long addressed ways to reduce poverty in its operations and has now established poverty reduction as its overarching objective. The intensified focus on poverty reduction needs to be addressed in conjunction with questions in development that remain on the agenda, for example, economic structural change (both intersectoral and intrasectoral), industrialization, urbanization, and demographic changes.

The general association between economic growth and poverty reduction is well documented.¹ However, the nature of economic growth is influenced by numerous and constantly changing noneconomic factors, which in turn will influence the nature of poverty reducing effects. Influences include a country's resource base, the sectoral composition and structure of the economy, the political and policy environment, the legal and regulatory environment, institutional structures, governance, social structures, and human capital. Combined, these features determine the nature and performance of the economy in aggregate and the economy's sectors, including productivity and equity, resulting in different levels of benefit outcomes for different groups including the poor. A basic strategy in ADB operations has been to enhance reduction of poverty through economic growth. However, the renewed concern under the poverty reduction mandate relates to the distributional impact of economic growth that may not adequately benefit the poor, or in some cases negatively affect the poor. This realization has motivated a global reexamination of the appropriate development policy mix that does not leave the poor behind.

Rodrik (2000) observes that the now well-documented correlation between growth and poverty reduction is compatible with various arguments that span the entire spectrum of views on the growth–poverty debate. But the question of whether growth is good for poverty reduction, or vice versa, provides little guidance for operational purposes or policy analysis. The currently available cross-country evidence does not help much beyond what we already know in general: that macroeconomic imbalance is bad for growth; and that economic growth and good institutions are a necessary condition for poverty reduction. Cross-country evidence also does not help much in understanding the factors underlying changes in income distribution that make growth more or less pro-poor. Country-specific and institutional analyses provide a more nuanced picture, highlighting a complex set of reinforcing and countervailing forces.

¹ Empirical studies on poverty in the economic literature are mainly limited to income or, at best, consumption poverty. While this treatment does not cover all dimensions of poverty, it is often justified from the purpose of policy application that requires some level of consistency in measurement (for example, Lipton and Ravallion 1995, 25-53).

The focus on poverty reduction has implications for the design and structure of loan and technical assistance (the kinds of modalities ADB supports), and the way in which ADB analyzes and evaluates its operations. This paper discusses preliminary implications of ADB's poverty reduction goal for the policy aspects of ADB operations. It considers the importance of the processes involved in the preparation of PBLs, and issues in weighing policy alternatives and assessing the impact of PBL on economic growth and poverty reduction. It is intended that more in-depth studies of the processes outlined, good practice analytical techniques, and specific recommendations for PBL will follow this paper.

B. Overview of Reforms, Adjustment, and Poverty Reduction

Reforms can be described as a change in the way aspects of an economy are managed to better enable the economy and its institutions to meet immediate and longer-term needs and respond to changing international and domestic circumstances.² The motivation for reform typically arises during a period of economic or institutional difficulty to cope with chronic poor performance, external shocks, or systemic transition.

Causes of difficulty may include a range of economic and noneconomic factors:

- external shocks and instability resulting from, for example, adverse changes in key world prices and terms of trade, and natural disasters;
- internal shocks and instability resulting from domestic action such as an excessive increase in money supply, events leading to a sudden devaluation such as capital flight, unsustainable public spending, a high level of imports and low exports, loss of confidence due to political risk, pervasive corruption, low ability to enforce law and order, and open conflict;
- low productivity and production of goods and services, and weak and contracting markets and competitiveness, due to pervasive and chronic economic and institutional inefficiency and market imperfections.

Each of these difficulties can contribute to the contraction of economic activities and low or negative economic growth with implications for all groups including the poor.

At the macro level, short-run and chronic imbalance and instability are the main sources of pressure for macroeconomic adjustment. This is reflected through unsustainable balance of payments deficits, fiscal deficits, and a high rate of inflation. Changes in the key macroeconomic determinants such as exchange rates and interest rates and in the fiscal situation occur constantly,

² At an analytical level, a precise definition of policy reform is hard to find. While a (public sector) project can be considered as a change in the pattern of production of the public sector with the aim of enhancing consumer welfare, policy reform could also directly affect the pattern of public production and could be analyzed in the same benefit-cost framework. At an operational level for development banks, projects associated with investment loans and policy reforms associated with program loans mainly differ in their nature and speed of disbursement (see for example, Kanbur 1991).

and management of these changes routinely occupies governments' agendas. When changes have a significant negative effect on key economic variables that undermine economic performance and social development, then reform-type corrective action may be warranted.

At the sector and microeconomic level, pressure for reform can stem from macroeconomic level imbalance, inefficiencies in factor use and related low productivity, or market and institutional inefficiencies specific to the sector. For example, a protracted tight fiscal situation may pressure a government to control public expenditures or raise revenues through sector-specific tax measures, reduction of sector subsidies, and adjustment in the provision of public services to specific sectors. Chronic inefficiencies may pressure the government to retract from the provision of key services (e.g., due to lack of resources to sustain loss-making public enterprises) requiring reforms at the subsector level. Examples include public enterprise reforms, deregulation of markets and institutions, improvement of the enabling regulatory environment for private sector operators, and tariff policy adjustment.

In addition to macroeconomic and structural economic problems, multilateral development bank (MDB) experience with PBLs³ shows a range of outcomes that can be traced to the influence of noneconomic factors (ADB 2000d). Governance, and the performance and absorptive capacity of institutions substantially affect the impact of reforms and have increasingly become reform issues in their own right. The World Bank (2000c) highlights the importance of governance, the distribution of opportunities, environmental sustainability, and the management of global risks as elements that directly contribute to development and shape the desirable and undesirable features of growth. Addressing these aspects will support growth by adding to the impact of growth on welfare, boosting investor confidence, and helping make growth more sustained and less volatile.

Political ideology has a major bearing on the acceptability and choice of approach and policy priorities. Political economy factors are especially evident in PBL and help to explain why, in some cases, reform measures gain the support to implement far-reaching changes and result in the intended impact. In other cases reform efforts fail to gather the momentum needed to begin the change process or are short-lived, reverting to their pre-reform position. A sometimes important perception in both macro and sector level reforms is that where there is a pre-reform fall in income then the reforms themselves may be seen as the cause of the problems. This can result in implementation difficulties.

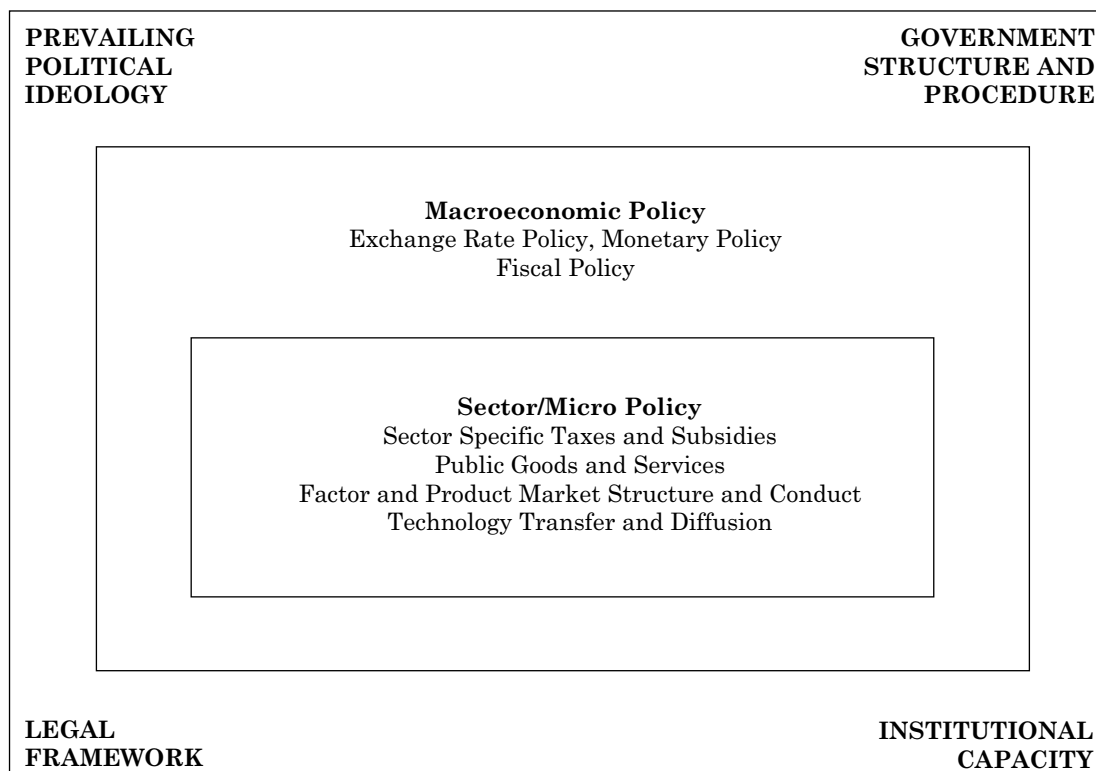
Figure 1 presents the various levels, range, and influences on development policy formulation. Aside from economic influences, pervasive cross-cutting influences include the prevailing political ideology, government structure and procedures, legal framework, and institutional capacity. As the figure shows, reforms are influenced by many direct and indirect economic and noneconomic factors at a number of levels that need to be explicitly considered.

³ Policy-based lending, generically known as program loans in ADB, has at its core policy changes or reforms (e.g., price changes, institutional reform). The disbursement of policy loans, or tranching, is tied to the implementation of specified policy actions after which funds release may be relatively quick and with less restriction on their use compared with project loans. Policy loans can be combined with investment and capacity building components through sector development programs.

Therefore, a focus on poverty reduction requires no less than a greater understanding of these factors than before as the basis for policy and strategy development. Identification of influences at all levels must be systematically assessed for their possible causes and effects on poverty and its reduction.

A detailed discussion of strategies and policies to address macroeconomic adjustment is well beyond the scope of this paper. At the risk of generalization it is sufficient at this stage to say that the intended effect of macroeconomic adjustment is to restore external and internal balance and stability as the prerequisite for reestablishing sustained growth. The subsequent positive intended effects on poverty reduction from successful adjustment occur through an array of channels and are largely indirect effects. These include, for example, adjustments that result in an improved revenue base from which government can finance the provision of services for the poor. Other adjustments may result in an increase in the real wages of the poor in a particular sector, which also implies that subsequent economic growth in the sector that increases the use of labor will effect better distribution of the benefits of economic growth.

Figure 1: Levels of Policy-Making and Influences



Structural adjustment programs, typically carried out by the World Bank in the 1980s and 1990s, covered a wide range of sector and microeconomic policy issues with considerable focus on market liberalization. Reform measures included:

- trade policy (removal of tariffs, quotas, and export taxes);
- market deregulation (reduction of subsidies and price controls);
- tax reform;
- improved financial performance of state-owned enterprises including restructuring, corporatization, privatization, and divestiture;
- promotion of foreign direct investment (FDI); and
- reform of financial and banking systems.

The underlying objective in structural adjustments is to achieve efficiency gains and productivity improvements by, for example, reducing the role of the public sector (due to lessons learned on its relative inefficiency), and increasing the role of the private sector in the economy, with emphasis on a market-based system. In terms of poverty impact, an increase in the poor's productivity (e.g., returns to labor) should allow the poor to consume and sell more. This will have greater effect on the poor if reforms target sectors that are the main sources of income for the poor (e.g., rural industries, agriculture, urban informal sectors, etc.).

Understanding the dynamic nature of reform is essential. The events leading up to reforms and the adjustment itself are part of a process. The situation itself is inherently dynamic. While reforms may be beneficial for the economy as a whole over time, they may also have a negative short-run impact on specific groups. Reforms that result in price changes can cause a shift in resource allocation. An increase in utility service fees will have implications for current users. Either example can have positive or negative effects depending on the user response to changes. Where the short-term negative effects of adjustment are assessed to be less than the cumulative longer-term negative affects under no adjustment, then action is preferable to no action. Nevertheless, for the poor who may have a higher than average rate of time preference, the immediate hardships of reforms can be unbearable. Identifying such effects is necessary to highlight where policy trade-offs must be made, to assess alternative responses, and to make allowances in reform design for short-term mitigation measures and/or ways to enhance access to new opportunities. It also suggests a flexible approach to implementation to allow for refinement of policies consistent with developing circumstances. However, it is important to distinguish between mitigation and pro-active income distribution, and between equality and equity.

This overview raises three basic questions which are further discussed in this paper:

- How does one predict and address any immediate negative impacts arising from the adjustment process on the poor?
- How does one target and involve the poor in adjustment efforts, especially at times when government is under pressure to control or even reduce redistributive expenditure to restore or maintain macroeconomic equilibrium?

- Is the growth–poverty reduction relationship and other qualitatively traced impacts an acceptable outcome where a reform indirectly impacts poverty and these effects are difficult to predict or quantify?

The challenges of prediction and the political economy implications of these questions imply the need for analysis of alternative options, consultation, and shared understanding at an appropriate level between ADB and key stakeholders of the client country, and selection and commitment to the appropriate option by the client. It is not appropriate for ADB to decide policy emphasis on behalf of client governments.

Finally, for the purposes of this paper, policy reforms are broadly categorized as:

- macroeconomic adjustments (fiscal, monetary, and exchange rate measures);
- market liberalization (price decontrol, import liberalization, etc.); and
- institutional change (public enterprise reform, civil service reform, etc.).

While the first type is associated with “first-generation” reforms, the third type is associated with “second-generation” reforms. The market liberalization type can be considered a subset of the first-generation reforms at sector level. First-generation reforms, triggered by macroeconomic instability, have normally focussed on restoring external balance, fiscal balance, reducing inflation, and restoring growth. Second-generation reforms are triggered by policy anomalies that hinder sustained and broad-based growth and overall inefficiency of the state institutions.⁴

II. DIMENSIONS OF ADB’S POLICY-BASED LENDING AND POVERTY REDUCTION

ADB operations in PBL have largely focussed on the micro and sector level reforms (except perhaps for Pacific DMCs, and the Asian crisis loans). Focus at this level still requires an understanding of the context of the macroeconomic situation and macro-level policy, related adjustments, and their impact on the poor. Furthermore, as sector-level adjustments or reforms often have macroeconomic effects (e.g., fiscal balance and inter-sectoral public spending reallocations), it is important for policymakers to be aware of the transmission of impact to the poor through macro-meso and meso-micro linkages.⁵ While a great deal has been written on the first-generation reforms and their evaluations, little is known about the impact of the second-generation reforms primarily because they are country-specific, and it is difficult to generalize on the approach to their evaluation. This part outlines key considerations for economic and social

⁴ For a distinction between first and second-generation reforms, see, for example, World Bank (1997), page 152.

⁵ The word “meso” can be understood to cover any intermediate level between “micro” and “macro”. In the context of the poor’s risk exposure, it appears to refer to community level. For example, the World Bank (2000a, 136) explains that “Risks can be classified by the level at which they occur: micro, meso, and macro. Micro shocks, often referred to as idiosyncratic, affect specific individuals or households. Meso shocks strike groups of households or an entire community or village. These shocks are common (or covariant) to all households in the group. Shocks can also occur at the national or international level” (World Bank 2000c).

policy during the reform and adjustment process and the effects on and implication for poverty. Much of the discussion in Section II.A is in the context of first-generation reforms while the discussion in Section II.B addresses second-generation reforms.

A. Adjustment and Poverty

1. Effects of Adjustment

In responding to an unsustainable balance of payments situation governments have three general options:

- further international borrowing to finance the deficit,
- decrease the deficit by restructuring international trade and capital payments through economic controls, and
- restore a sustainable balance of payments situation by increasing exports and competitive import substitution.

Each of these measures is intended to restore macroeconomic stability and economic growth. However, they require profoundly different macroeconomic adjustment policy stances, with different short-term effects on all groups, including the poor, and implications for long-term sustainability and recovery. Ames et al. (2000) outline five general ways in which macroeconomic policies can affect economic growth and poverty reduction (Box 1). Economic controls will not be discussed in detail here except to say that there is evidence showing that less distorted and more open economies generally suffer less growth contraction from negative terms of trade shocks (e.g., Balassa 1981 and Mitra 1994).

Box 1:
Macroeconomic Policies and Poverty Reduction

- Overvalued exchange rates affect the composition of growth through the influence on the relative prices of tradable and non-tradable goods and services. Real exchange rate depreciation can benefit net producers of tradables (e.g. agricultural exports), but negatively affect those whose income is derived mainly from non-traded goods and services or who consume products that are exported or imported.
- Sustainable domestic and external debt levels, and appropriate use of debt in balance with non-debt resources, is necessary to increase the certainty of available finance, including new debt for social and other programs that can benefit the poor. Achieving this balance can be difficult in the early stages of adjustment where fiscal deficits are severe.
- Where macroeconomic instabilities are moderate or temporary, including disequilibrium arising from macroeconomic mismanagement, they can be absorbed through maintenance of adequate international reserve levels and prudent fiscal management.
- Use of a monetary policy stance that results in low and stable inflation diminishes the negative impact on the poor of real income reduction that occurs with high inflation.
- Sending clear signals on a pro-private economic environment significantly builds private sector confidence. Private sector capital accumulation is an essential driver of growth given its proven greater efficiency versus public sector capital expenditures.

Source: Ames et al. (2000)

The sectoral structure of economies has an important bearing on the composition of economic growth and poverty reduction. In general, sectors that are growing and are significant generators of production and income to a significant proportion of the poor, will likely have a positive and direct impact on poverty reduction (Weiss 2000). On the other hand sectors that are underperforming and inefficient in terms of production, income generation, and delivery of goods and services, will have negative implications for all groups related to the sector including the poor.

By identifying the linkages and effects of macroeconomic policy changes on production, income, and consumption, the effects on different sectors and among different groups can be identified. Two aspects provide a starting point:

- assessing the impact of adjustment on the relative prices of nontradables (i.e., goods and services only traded within the economy) and tradables (i.e., goods and services that can be exported and imported); and
- assessing the impact of public expenditure on the poor.

a. *Price Impact*

In the case of adjustment involving currency depreciation, for example, groups who should gain will include net producers of traded goods, for example, export crops, the relative price of which should fall on the world market in foreign currency terms and rise in local currency. Net consumers of nontraded goods such as local staple foods will also gain, as their relative price should fall in local currency terms compared to imported foods. Producer and consumer categories may include farmer families and rural workers in an export production sector. Workers in unprotected and relatively competitive import-substituting industries can also gain from domestic currency depreciation through increased demand, substitution effects, and production stimulation. In this sense the traded sectors upon which the poor rely could be seen as a safety net during times of adjustment.

Categories of producers and consumers who are at risk of being negatively affected are those whose income is obtained primarily from nontraded goods and services, and who are significant consumers of products that are also exported or imported (the relative price of which will rise). Typical groups include, for example, public sector workers who may be laid off due to government expenditure cuts, and, for example, workers employed in protected import-substituting industries that are subject to market liberalization policies causing unemployment and lower wages. In this sense, nontraded sectors are likely to be adversely affected during periods of exchange rate adjustment, and poor workers who are dependent on these sectors will be more vulnerable. However, as adjustment will lead to relative price and income changes, the combined effect will determine the net impact on different groups. As labor and resources flow to activities with greater returns, and as consumers substitute to cheaper nontraded goods, there should be more gainers than losers. Nonetheless, this is complex to analyze and predict in the short run (Weiss et al. 2001).

Tradable sectors also face substantial risks in times of adjustment. For example, the production of goods such as agriculture or new capital-intensive industries will tend to lag behind changes in prices. The speed with which the economy adjusts depends to a large extent on options for production and consumption substitution. Well-known cases where substitutions will be more difficult include retrenched low-income and unskilled urban workers and agriculture, due to the sector's inherent supply response limitations. Substitutions will also be difficult when the cost of capital is high and/or investors lack confidence in economic recovery, as was evidenced in Indonesia and to a lesser extent Thailand in the period following the Asian financial crisis. Consequently, sudden liberalization for producers and workers in import-substituting industries may result in reduced incomes, especially where short-term alternatives have not been considered or identified. Policymakers will need to weigh the effects of market liberalization of protected industries as a short-term strategy to address a balance of payments problem. Macroeconomic adjustment that includes a tightening of monetary policy to fight inflation will reduce the availability and access to bank loans, especially for small business and poor families with limited or no collateral. In addition, the marginal impact of depreciation on assets during periods of economic downturn may be greater. This will reduce their spending and consumption earlier and more sharply under adjustment than without adjustment (Ames et al. 2000).

Furthermore, unless the demand for labor increases in sectors that respond favorably to adjustments, workers will not benefit directly from the adjustment, and owners of land and capital will become the main beneficiaries of renewed growth. This depends on a number of factors including a country's stage of development and related policy (e.g., progression from agrarian to industrial base and consequently labor relocation), and the elasticity of input substitution (e.g., price and productivity of labor compared to the price and productivity of capital). Economic adjustment that leads to an increase in the demand for labor, especially for labor intensive industries requiring unskilled workers (e.g., rural-based production), is more likely to be pro-poor. Thus, labor intensity is desirable for unskilled worker employment creation. Caution is nevertheless required in inadvertently encouraging a wage-productivity trade-off that could undermine competitiveness in, for example, export markets (see Lall 2001).

b. *Public Expenditure Impact*

A reduction in government expenditure as a result of fiscal constraints and the need to restore macroeconomic balance can be especially serious for the poor. However, this assumes that pre-adjustment expenditures reached the poor (subsidies intended for the poor may have been biased toward the middle classes) and that the services were effectively provided to and demanded by the poor. Where expenditure allocations and demand were both low prior to adjustment, then the effect is likely to be less severe, but it also indicates government failure in the first place. The latter situation is a more onerous starting point for providing targeted services to the poor in times of crisis and imbalance. Public expenditure reviews and incidence analysis supported by the World Bank and other donors are providing insights in this regard.

Tracing the price and government spending impact of reforms indicates the limitations in generalizing about the positive and negative effects of adjustment and reform strategies. A study by Mundle and Tulasidhar (1998) on India concludes that the distributional impact of the adjustment program up to the first half of 1990s is on the whole quite limited, and that the main concern for India's adjustment program is that it remains incomplete. As far as possible each case should be analyzed on its own terms both for understanding the context under which adjustment and reforms will be implemented, as well as planning the design of the reforms themselves. However, the fundamental implications for economic sectors are that policy reforms that seek to address poverty, as well as growth and efficiency, should aim at reforming or eliminating institutions and policies that are counterproductive to the economy as a whole on the one hand, and building the coping capability of the poor on the other.

2. Response Considerations for Adjustment and Poverty

a. *Social Impact of Policy Change*

ADB's concerns over possible negative impacts of policy lending on poor and vulnerable groups were first raised in the early 1990s. In 1994 ADB carried out a technical assistance (TA) to assess the social impact of program lending. This study (Papanek 1994) included a discussion of the linkages between the macroeconomic changes and the consequences for poor and vulnerable groups. The study assessed that up to the mid-1990s the International Monetary Fund (IMF) and World Bank (WB) macroeconomic adjustment and structural adjustment programs had set instrumental goals such as inflation rate and fiscal deficit level, but had made no attempt to quantify the effects policy loans had on national or per capita income, let alone its impact on a particular group such as the poor. A focus on the impact on the poor could be realized by identifying economic variables that change with adjustment and their transmission channels, including price and transfer effects discussed above. The approach identified four major channels through which policies affect the poor, specifically:

- the demand for unskilled labor;
- prices of inputs bought and outputs sold by the poor;
- net transfers to the poor; and
- access to public and rationed goods and services to the poor (ADB 1994).

Recognizing that the adjustment process is dynamic, the study also distinguished the major types of effects: direct, indirect, macro, and the near poor who might fall into poverty due to reform. The currently used poverty impact assessment (PIA) matrix is a way of organizing this information and logic (see Section II.C.2). Admittedly distinction between these groups was not clear-cut. However, as discussed further in Section C.2, to date the PIA matrix has not been used for PBL design itself or for targeting program inputs, but more as a means of tracing effects.

b. *Fiscal Policy, Social Development, and Poverty Reduction*

Fiscal policy and related design are clearly central to ensuring that key services are provided to the poor. Yet Nixon and Evers (2000) point out that a definition for "pro-poor" macroeconomic policies has not been adequately explained in the literature. This does not necessarily mean that such policies do not exist. In the context of fiscal policy, they explain that when under pressure to reduce their public sector borrowing requirement as part of an orthodox stabilization program, trade-offs and choices must be made in the area of fiscal policy in particular. This includes the balance and content of expenditure reduction and revenue raising. A feature of adjustment is that although the government is likely to be facing a tight fiscal situation, it will be under political pressure to at least maintain expenditure as well as sometimes select incompatible policy alternatives.

It is also sometimes perceived that shifting fiscal instruments (tax and expenditure) in favor of the poor is an obvious pro-poor policy. This is not necessarily so. First, the change in the public spending incidence across different income groups may have a negative impact on the subsequent economic growth (e.g., adverse incentive effect on entrepreneurs), which in turn decrease the subsequent growth-induced poverty reduction. Second, if the efficiency of service delivery does not improve, it is unlikely that the increased government expenditure allocation targeted to the poor will have positive impact on the poor. Such situations can arise where, for example, allocation of funds to government services are often largely on salaries with insufficient expenditure on operational costs. Assessment of the current spending patterns and institutional capacity is needed, as well as the scope for reallocating existing government spending into new priority areas and away from currently nonproductive areas if inefficiency and waste are to be avoided.

This point is also reflected in Ames et al. (2000), which indicates that macroeconomic policy can have a direct impact on poverty through the effect on the aggregate fiscal stance, and through the distributional implications of public spending and tax policy. In weighing the current composition of public expenditure and its financing, a country's policymakers will need to consider the growth, equity, and equality impact of spending intended to meet various development objectives. Nevertheless, given the heterogeneity of households and firms and diverse transmission channels of relative price changes, it would be unrealistic to design and put in place a policy reform that leaves no single individual worse off. Even the requirement that no household should fall even temporarily into poverty is likely to be extremely restrictive in poor countries. The more utilitarian view that the number of households in poverty should not increase may be realistic (e.g., Winters 2000, 5-6). A government's social development and poverty reduction objectives will also have a bearing on their defense of expenditure levels and consequently fiscal and monetary policy as it relates to borrowing. However, excessive and improperly targeted borrowing, domestically and internationally, is also not always an answer and acts to delay needed adjustments. Policymakers often cannot escape trade-offs (Box 2).

Box 2:

Policy Priorities and Trade-offs

Given the absence of universal policy ranking applicable to all countries in different macroeconomic conditions and limited public resources, policy prioritization owned by DMCs in coordination with donor agencies becomes crucial. Prioritization is especially important when policy makers face trade-offs, often involving political economy factors. Examples include:

- fiscal policy trade-off between a need for tight fiscal policies and poverty-targeted programs;
- price policy trade-off between a need for liberalizing price controls and livelihood security for the poor; and
- investment policy trade-off between a need for liberalizing FDI restriction and markets served by domestic SMEs.

Nevertheless, there is a strong case for ensuring that the poor, at least, are protected from the worst effects of economic recession and adjustment. This involves understanding the dynamics of adjustment considering measures to help the poor manage adjustment.

Source: Based on Ames et al. (2000).

3. Maintaining a Dynamic Perspective

a. *Hitting a Moving Target*

Despite possible negative short-run effects of reforms, the economic logic behind the reform requires that production/income and consumption/expenditure effects of adjustment should change over time as the economy adjusts to new prices. This occurs through reallocation of resources to more profitable enterprises and substitution to cheaper consumption goods, with fewer losers and more gainers. Nevertheless, the assessment and selection of an appropriate and acceptable policy mix to maximize economic growth performance while maximizing the impact on poverty through explicit equity considerations is not a simple undertaking, especially when the analyst must work within a framework of second-best economics.⁶ The policy stance for each of these situations will be different as a country moves from instability to stability, necessitating regular review and appropriate modifications in order for the policy stance to be consistent with the developing circumstances. There are also many factors that can affect the expected and actual

⁶ The economic theory of the second-best highlights the effect of existing market distortions in determining the effect of policy reforms. The existence of market imperfections (including those caused by policy distortions) can create conditions for *second-best* policies, defined as interventions that are Pareto-improving given the existing imperfections. The general conclusion from neo-classical economics—that policy reforms that act to liberalize markets act to enhance social welfare (first-best result)—is often shown not to hold when existing market imperfections and distortions are taken into consideration. Second-best models of policy reform are widely applied in economic analysis of agricultural, trade, and industrial policy. Roumasset and Setboonsarng (1988) is a good example.

timeframe for each stage. Unanticipated setbacks and exogenous factors may arise which may require more than one generation of reforms. In this sense, the process of policy change and reform is very much one of hitting a moving and often erratic target.

b. *Economywide Effects of Pro-poor Policies*

Just as economywide policies have effects on the poor, poverty-targeted policies have economywide effects in the short and long run. The latter effects will depend on the mode of financing and the response of the economy. At one extreme, if the economy is small and open producing only traded goods, and if the additional demand for food is met entirely by imports financed by external grants, expanded distribution of subsidized foodgrain to the rural poor would have no economywide effects in the short or long run. Welfare of the rural poor would increase. At the other extreme, if the economy is closed and the food subsidy is financed through a reduction in public investment, say, irrigation, then there could be significant macroeconomic effects. In the short run, the rural poor would be better off and the urban population would be worse off. In the long run, agricultural growth and therefore rural income growth will be reduced, possibly leading to an increase in rural poverty. If the government finances the subsidy through domestic borrowing or printing of money, a different macroeconomic situation will emerge (Srinivasan 1993, 119-20).

c. *Longer-term Effects of No Adjustment*

It would not be advisable to use the possibility of negative short-term effects as a reason to avoid reform measures. This is especially the case where the short-term negative effects of adjustment are assessed to be less than the cumulative longer-term negative effects of no adjustment. First-generation reforms often lay the basis for subsequent micro-level adjustments focusing on, for example, efficiency. It would also be self-defeating if the financing of poverty reduction measures became a contributing factor to macroeconomic instability. Ames et al. (2000, 13-14) caution against careless pursuit of budget allocation to poverty reduction programs at the expense of macroeconomic stability, which will eventually undermine growth. The more stable the macroeconomic conditions, the greater the choice and flexibility a country generally has in terms of the nature and scope for policies that can explicitly address poverty reduction. Furthermore, during recovery and establishment of steady economic growth, policy strategies can be developed that provide pro-active opportunity for the poor to be involved in the process. However, the extent to which a pro-active redistributive policy stance should be taken is a more profound public choice element. In the context of ADB operations, such positions should be a matter for discussion during preparation of the Country Strategy and Program (CSP) and Poverty Partnership Agreement (PPA), and the medium to long-term feasibility of alternative approaches must be carefully considered.

4. Helping the Poor Manage Adjustment⁷

a. *Avoid Crises First*

Clearly avoiding crises should be a top policy priority. Governments should avoid profligate fiscal and monetary policies, overvalued exchange rates, and unsustainable current account deficits—all problems in the 1970s and 1980s that invoked adjustment loans by aid agencies. As developing countries proceeded toward open economy direction, the 1990s saw various types of crises associated with weak banking systems and weak financial regulation in a world of large and volatile international capital flows.

b. *Public Choice Must be Made Once Crisis Hits*

In comparison to the crisis response in Latin America, there are some indications that the response to the Asian crisis was overshooting toward austerity. Admitting the uncertainty of the precise scenario of the counterfactual, once adjustment policies are accepted as inevitable, the way governments introduce fiscal and monetary austerity can worsen the adverse effects on the poor and near-poor. Poor people may prefer an adjustment that leads to the smallest drop in GDP at any point in time even if it implies a slower recovery, while nonpoor people are likely to prefer more severe adjustment in the short run but that yields higher growth in the medium run. This is due to divergence in rates of time preference. When a country introduces adjustment measures early on, the government may have more freedom to choose among different policy combinations and thus be more likely to manage a soft landing.

c. *Poverty-sensitive Response to Crisis and Adjustment*

By explicitly considering the implications for poverty reduction, sector-level policy lending offers the potential for micro-level improvement in efficiency and at the same time well-targeted mitigation measures that may arise from the negative short-term effects of adjustments. A poverty-sensitive response to crisis needs to consider: ways to help the poor households maintain their consumption; identifying opportunities for sustainable income gains for the poor; increasing government spending on services and infrastructure that can be accessed by the poor; preventing permanent reversals in the poor's human and physical capital; averting self-defeating behavior through the erosion of social capital (e.g., crime, prostitution, child exploitation, etc.); and ways of improving the poor's access to opportunities under a restructured economy (Box 3).

⁷ This subsection relies on World Bank (2000a).

Box 3:
Considerations for Safety Nets and Social Assistance

Safety nets and social assistance programs targeted to poor people need to be protected if not expanded as a short-term response by adequately identifying the groups most vulnerable to the shocks and evaluating the cost-effectiveness of different social protection options. For example, common considerations that arose for MDBs, including ADB, during the Asian financial crisis include:

- graduation strategies from assistance once the immediate problems have diminished and avoiding creation of dependency (or moral hazard);
- increasing resource allocation to investments in, for example, infrastructure and social capital development for the poor;
- the maintenance of safety net programs during normal times, which can operate as a form of insurance in times of economic distress (e.g., World Bank 2000c, pp. 165-170);
- public investment in the removal of constraints to production in tradable sectors as a way of facilitating adjustment, including, infrastructure to boost access to markets, improved access to technology, and improvements in the enabling environment to help facilitate production expansion and raise productivity.

d. *Avoid Generalizations*

Different sectors and subsectors, by their nature, let alone contextual circumstances, vary in the channels through which they affect poverty reduction as well as the directness of their impact. Sectors with indirect linkages and effects can have an essential role in poverty reduction as a means to an end. Important and sometimes contradictory considerations are their cost and efficiency in impacting on the poor. Individual sector performance can also vary considerably within and across economies, and caution is required in generalizing about the sector features, including in the context of poverty reduction. ADB's sector policies and strategies, while having addressed elements of poverty from the outset, are being updated to reflect recent and growing knowledge and experience with sector-specific dimensions of poverty. Appendix 1 summarizes the general role of specific sectors in poverty reduction, lessons learned from ADB and other development efforts, and current ADB and other strategies to reduce poverty through the sector. Implications such as macroeconomic issues and political economy are also considered in the appendix.

B. Political Economy Processes and Institutional Capacity

Between 1987 and 2000, ADB made 67 program loans and 22 sector development program loans. In addition, project lending and TAs have also increasingly involved policy-related dialogue and activities. PBL deals with complex socioeconomic and politically sensitive issues and it is not surprising that ADB would find PBL challenging. A fundamental problem in PBL design involves the extent of understanding of the policy context, in particular, political economy factors. A review of ADB experience (Abonyi 2001) suggests that supporting policy reform effectively through PBL requires extensive preparation and country knowledge in areas such as sectoral

policy context, policy making process, political factors including the role of key stakeholders, and institutional capacity requirements and constraints related to implementation. A certain level of ADB staff skill and experience is also needed to manage the relationship with DMC governments and stakeholders on sensitive domestic matters that characterize the policy reform process. It is important to see policy reform and therefore PBL as a process of change over time, where designing “good policies” is not enough; they need to be effectively implemented and sustained. This section, which draws on Abonyi’s (2001) work, discusses the process aspects of political economy, institutional capacity and governance influences, experience with policy dialogues and reform formulation, and their operational implications for PBL.

1. The Relevance of Political Economy Processes in Policy-based Lending⁸

a. *Factors that Initiate and Shape Reform*

The interdependence between political and macroeconomic stability is well reflected in the changing fate of governments. Krueger (1992) suggests that understanding the factors that set countries on a reform path and the critical momentum needed to sustain reform measures is a necessary starting point in considering the need and design for a support program to facilitate reforms. This includes understanding a country’s policy development processes and the broader political economy factors that are important in assessing why certain reform measures may be more desirable from an economic point of view but are unacceptable from a political point of view. In addition to understanding the motivation for change and the factors that determine the momentum of change, the ability to respond to new and unforeseen factors is necessary to increase the likelihood of successful reform.

Krueger (1992) also describes a range of political economy considerations that affect the choice of policies in a country embarking on a reform program. Of fundamental importance is the prevailing political and development ideology, which has a major bearing on policy decisions (e.g., a modernization or pro-industrialization policy may negatively affect agriculture through intersectoral transfers). The bases for ideologies can range from purely political, to an adopted development strategy arising from the desire to break with a politically and socially unacceptable past (e.g., colonialism or a previous government), and to the continuation of economic development thinking taken under advice. Understanding the prevailing ideology and the processes of shifts in ideologies is necessary. This understanding should include allowance for inertia in adopting changes from opposition groups and for capacity of institutions to adopt and implement changes in policy.

⁸ This subsection relies on Krueger (1992) and Abonyi (2001).

b. *Context and Reform Ownership*

Furthermore, while ADB's new mandate requires an additional consideration of how state institutions can be made to work better for the poor, growth-enabling institutional reforms as a necessary condition for poverty reduction had only begun to be widely recognized prior to the Asian financial crisis. For second-generation reforms to be successful, it is more important for their processes to be owned by middle management as well as top-level technocrats in the public sector (see, e.g., World Bank 1997, 152). These issues remain central concerns for institutional reforms. Designing institutional reforms would require much deeper knowledge of the country context than currently practiced by aid agencies as in many ways the designer must anticipate a new trajectory of dynamic institutional responses to reforms that will inevitably be path-dependent.⁹

Policy decisions made by a government are usually the result of an interactive process. Even in a relatively autocratic government, some consultation occurs. In democratic or consensus-based societies these consultative processes can be protracted and involved depending on the nature of the policy and the extent of its likely impact and trade-offs that may be required. The subsequent political equilibrium is a balance of interests and wants and usually cannot be reached in a way that caters to all needs. Furthermore, policy instruments may not be applied in a discrete way, i.e., all or nothing, but may be applied or reduced in increments depending on the assessed political benefits or costs. Stakeholder analysis of who stand to lose from the reform helps to understand the nature of losses associated with the reform and decide whether compensating the losing groups will ensure the reform's political feasibility. This also underscores the need to consider political bargaining and trade-offs in policy making.

Policy-based lending inevitably faces similar processes, especially where reforms necessitate economic policy change that will result in economic reallocation of resources and social impact, if not at the society and community level then often at the household level. In the interests of improving efficiency and performance at the macroeconomic, sector, and subsector levels, reforms will impact on one or more of four key economic variables that affect households: employment and income, prices and markets, transfers, and access to public goods and services, as discussed above. Changes in these variables not only impact directly on households but is often closely observed by interest groups and political representatives. Ignoring their views and response can seriously undermine the effectiveness and outcome of the loan from conception to negotiation and implementation. Understanding and accommodating key political economy factors is an essential part of a reform process both in terms of raising broad-based civil and stakeholder support and in identifying and mitigating political risks. Failure to correctly assess the political economy landscape will add to the risks of failure. Nelson (1998) assessed that ADB is not fully tapping the potential sources to improve policy analysis or policy dialogue at the national or regional level.

⁹ There is a growing amount of economic literature that can be loosely grouped under "path dependence" or "hysteresis", e.g., David (1985), Arthur (1988), and North (1990) to name a few from early contributions.

c. *Time Dimensions*

Political time dimensions and stability can affect PBL in several ways. Periods of political change or reforms introduced toward the end of an administration can slow or stall the political decision making process, especially where the reform is perceived to bring short-term costs over the longer term and less certain benefits. A similar situation can affect the commitment to follow through with reforms, especially at the second tranche stage where costs are clearly being experienced and benefits have yet to be realized. At the other extreme a new government, eager to distance itself from the actions of the previous administration, may effect rapid policy reversals. On the other hand an administration that was elected to effect needed reforms can become the necessary advocate, and depending on the constitutional time horizon provided to the administration can provide considerable scope and opportunity for a variety of reforms. This also increases the possibility that the benefits of successful and significant reforms will be seen during the life of the administration, further enhancing its credibility.

d. *Political Stability and Will*

Political stability clearly affects the political will to proceed with needed reforms. Nevertheless, even stable governments may lack the will to undertake or carry through with reforms, preferring to maintain the status quo. Similarly, a stable and accommodating government willing to proceed with a series of reforms may itself eventually face reform fatigue and change its stance. Assessing the interest and likely commitment to reform measures at an early stage is necessary. This is best achieved through early participation by key lawmakers, in addition to government and civil stakeholders, in the concept and design phase. Involvement in the design ideally involves a consultative process that allows key decision makers to understand the basis, need, and rationale for reforms; assess options; and contribute to the design and final decision making, resulting in greater ownership of the resultant program. This may result in some unexpected design outcomes, but on balance it is preferable to have a reform package that is understood and has ownership and commitment to follow through, than to have a package that is poorly understood, regarded as externally imposed, gives the impression of lack of transparency, and lacks the required political will for implementation.

e. *Effects of Crisis*

A case in point is the existence of crisis, which is often an opportunity to bring about necessary reforms, especially where inefficiencies, waste, and inappropriate domestic policies are an underlying cause of the crisis. During periods of crisis, governments and the public are more likely to understand the causes of the crisis and accept the necessary steps to effect recovery and avert future recurrence, especially when the alternatives are visibly bleak. Nevertheless, a crisis period is usually fraught with political uncertainty, and caution is still required in assessing

an often volatile political situation with interest groups also looking for opportunities to gain from and influence change in their own favor. In such a high stakes and dynamic situation, assessment of the political economy influences, involvement of a broader range of interest groups in the reform design process, and swift reaction to changes in the political climate and opportunities are required. Externally forced and poorly understood reforms can be counterproductive in the medium to longer term, especially if the crisis leads to a change of government eager to disassociate itself from the mistakes and misfortunes of former administrations.

f. *Social Cohesiveness*

A further political economy factor is social cohesiveness. The more socially cohesive a society and the more confident its members are of fair representation through locally defined procedures, then the easier it will be to achieve a consensus. This also implies that these procedures should be acknowledged, respected, and followed in the reform process. Circumvention of locally defined consensus building mechanisms is likely to be viewed with suspicion and undermine well-intended reforms. On the other hand, as with political instability, the presence of open social conflict is likely to undermine and limit reform design and implementation. In other cases, themes of common interest to different and competing social groups can be used as an opportunity to build consensus on mutually beneficial policies.

g. *Consultation and Champions*

While effective two-way consultation with key government stakeholders is essential in PBL, consultation with civil society in reform design is increasingly regarded as a necessary step to measure reaction, assess impact, and to obtain input for the design of PBL. This includes interacting with leadership to obtain input into reform design and gauge the level of support, as well as identifying reformers who can act as "champions" during implementation (Knapman and Saldanha 1999). Furthermore, despite the policy orientation of program lending, consultation needs to extend beyond lawmakers and executive agencies. For reforms requiring legal changes and depending on the impact of changes, it is likely that legislators will consult their peers, local advisors, and constituents first as well as sound out possible opposition. Based on the reaction they will decide how to proceed. To the extent possible, reform program designers need to make a similar broad-based assessment of reaction.

h. *Donor Neutrality*

Reforms, policy changes, and implementation are usually challenging within the context of a country's own political, government, and civic institutions. This task can be more demanding when the change is encouraged from outside, especially when it is possibly perceived as an external agenda. While ADB policy requires that its operations and position should be politically neutral,

reforms by their nature, and consequently PBL, inevitably enter the arena of political process. Consequently, it becomes a matter as to whether ADB operations implicitly or explicitly consider political economy factors. Political economy involves the interaction between political science and economic management.

i. *Conditionality*

The purpose of conditionality in PBL is to help bring about effective and sustainable reform in order to resolve perceived policy problems. Conditionalities link or “intermediate” the policy problem and desired results by specifying key actions to be taken that are expected to lead to improvements in economic performance or in quality of life. From this perspective, conditionalities in PBL implicitly assume a great deal of knowledge about the policy problem, about effective actions for resolving the problem, about implementation requirements and conditions, and about desired results. As conditionalities increase in number and detail, so does the assumed knowledge about the policy problem, its context, and feasible means for its effective resolution.

However, in practice, there is generally limited knowledge and significant uncertainty about means/ends relationships and therefore associated conditionalities required for policy reform, i.e., what is likely to work, and how. These limitations may become apparent as difficulties arise in implementation, or as desired results do not materialize even when conditionalities are complied with. In this context, too many conditionalities, excessive details and complexity, and inflexibility in their formulation have generally not proven to be the most effective means for PBL to support implementable and sustainable policy reform, and have at times unnecessarily complicated ADB/DMC policy dialogue.

It is essential not to lose sight of the basic intent of PBL in the numbers and details of conditionalities. The purpose of PBL is not formal compliance with a large set of detailed conditionalities whose relevance and feasibility may be uncertain. The purpose is to contribute to the process of policy reform. From this perspective, it may be more effective for PBL design and associated conditionalities to be more limited in number and more modest in scope, with a readiness to adapt to changing conditions. Conditionalities may therefore be more usefully seen as “working hypotheses” than certainties in guiding policy reform in a complex, dynamic, and uncertain environment (Abonyi 2001). Nevertheless, defined conditionality is sometimes needed to preserve reform momentum, support and strengthen the position of a reform minded government, and establish targets for monitoring purposes.

2. **Institutional Capacity and Governance**

Abonyi (2001) describes that in addition to political economy factors, the institutional capacity of executing and implementing agencies to effectively put reforms into practice can greatly affect the outcome of a reform program. Policy reform relates to basic changes in incentives, behaviors, expectations, and power relations. PBL initiatives usually require administrative,

technical, and organizational capabilities that are often in short supply in DMCs. Yet in general, there is limited recognition of the nature, role and relevance of the institutional context of PBL. The result is often a lack of realism in PBL about the institutional capacity needed to implement and sustain policy reforms, which surface only at the implementation stage. Considering the totality of institutional and political economy factors, PBL can be more complex than project lending, and in part could explain its more variable performance.

a. *Institutional Capacity Constraints and Requirements*

Clearly policy reform and PBL are fundamentally about institutional capacity and change (involving considerable time and resources) that must be reflected in PBL design. Capacity issues that need to be explicitly considered include the ability to absorb and disburse program inputs, meet conditionality schedules, and realize the expected outputs of reform measures. In part this may arise due to the additional dimensions that program lending may have to address. Sector Development Programs (SDPs), for example, may require policy measures that require legislative action as well as project-type implementation of the accompanying investment components. Excessive design complexity and conditionality will only compound this risk as will unrealistic time-bound conditionality. Further problems can arise if conditionalities are inflexibly applied especially where political changes occur. A key requirement in PBL design is therefore an assessment of the institutional capacity constraints and requirements for PBL implementation. Such assessment can lead to more effective PBL by bringing design in line with implementation capacity, and by leading to capacity building initiatives that strengthen implementing institutions.

b. *Capacity and Poverty Reduction*

When poverty reduction and local level conditions are also factored in, it might be thought that this will further complicate the PBL design and implementation process. The World Bank (2000c, 99-115), however, points out that making state institutions work better for the poor, from a capacity and governance point of view, promises broad-based poverty impact, and provides the basis for improving the effectiveness of public spending. These are areas that MDBs have avoided due to their being politically sensitive, but are becoming increasingly explicit items on the policy dialogue agenda.

c. *Incentives and Motivation*

Having the right incentive and motivation smoothes the delivery of public services to the poor. Key incentives include merit-based recruitment/ promotion, clear specification of tasks, rewards for good performance, and insulation from political pressure. Together with skilled technocrats and close collaboration with the business community, these make up what has been termed “developmental state.” Promoting an evaluation culture for staff and agencies is important,

Box 4:

Decentralization and Political Economy

Decentralization is in part being driven by political mandates to provide greater local-level political and administrative autonomy. It is also seen as a means of taking advantage of local-level understanding of an area's specific needs. Local knowledge and information can help identify more cost-effective ways of building infrastructure, providing public services, and organizing their operation and maintenance. Knowing what local needs are most pressing can help the disadvantaged. Local monitoring and supervision for many types of projects and programs can also be more cost-effective. Local authorities and agencies would need considerable autonomy in this regard including fiscal matters as well as considerable support and safeguards from the center. Mechanisms for redistribution from the central budget can mitigate inequalities across localities.

However, many local governments lack the administrative capacity for large-scale decentralization and need training in accounting, public administration, financial management, public communications, and community relations. Safeguards are also needed to monitor financial probity and discourage their capture by local elites. Widespread popular participation is vital to successful decentralization. Having local communities participate effectively in the planning and use of municipal resources greatly influences the potential for successful decentralization. Experience is showing that building this capacity takes time, and until it occurs there are situations where ineffective and hurried decentralization will not lead to improved poverty reduction efforts.

Source: (Moore and Putzel 1999).

together with clearly specified and tractable tasks and competitive salaries. While this is ideal, implementation may be met with considerable inertia given the changes required in behavior and related incentives. Using mass media to disseminate information on budget allocation and spending enables people to hold civil servants accountable, reducing inefficiency and corruption.

d. *Rule of Law*

How state institutions comply with the rule of law greatly affects the daily lives of poor people who are very vulnerable to abuses of their rights. Also the rule of law promotes poverty reduction through better overall growth performance. Making the rules and procedures simpler and clearer is important in the areas of greatest concern to the poor, such as labor disputes, land titling, tenant rights, and protection of their civil rights (including equal access to police services and protection). Small claims courts and other informal proceedings can reduce the backlog and widen access. Alternative dispute resolution mechanisms hold considerable potential for reducing delays and corruption. Specific interventions for aid agencies and NGOs in this area include establishment of legal service centers for the poor. The most effective legal service organizations work outside the judicial system, protecting rights without resorting to lawsuits. The work of legal service organizations helps create a culture of rights that changes the way poor people think about themselves relative to those who have power over their lives.¹⁰

¹⁰ See also ADB RETA 5856: Legal Literacy for Supporting Governance (for \$500,000, approved on 24 August 1999) reports on Legal Empowerment: Advancing Good Governance and Poverty Alleviation (dated November 2000).

e. *Poverty Reduction as a Public Good*

The interests of the poor and nonpoor are intertwined in many ways, making it beneficial for the nonpoor to take an interest in policies that help the poor. Governments and aid agencies need to facilitate the perception of common interest between the poor and nonpoor. Key to this is systematically introducing into the public debate the notion that poverty reduction is a public good, therefore, it is in the interest of the nonpoor to pay for, e.g., control of civil disturbances and crime, communicable diseases, urban sanitation for the poor, mass education, etc. The state can undertake key actions to foster developmental synergies between communities and local governments, such as information dissemination, networking, training, and motivating government staff.

3. Implications for Loan Preparation Processes

An Operations Evaluation Department (OED) evaluation study (ADB 2001e) addresses a valid point about policy reform: it is characterized as a nonlinear, chaotic process rather than linear, “blue-printable” process, therefore, needs to be evaluated as such (e.g., over a 10-year time horizon). This being a new and emerging field, no standard criteria are available to evaluate processes, let alone to analyze the impact of processes *ex ante*. This is especially true for the second-generation reforms. In terms of planning for policy lending, a clear operational implication is that policy reform programs need much more time and care in preparation and in ensuring ownership than is currently practiced. Because participatory program design is crucial to nurturing government ownership, the points made in the OED report about the evaluation of policy reform TAs loom even larger for *ex ante* analysis of policy loans.

Participatory approach has gained much attention and been increasingly applied for project operations. Stakeholder and beneficiary analysis and participation are being recognized and accepted as a vital step in improving the relevance, performance, and impact of projects. However, what a participatory approach holds for PBL at macro and even sector level is much less clear. There is an obvious representation difficulty since some categories of stakeholders will be too diffuse for direct participation in reform formulation process. Gainers from reforms are likely to be too numerous and unorganized for realistic participation, while losers from reforms are likely to be more organized and articulate. Given the large transaction costs involved in appropriate representation, direct participation in PBL would most likely be infeasible and some indirect approach would be called for. A minimum requirement would be an adequate understanding of local political, legislative, and civic procedure and the extent to which proposed reform measures will be subject to due process. Another requirement would be a political risk assessment of reform implementation (e.g., Dinar, Balakrishnan, and Wambia 1997). A common experience in MDBs seems to be that resistance to reforms becomes more pronounced during PBL implementation rather than during its preparation.

Pursuit of active participation has important implications for the design process, resource and time requirements for design, and the facilitation approaches used by staff and consultants. This implies that the decisions surrounding reforms should, within reason, be made at a pace determined by, for example, the client government. As described earlier, reforms are often required because of inefficiencies and underperformance that necessitate remedial action and difficult decisions, sometimes swiftly. In reform situations there is rarely universal support. However, even under such circumstances the use of misplaced pressure tactics when the political dynamics are not fully understood can be counterproductive to building political will. This can add to the risk of nonacceptance and failure. Even under pressure, building and protecting credibility in the eyes of the client is necessary for building confidence in reform measures. Building effective support for reformers against nonreformers requires skilled practitioners.

A participatory consideration applied to PBL requires a much broader knowledge and skills than required for project lending. Staff and consultants handling PBL ideally should be knowledgeable about the country's political economy, possessed with diplomatic and yet savvy communication skills. This includes analytical skills needed to weigh benefits and costs of alternative options as the reform process unfolds. Fielding of staff with adequate capacity in these aspects would support PBL preparation as well as its implementation. If this is not possible, an alternative would be fielding of experienced consultants with an adequate level of delegation of authority. However, an issue raised by the OED reports is the limits placed on government ownership when they do not participate in the selection of the TA team that will design the reform process for the country.

Usually, there are multiple donors involved in supporting policy reform in particular DMCs. This can provide additional resources and sources of advice to support reform. It may also complicate the policy reform process, as donor perspectives and preferences may differ from each other as well as from the government on key policy issues. Such differences can have the advantage of providing options to DMCs on policy reform, but they can also result in conflicting advice and pressures that may be difficult for governments to reconcile. Alternatively, consensus among donors may lead to a convergence on "international good practice" solutions that reflect donor interest and consensus more than particular DMC needs and circumstances. Therefore donor coordination is important in PBL and requires attention, but with the objective of leading to a reform program consistent with and responsive to DMC needs and circumstances, rather than donor preferences. World Bank (2000b) discusses the donor coordination issues in the context of a comprehensive development framework. ADB would also need to explicitly tackle the coordination where its DMCs are concerned. It also needs to examine the relevance of the existing analytical tools and desirable extent of participatory practice within the organizational incentive structure (Fujimura 2001).

C. Addressing Poverty Reduction in Policy-based Loans

The discussion in the previous section highlights the need for a systematic analysis of institutions and current policy as the basis for preparing policy-based loans. This section discusses

issues that underlie analysis of policy in relation to policy loan design, and the assumptions that underpin the expected outcome of PBL and their impact on poverty reduction.

1. Assessment of Policy

In considering policy options it is highly desirable to have an assessment of the possible outcome including a simulation of what would happen if each alternative were followed compared to the "without change" situation. The counterfactual problem in PBL arises from the fact that reforms are taking place in a constantly changing domestic and international environment with many influences that can affect the outcome of a reform. Frequently, reform programs are implemented within an envelope of reforms supported by various donors and government branches and levels (Nelson 1998). The environment cannot be held constant to isolate the impact of the policy changes associated with a single loan. Response times may vary depending on policies: monetary variables respond faster than real variables. Furthermore, the program cycle is unlike the project cycle as there may be no defined beginning, middle, or end. Cycles overlap and data collection may be indistinguishable for monitoring. Policy reforms may also require frequent mid-course changes as the external environment changes. Bearing these complexities in mind, this section outlines possible ways to assess the economic, social, and poverty impact of program loans.

Notwithstanding the inherent problems of ex ante analysis of policy impact, attempts have nevertheless been made to assess impact. For example, a conceptual framework for assessing program loans suggested by Evans (1999) is based on a "with" and "without" program perspective. This is familiar and convenient in terms of ADB operations given its established use of the perspective in project assessments. But in view of the problems of establishing the counterfactual under a situation of change, it may be more appropriate to place emphasis on a broadly described expected outcome that explicitly recognizes the possible influences on the outcome. Furthermore, for PBL that involves several, sometimes loosely connected policy measures, it is more appropriate to indicate the expected outcome for their combined effect rather than individual policy measures. Table 1 lays out a modified version of Evan's framework.

The table's contents have much in common with project analysis, but the actual completion of each of these steps is intrinsically difficult for several reasons. First, there are the problems of separating the impact of the program on the sector from nonprogram effects, which can make even static analysis difficult. Second, this implies that estimating counterfactual performance can be more difficult when the influence of reinforcing and countervailing forces are not known. Third, even where key indicators and their determinants can be identified, data shortages may limit analysis. This often results in a diminishing level of rigor in the analysis that underlies policy analysis and program design. In considering these challenges, Evans provides a summary of the kinds of analysis that are possible, and the fallbacks that might be taken when data and resources are not available.

The effects of a program loan should be based on as thorough a statistical analysis as possible including, for example, econometric estimation using time series data for estimating sector

Table 1: **Without Program and Expected Outcome Framework**

Without program situation, the range of possible future scenarios	Benchmarking of the economy/sector in terms of key economic and social indicators, description and assessment of current policy environment, possible trajectories of the target sector
Rationale	Summary of why the sector or institutions are under-performing and the causes and effects, scope for improvement through reforms, and the costs that are likely to be incurred during the process of adjustment
Objectives	The aspects of the rationale for economy/sector reform that can be addressed in a particular program loan
Policies and justification	Choice of policy instruments, the way in which they are likely to achieve the objectives, and the items to be covered in the policy/program matrix
Expected policy outcomes	The expected impact on economy/sector development and specific indicators identified in the 'without' situation. Description of key assumptions, identified exogenous influences and risks and their possible effects

trends and parameters. A voluminous amount of time series and cross-sectional data has been produced to examine the impact of, for example, adjustment loans. However, while statistical analysis can be useful in sorting out the relationships between policies, growth and variables, other results have proved less definitive. Cross-country studies, for example, provide broadly identifiable trends in economic development, but only country-specific analyses yield operationally useful policy options for agencies such as ADB. Accurate confirmation of hypotheses and representation of development principles being used in reforms points to the need for further rigor in the use of statistics and avoidance of misuse.

a. *Economic Modeling*

Economic policy modeling can help quantify aspects of program projections through the selection of an appropriate analytical framework combined with benchmark accounting data. Partial equilibrium analysis has been applied in some ADB projects to assist in understanding how a sector works, to assess distortions and to roughly estimate orders of magnitude changes. Evans (1999) lists areas where partial equilibrium analysis can be usefully applied including: (i) fiscal impact of interventions; (ii) consequences of price policy changes; (iii) impact of changes in education policies on costs, teachers, and graduate numbers; (iv) impact of health policies in numbers of health workers required to treat patients; and (v) risk analysis. However, partial equilibrium analysis cannot handle changes in macro-level variables that affect several sectors and are likely to progressively change themselves as a result of certain reform measures. In this

case general equilibrium analysis is needed, but requires a great deal more data, time, and resources for useful and accurate modeling. Social accounting matrices are also a useful way to test policy outcomes on the economy as a whole (for a fuller discussion see Weiss et al. 2001).

b. *Historical and Qualitative Analyses*

Full quantitative analysis (such as applied general equilibrium) can be constrained by data limitation and research resource availability, and use of qualitative methods including historical and institutional analyses are helpful in understanding the nuances of policy applicability in individual DMCs. ADB produced comprehensive survey volumes on poverty in Asia with seven country studies: Quibria (1994) on rural poverty and Pernia (1994) on urban poverty. While several new countries have joined ADB since these studies were prepared, they nevertheless provide a useful guide upon which to build further detailed country-specific poverty analyses.

c. *Country Comparisons and Estimates*

When data are short and modeling is not possible, Evans (1999) suggests country comparisons and direct country estimates to be the next level or fallback. For example, an earlier experience in the country or in other sectors may provide some clues on sector workings and comparable productivity and performance, as could comparison with similar situations in other countries. However, such comparative studies must be used with great caution and benchmarking does not necessarily say anything about how to improve performance or expected outcomes given the difference in contexts.

d. *Checkable Stories*

A related fallback described by Evans (1999), is the telling of “checkable stories.” Economic historians often look at past events as the basis for hypothesizing and principle inference when formal evidence is not available. Program loan formulation in the transition economies has very much relied on this when considering the approach and outcome of moving from centrally planned to market economies. The key to appropriate use of the approach in the absence of reasonable statistics and statistical analysis is their “pertinence and checkability”.

A key to the checkable story approach has been the development and increasing reliance on the use or rapid appraisal (RA) techniques over the past 20 years. RA techniques have become widely used not only because of their increasingly participatory approach that involves key stakeholders and knowledgeable informants, but also because of their potential for relatively low cost in time and funds. However, the more participatory and intensive the technique, the higher the cost in terms of time and often funds to hire skilled operators. Furthermore, despite their effectiveness as a consultative and participatory tool, if not used in conjunction with quantitative data collection, they will not provide the necessary data that allows modeling for

hypothesis testing and predictive purposes. This further confounds the quantitative estimation of expected program effects.

e. *Household Surveys*

Living standard measurement studies (LSMS) and similar household surveys are becoming an important source of poverty impact benchmarks and indicators. The World Bank is increasingly collecting poverty data by employing participatory methods. Its staff recommends a two-pronged strategy: a more structured approach to data collection; and improved, unstructured attempts to measure the impact of specific interventions (mainly project loans as it is impossible to design a control group for program impact). The World Bank's model five-year work program has five components: (i) national household survey every five years, (ii) collection of consumer and producer prices to monitor spatial and temporal price changes, (iii) regular participatory poverty assessments to gather communities' own perceptions of needs, (iv) annual Core Welfare Indicators Questionnaire (CWIQ) to monitor key socioeconomic indicators and provide quick feedback on changing access to and utilization/satisfaction of services by different groups, and (v) a household panel survey to monitor the dynamics of poverty and intrahousehold issues. These components are supplemented by timely annual national accounts and disaggregated public expenditure reviews. However, these measures are intended to serve country strategies, not individual loans. The World Bank has concluded that it is impossible to measure or even attribute additionality at the level of the individual program¹¹ (Nelson 1998, 9).

f. *Limitations in Measuring Poverty*

Other limitations in poverty impact assessment of PBL pertain to measuring poverty's multidimensionality. Apart from income/expenditure poverty defined in food and nonfood commodity baskets, many attempts to capture the multidimensionality of poverty have not been very useful in MDB operation. For example, World Bank (2000c, 19) notes: there is now a growing consensus that it is neither feasible nor desirable to capture vulnerability in a single indicator. Measuring other dimensions in a meaningful and consistent way to facilitate comparisons across countries and over time will require considerable additional efforts on both the methodological and data-gathering fronts.

Even the narrow definition of poverty as command over commodity consumption poses serious measurement problems. However, "it is not controversial that inadequate command over commodities is the most important dimension of poverty, and a key determinant of other aspects of welfare such as health, longevity, and self-esteem. And it has been a powerful motive of policy" (Lipton and Ravallion 1995, 2553). From a consistency and operational point of view, it is

¹¹ The World Bank has, however, produced a handbook for ex post poverty impact evaluation in the context of project loans (Baker 1999).

recommended that economic analysis of poverty impact of PBL is presented in terms of income/expenditure poverty or simpler and less manipulable physical indicators such as literacy, morbidity, and illness that are more amenable to quantitative analysis. In choosing the conservative definition of poverty, this does not deny the importance of other aspects such as vulnerability and social exclusion, but it suggests that the first step should be to focus on the most directly observable aspect of poverty. Nonquantifiable dimensions of poverty could be supplemented in other forms of documentation to better inform the decisionmaker.

These points, together with the World Bank experience, suggest a clear analytical limitation to assessing the poverty impact of individual program loans and provide an important warning for ADB's operations regarding the meaningful extent of rigor and comprehensiveness that can be demanded in the *ex ante* assessment of individual loans. As implied in the discussions in the preceding sections, it is uncertain whether poverty reduction outcome can be radically improved by changing the way aid agencies assess their policy-based loans. It would be most pragmatic to start where ADB currently stands in the practice of PBL assessment, and to explore ways to improve the practice, and in turn, improve the effectiveness of PBL at the margin.

a. *Limitations of a Relative Poverty Focus*

Furthermore, in thinking about poverty impact of PBL, focusing on only the bottom quintile (or quartile) is too narrow and impractical. Unlike cross-country regression analyses, country-specific assessment of poverty impact would inherently involve analyzing interrelated effects of policy reforms in the entire economy. The analyst should also be advised to look at the layer of the population that successfully moves out of poverty into middle-income groups and further up over time, which may yield important policy lessons for the overall development process, of which poverty reduction is the intended outcome. Some DMCs may graduate faster than others from a sole focus on poor groups, thus government policymakers must start considering the welfare of the whole population, whose bottom quintile may well be thinking beyond poverty.

2. ADB Practice in Poverty Impact Assessment of Policy-based Lending

ADB currently has in place a method devised for poverty impact assessment of program loans based on the RETA report by Papanek (1994). The findings were summarized in a Strategy and Policy Department (SPD) RETA summary report (ADB 1994), and a Staff Instruction (ADB 1995) was subsequently issued (GP Section 47–PIA Matrix). The Papanek report stresses that the PIA matrix is not intended to be a complete social impact analysis, but a way to assess the types of effects of reforms and their channels of transmission as a means of assessing the overall economic impact on the poor.

As knowledge and experience accumulated in the use of the matrix, concerns arose over its limitations as a tool for assessing the social effects of reforms. Nelson (1998) assessed the technique's strengths and weaknesses. Strengths of the PIA matrix included: its provision of an

analytical framework that incorporated the main economic dimensions of poverty and channels of transmission; its explicit consideration of poverty impact with potential for influencing program design, including mitigation of short-term effects; accommodation of adjustment's dynamic perspective; and low preparation cost. Weaknesses included: the potential for imposing multiple goals if, for example, intangible social goals are brought into the matrix; inability of a forward-looking assessment to serve impact monitoring (designed as a reporting tool); tendency for sector level loans to ignore the confounding effects of policies and other interventions outside the sector; inclusion/exclusion of particular impact channels and types depends on the analyst's judgment; potential to become an end-of-mission exercise; and uncertainty of underlying data and evidence of transmission effects. The matrix also left out the governance linkage, perhaps because "second-generation" reforms had not yet emerged in 1994.

To reflect the need to broaden some impact channels and further emphasize mitigation and enhancement measures, recent program loan documents have independently modified the matrix. For example, a column is sometimes added to the PIA matrix that explicitly incorporates mitigation or enhancement measures to address negative effects or to accelerate reform intentions.¹² In some instances these were the bases of the adjustment costs and became the bases for the policy loan, and in other cases became the bases for the investment components of a sector development program (SDP).

Along these lines Bolt et al. (2001) proposed a few simple refinements in a Poverty Impact Assessment and Mitigation Matrix (PIAM) provided in Table 3.

The table reflects a number of considerations. Key points described in Bolt et al. (2001) area as follows. First, there are cases where it is necessary to distinguish between the labor market and employment consequences of policy changes on both the formal and the informal sector employment (e.g., public sector reforms and labor market deregulation). Second, as discussed earlier, in some cases it may be important to distinguish between the impact of relative price effects on the poor as producers and consumers, as well as general price changes (e.g., decontrol of agricultural prices may benefit poor farmers but hurt poor consumers who are net consumers of the goods concerned). Third, access by the poor to public services should only cover nonmarketed services provided for a nominal or zero charge basis. Services provided on a commercial basis should be included in the price row. Fourth, as direct government program to help the poor are provided in the service access row, transfers should only cover the indirect impact of a policy. However, this may be difficult, as it requires knowledge of endogenous finance mechanisms and household behavioral response.

In terms of the horizontal axis, the direct/indirect/macro distinction used in the PIA makes sense in a clearly defined market, but once broad based policy interventions and institutional reforms are considered, the distinction between indirect and macro effects becomes unclear and hard to justify. Where feedback effects (e.g., due to the size of the variables being reformed) are

¹² For example, Loan No.1568-69 Mongolia Health Sector Reform (ADB 1997c), and FSM Private Sector Development draft RRP (ADB 2000c).

Table 3: Proposed PIAM Matrix

Channel		Type of Effect			Major Groups Affected	Mitigation or Enhancement Measures
General	Specific	Direct short-run	Indirect short-run	Indirect medium-run		
Labor Market	Formal Informal					
Prices	As output consumer As output supplier As input consumer As input supplier General prices					
Access for Poor	Nonmarketed Public services					
Transfers	Private transfer Public transfer Net Impact					
Information Basis or Crucial Assumptions Brief Narrative						

likely and intertemporal trade-offs are important, a refinement is the distinction between the indirect short-run and medium-run effects on the poor which could be macro or otherwise. Direct effects can all be considered short-run.

In line with practiced modifications, any mitigation measures that are needed to offset the negative consequences of the poor can be explicitly added in the matrix as an extra column. To help overcome the problems of treating the poor as a homogeneous group, and add to the specificity of the impacts and mitigation measures needed, it is suggested that another column be added describing the groups affected.

Given the limitations of ex ante poverty impact analysis of PBL, completion of PIAM may to a large extent remain a qualitative exercise or selectively quantitative for practical purposes. In such cases understanding can still be raised for all parties by laying out identified benefits and costs of reforms explicitly to stakeholders. Furthermore, ADB would need to consider appropriate approaches to mid-reform monitoring and evaluation, preferably in coordination with other aid agencies involved in the process. The recently approved cluster TA and program loan approaches has the potential to overcome the limitations of ex ante analysis, provided monitoring and on-going analysis are sufficient to track and justify mid-course corrections. Joint evaluations could enhance cost effectiveness in seeking evidence of impact by aid agencies in this area.

Box 5:

Summary of Recommended Improvements to the PIA Matrix Analysis

- Distinguish between formal and non-formal employment.
- Distinguish between relative price effects that impact on the poor as either producers and consumers.
- The mechanism of access of the poor to publicly provided services should only cover non-marketed services or for services with a nominal or zero charge.
- The mechanism of transfers will largely occur indirectly through public or private transfer impact. Transfers with a direct impact will likely be reflected in publicly supplied services.
- The first focus of the PIAM should be on the short-run impact on the poor groups of the intervention.
- The second focus should be the mechanisms through which the poor are affected.
- The third focus should be mitigatory measures to reduce the negative impacts on the poor as appropriate.
- The fourth focus should be temporal targets for the removal of negative effects or the creation of positive short-run effects.
- Test the logic used and assumptions with stakeholders, data, and information and revise iteratively during loan preparation.
- Incorporate PIA matrix preparation as part of the planning process.
- Ensure that the assumptions and measures suggested in the PIA are explicitly linked to the program logical framework, and considered in the use of tranche releases and the investment components of SDPs.

3. Poverty Impact Analysis for Sector Development Programs

Regarding the investment components of SDPs, the *Handbook for Integrating Poverty Impact in Economic Analysis of Projects* (ADB 2001a) is directly relevant. Given SPD's (November 2000) loan classification of Other Interventions and Poverty Interventions (including Core Poverty Interventions), the Handbook recommends separate approaches for each category. For Other Interventions, it recommends the use of conventional economic analysis plus additional demonstration of the pro-poor institutional and policy context of the investment project. In judging such context, the discussions above should be helpful. Ideally, a clear link needs to be demonstrated as to how the investment benefits going to the poor can be optimized contingent upon what the policy conditions are expected to do in the macroeconomic or sectoral context in the short and long run. For Poverty Interventions, much of the Handbook is devoted to discussions and illustrations on how to extend the conventional benefit-cost analysis to distribution and poverty impact analyses. For this category of investments, it is suggested to demonstrate the benefits going to the poor disproportionately in one way or another (full benefit-cost analysis or cost effectiveness analysis).

4. Responding to Effects on the Poor

This involves mitigating or alleviating the short-term effects of change, and enhancing the involvement of the poor in adjustment. In the specific context of PBL, targeted mitigating measures are the usual ways to provide short-term targeted alleviation from the negative impacts

of adjustment. Enhancement measures are also a means of designing reforms to bring benefits to the poor at an early stage. This includes ensuring the inclusion of the poor through equality of access to opportunities presented through reform. Knowledge of the circumstances and trends in the pre-reform period can greatly assist in the design of these measures. This includes, for example, understanding how the effects of instability and inefficiency may have affected society and the poor in particular (ADB 1999c). General mitigation and enhancement considerations for PBL, broadly provided through economic and social investments, include:

- Mitigating measures that at least minimize the negative effects on the threshold poor and absolute poor.
- Investments that lay the basis for new economic opportunity and sustainable income gains for the poor during the recovery period, including policies and programs that explicitly provide the poor with the opportunity to become involved in economic growth. These include, for example, opportunities to use their assets for income-generating activities (e.g., informal and formal business); training; and provision of effective support services, information, and access to markets and employment.
- Public expenditure measures that increase the provision and accessibility of relevant government services to the poor, especially those that enhance the development of human capital (e.g., health and education).
- Parallel investments through projects that improve the provision and accessibility of physical infrastructure, such as water supply and roads, to affected poor groups.

These interventions, however, appear oriented toward project or sector development investment loans. Sector-specific discussions are contained in Appendix 1.

D. Implications for Policy-based Lending

In terms of ADB's operational interests in PBL design and loan preparation, several implications can be inferred from the discussions in Part II.

1. **Begin with a Sound Assessment of the Impacts on Efficiency and Macroeconomic Stability as well as Institutional Capacity and Consideration of Stakeholder Views**

- a. *Undertake Ex Ante Economic and Social Assessment*

There is a limit to standardizing economic analysis tools for assessing policy-based loans ex ante. For economies undergoing a continuous reform process supported by various aid agencies, which may not be characterized as a linear process, there are limits to identifying and isolating where the impacts associated with individual policy loans start and where they end. There is inevitably a limit on the extent to which tangible benefits of individual policy loans, let alone

their poverty impact, can be estimated ex ante. Nonetheless, efforts are warranted to better understand, ex-ante, the likely impact of policy reforms within information and assumptions shared by key stakeholders. Economic policy modeling can help simulate the expected outcome through the selection of an appropriate analytical framework combined with benchmark accounting data. But this requires much more data and research resources than are currently available. Comprehensive country level poverty analyses in coordination with other donors can be useful in providing an “envelope” information for considering the poverty reduction aspects of individual policy loans.

b. *Assess Feasibility of Changes that Must Occur and Capacity of Institutions to Absorb Reform Measures*

Reform is fundamentally about institutional capacity and change—involving time and resources—that must be reflected in reform design. It relates to basic changes in incentives, behaviors, and expectations and in power relations and institutions. A key requirement in reform design is an assessment of institutional capacity constraints, processes through which change will occur, and time and resource requirements for reform implementation.

c. *Understand the Local Institutional Context and Involve Stakeholders in Design and Implementation of Policy Loans*

Understanding the motivation for change and stakeholder views assists in responding to new and unforeseen factors. Institutional, stakeholder, and beneficiary analysis, including the poor, is an essential step in enhancing the relevance, performance, and impact of policy-based lending, and the critical element of local ownership. Given the limits to the extent of participation in terms of time and resources, the minimum requirements would be an adequate understanding of local political, legislative, and civic procedure and the extent to which proposed reform measure will be subject to due process, and a political risk assessment of reform implementation.

2. Incorporate an Appropriate Assessment of the Impact on the Poor Over Time

a. *Articulate Assumed Linkages Between Policies and Poverty Reduction*

The current ADB procedure for PIA matrix focuses on the impact on the poor by identifying the economic variables that change with adjustment and their channels of impact. Proposed improvements to current procedures include: use of the matrix as a design tool using a participatory approach; incorporation of governance/incentive structure linkages to economic impact channels; quantification of net benefits for the poor where feasible; and greater use of household surveys, statistical inferences, and risk analyses. Even where quantification may be limited there is a

significant learning benefit for all parties of the policy dialogue from laying out envisaged benefits and costs of reforms explicitly to stakeholders, and narrowing down the policy focus through an iterative process. While there is still likely to be uncertainty surrounding the outcome, at least stakeholders are aware of the possibilities. Through a better understanding of both positive and negative effects, the final local decision is made in a transparent way with the critical ownership needed to avoid later regrets should the reform invite unforeseen reactions for certain stakeholders.

b. *Emphasize Mid-course Monitoring and Evaluation*

Given the limitations of ex-ante poverty impact analysis of policy based loans, ADB would need to consider appropriate approaches to mid-reform impact monitoring and evaluation, preferably in coordination with other aid agencies involved in the process. Joint evaluations could enhance cost-effectiveness in seeking evidence of impact by aid agencies in this area.

3. **Develop Appropriate Measures to Mitigate Possible Adverse Impacts on the Poor and Vulnerable and Enhance the Potential of the Poor to Benefit**

a. *Identify Effects of Reforms on the Poor*

This allows more explicit consideration of courses of action for mitigation and inclusion of the poor and the overall costs of adjustment.

b. *Address Poverty Reduction at the Country Programming Level*

This is necessitated since there may be cases where poverty reduction cannot be effected within a specific sector, and mitigation can be incompatible with other sector policies.

III. CONCLUSION

This paper has attempted to provide an overview of some of the broader contexts that ADB currently faces in addressing poverty reduction through its generally sector-oriented PBL. They include the implications of ADB's overarching poverty reduction goal in the context of interrelated considerations such as broader economic growth goals, macroeconomic management, political economy, and other sector policies and strategies. One overriding and already shared view is the interconnectedness of poverty reduction with wide-ranging economic, social, and political factors. Consequently, there are inherent risks of a narrow focus on programs that attempt to directly target the poor without considering the broader context.

It remains to be seen how much room there is to maneuver in terms of redirecting the goal of macroeconomic and sector policies from that of improving efficiency in the economy and institutions to that of directly targeting the poor. Doing so in a way that undermines macroeconomic stability and economic incentives would undermine the infrastructure of poverty-reducing growth. A tentative conclusion here is that the selection of policy content can consider the enhancement of growth performance while addressing the impact on poverty. Similarly, due consideration is required for the consistency of policy changes and supporting programs that affect all groups, including the poor, with macroeconomic stability. The existing analytical tools may limit the ability to demonstrate the poverty reduction impact of policy changes *ex ante*. Nevertheless, the indirect beneficial effects need to be traced to the extent that is practically possible and the importance of indirect effects acknowledged.

Policy and institutional reform is a change process and is long-term in nature. Sustainable reform must inevitably be evolutionary and the reform program is less “blueprintable” but a learning process in itself. There are no standard recipes on how to formulate programs especially for second-generation reforms, except that government ownership and participatory design are fundamental conditions for successful reform. An operational implication is that policy reform programs need much more time and due attention to process in preparation, ensuring ownership, and support for implementation where capacity is limited. This may have implications for increased resource requirements for preparation and supporting implementation.

Many factors can affect the expected outcome of each stage of a reform process. Regular reviews and modifications are required for the policy stance to be responsive to accommodate the dynamics of performance. ADB would need to consider appropriate approaches to mid-reform monitoring and evaluation, preferably in coordination with other aid agencies involved in the process. The recently approved cluster TA and program loan approaches will assist in overcoming the limitations of *ex ante* analysis. Joint evaluations could enhance cost effectiveness in seeking evidence of impact by aid agencies in this area.

Policy reforms and PBL have often been and will continue to be triggered by economic considerations such as efficiency, equality, and equity (as in more equal opportunity in access to resources, services, etc.). The main objectives of such reform measures are to ensure balanced and sustainable economic growth, which will ultimately improve the living conditions of DMC populations. As the majority of populations in developing countries are either poor or at great risk of becoming poor, such policy measures, if successful, will indirectly benefit a large amount of poor people. Therefore, the poverty reduction aspects of the bulk of PBL should primarily focus on identifying and mitigating the immediate adverse impacts of such measures and ideally promote preventive social protection measures before a crisis situation occurs. Enhanced use of analytical techniques such as the PIA matrix in consultation with stakeholders can assist in identifying short-term negative effects on the poor arising from reforms. Targeted measures can then be determined to ensure minimization of negative effects, and the greater involvement of the poor in recovery through enhancement-type measures.

Finally, while poverty alleviation is an indisputable and never-ending goal in development and the discussions surrounding aid agencies are swamped by a sudden increase in pro-poor literature, and perhaps social mitigation considerations after the financial crises, it is worth reminding ourselves that turning to a new focus on poverty reduction does not lessen the need for addressing the old questions in development that remain debated and inherently interrelated with poverty reduction outcome: e.g., economic structural change (both intersectoral and intrasectoral), industrialization and industrial policy, demographic changes, etc. The unique experience in high-performing East Asian economies continues to demand an exploration of an “Asian paradigm” of development by revisiting what made their dynamic transformation possible (e.g., ADB 1997a). As new groups of economies, at national and subnational levels, aspire to join the rank of high performers, there will be new evidence with which to further investigate this line of questions.

APPENDIX 1: OVERVIEW OF SECTOR POLICIES AND POVERTY REDUCTION

Different sectors and subsectors, by their nature, vary in the channels through which they affect poverty reduction as well as the directness of their impact. Sectors with indirect linkages and effects can have an essential role in poverty reduction as a means to an end. Important and sometimes contradictory considerations are their cost and efficiency yet ability to reach the poor. Individual sector performance can also vary considerably within an economy, let alone across economies, and caution is required in generalizing about the sector features, including in the context of poverty reduction. This section summarizes the general role of specific sectors in poverty reduction, lessons learned from ADB and other development efforts, and current ADB and other strategies to reduce poverty through the sector. Other implications such as macroeconomic and political economy are considered.

A. Private Sector Development

Consideration of sector-level policies and poverty reduction in this paper begins with the private sector because of its thematic perspective with implications for most sectors. It also facilitates a summary of generic poverty reducing features of economic sectors. The role of the private sector is reflected in ADB's Private Sector Development Strategy: Promoting the Private Sector to Support Growth and Poverty Reduction (ADB 2001c). The strategy emphasizes the Asian experience that the development of a strong and dynamic private sector is needed and better suited than the public sector for sustaining rapid economic growth, upon which sustained poverty reduction depends.

1. Lessons Learned

The experience and lessons learned of MDB involvement in supporting private sector development is vast. This ranges from progressive understanding of the relative roles of the public and private sectors, inappropriate involvement of the public sector in private goods and services, to aspects such as the inappropriate use of pricing policy, and the importance of issues such as governance and an enabling legal and regulatory environment. In its broadest sense, ADB experience in private sector operations shows that it is essential to develop capacity to create and sustain the legal and market institutions needed to enable and regulate private sector activities. Realistically, the present strategy recognizes that the private sector has an important role in poverty reduction but it cannot be expected to undertake extensive poverty interventions on its own. It points to combined public and private sector initiatives that pay systematic attention to private sector interests and concerns, but also private sector assistance in promoting poverty reducing impacts in their activities.

2. Current Strategy

The rationale behind ADB's current strategy places emphasis on the relationship between growth, employment creation, and income generation for the poor, stressing that private sector led growth creates employment that uses labor as a main asset of the poor. This highlights the importance, for example, of improving labor market operations to promote growth and poverty reduction, with efficient markets directing human capital resources to their most productive uses. This supports the position of encouraging a high degree of labor mobility to ensure labor reaches markets where labor is demanded. Well-designed labor market policies also help societies make growth more equitable by smoothing income fluctuations and broadening access to human capital development and employment opportunities, and increasing returns to labor. The removal of distortions and increased efficiency in other factor markets is necessary for poverty reduction, specifically capital (e.g., through specific financial mediation measures) and land

(e.g., through security of land use rights). Both of these markets can be enhanced to provide for more equitable consideration of the needs of the poor.

Underlying the efficient operation of markets is access to information and knowledge, an aspect that the poor can be especially disadvantaged in, further limiting their awareness and ability to respond to opportunities. Maintaining rural producer ignorance of market conditions and prices is a tactic used by opportunistic buyers, and in this sense improving knowledge and competition can be “empowering.” Development of a transparent and well-managed legal and regulatory environment encourages investment and fair practice, benefiting the poor directly and indirectly. This includes the streamlining and simplification of business regulation.

Other ways the private sector can affect poverty reduction discussed in ADB’s strategy include regulated private investment and operation of infrastructure projects and provision of social and economic support services under appropriate contractual arrangements, including concessions. Private sector involvement in the provision of goods and services with public financing can result in the delivery of better and more innovative services, at lower cost and greater overall efficiency, freeing public resources for social spending. Other examples include the private sector supply of for-profit social services to the higher income groups, freeing up government resources for the needs of lower income groups. Not-for-profit services can also be provided with appropriate compensation. Contracts and concessions can be provided in a way that requires private sector suppliers to service poorer areas with affordable tariffs (e.g., lifeline tariffs), with the associated costs to be borne by the government in the form of lower concession revenues. Such public-private partnerships address poverty through public budget underwriting while encouraging collaborative investing by the private sector. With appropriate and transparent regulation, private sector management can be more efficient than public administration with more innovative service delivery. However, the private sector should not be expected to provide poverty-related interventions at a loss or on their own.

However, a qualification is required on inappropriate approaches to, in particular, privatization. The approach to privatization efforts in some DMCs, especially in transition economies, may have exacerbated inequalities between the rich and the poor whereby a fraction of the population amassed considerable wealth and the majority of it fell into poverty. Reasons include the lack of alternatives in policy reforms, blanket prescriptions in privatization, absence of institutional capacity to carry out such tasks, and a lack of private sector response to build markets and competition in the nascent market economy due to lack of experience and confidence. Other reasons include misuse of information and corruption. The consequences of privatization and rationalization of public services have been especially severe for education and health services. In the Pacific privatization of essential public enterprises (e.g., utilities) has been slow to proceed due to the lack of private sector interest in the small, marginally profitable markets served by these enterprises. In such cases alternatives to privatization include restructuring to improve efficiency, management contracts, and as a last resort, liquidation. These examples emphasize the importance of considering alternatives (e.g., phased privatization and greater emphasis on competition among enterprises be they private, public or quasi-public enterprises) and at least proceeding with caution.

B. Agriculture and Rural Development¹³

Considering that approximately 60 percent of Asia’s poor live in rural areas with their livelihoods connected to agriculture, the agriculture and rural development sector has an important role in poverty reduction. This includes farm owners, renters, sharecroppers, herders, and the landless who depend on income from wages and service activities related to farming, processing and marketing, as well as

¹³ This subsection was prepared with support from Tumurdavaa Bayarsaihan, EDEV Economist.

nonagricultural rural industries. The contribution of the sector through its own production, backward and forward linkage effects, export-income earnings, and contribution to the livelihoods of the poor and nonpoor gives it a key role in most Asian economies. Even as economies become more industrialized and the relative importance of the sector falls, it can continue to have a crucial role in the livelihoods of the poor and act as a safety net during economic downturns in industrializing economies. Traded agricultural commodities have an important role in adjustment when, for example, exchange rates fall. During adjustments driven by devaluation, agricultural export prices become more competitive, increasing demand on the world market and production incentives. However, many policies directly affect the returns to agriculture and rural incomes, including exchange rates, domestic food crop prices, export prices, input and transport prices, access to markets, and government policy toward agriculture relative to other economic sectors.

1. Lessons Learned

The experience in many developing countries has been one of pursuing policies that have not favored agriculture (Krueger 2000). This is exemplified by pursuing agricultural pricing policies that ensured food prices were affordable to urban populations, taxing export crops as a source of revenue, keeping prices below border price equivalents to avoid price fluctuations with respect to world prices, and justifying public involvement in production and marketing in the interests of food self-sufficiency policies. Low prices and heavy taxes, especially on export crops, lowered returns to agriculture and rural incomes. Overvalued exchange rates were preferred for import-dependent industrial development that reduced the terms of trade for agriculture. On the other hand the use of policy instruments intended as incentives such as tariffs, quotas, and input subsidies have been distortionary in the other direction, even if they are contradicted by price controls. This has often resulted in a complex array of government policy interventions in the sector, the basis of which may not be well understood (Krueger 2000), and sometimes causing excessive inefficiencies and distortions. This can be to the detriment of farmers, the rural poor, and poverty reduction.

OED reports indicate that until 1995 over half of all programs or 40 percent of lending volume went into agriculture and natural resources sectors. Reform agendas supported by ADB's agriculture sector program loans aimed mainly at developing market-based systems. The key measures in such programs were: (a) reduction or elimination of input subsidies, especially on fertilizers; (b) increased recovery of irrigation costs; (c) raising of interest rates on agricultural credit; (d) enhanced taxation of agricultural income and wealth; (e) removal and/or rationalization of price controls on farm produce; (f) rationalization of public foodgrain procurement and distribution; (g) abolition of state monopolies over agricultural input and output trading; (h) external trade liberalization; and (i) increased security of land tenure.

However, several issues emerge as important for the design of future program loans including: the need for thorough and comprehensive preparatory sector analyses; the need for sufficient staff resources for program preparation and supervision; and the need for greater consultation to build country ownership of reform agendas. The complexity of reform processes necessitates a gradual and long-term approach that should give sufficient time for the sector and society to adjust to reform measures. It was also found that the policy measures were often too numerous, given the program time frame and the complicated nature of reform processes. The key lesson emerging from the implementation of these program loans is that strong government commitment to reform is essential to the success of the reform program, including the political will to adopt unpopular measures.

2. Current Strategy¹⁴

The emphasis is changing and the MDBs including ADB have more recently assisted governments by encouraging them to at least adopt policies that are neutral between agriculture and other sectors. Inefficiencies arising from public sector capacity limitations in input supply and marketing are being addressed through reforms that facilitate greater private sector involvement in marketing, fertilizer distribution, and agro-industries. Attempts are being made to transfer the management of irrigation to a decentralized level and farmer groups. Clarification of land rights is recognized as necessary to increase incentives to develop the private sector (ADB 2001c), with both indirect and direct benefits for the nonpoor and poor alike.¹⁵ Food security entails placing more emphasis on the ability to efficiently meet food needs at the national and household level through production or cash incomes. For poor households this includes meeting minimum daily nutritional requirements through production for home use or through sufficient income to purchase daily food needs.

Currently ADB's program loans in the agriculture sector address the key issues of policy reform, institutional strengthening, and investment plans in an integrated fashion. Program loans aimed at increasing the efficiency and competitiveness of the sector to ensure long-term sustainable growth are main features of ADB's policy-based interventions in the sector. Policy measures in the sector with the specific objectives of reducing poverty in a sustainable way have the potential to be promoted alongside the main objective of increasing the efficiency and competitiveness of the sector in a complementary and mutually reinforcing way. Such measures are succinctly summarized in the *World Bank Poverty Reduction Strategy Sourcebook* (<http://www.worldbank.org/poverty/strategies/courcons.htm>). They relate specifically to the lack of access to assets, low return to assets, and risk.

Tackling lack of access to assets:

a. *Secure Access to Land*

(i) Provide the poor with more secure access through clarification of land laws and rights and strengthening of institutions that improve land management and administration, even under customary tenure. (ii) Promote active and diverse land markets: e.g., land tax to induce landowners to sell or rent out areas of land, land titling program to stimulate the rental market indirectly, lift prohibitions on the subdivision of land, and clarification of long-term leasehold laws.

b. *Access to Water*

Where land market reform is difficult but surface water rights are less clearly specified, then initiatives in the water market may be a partial substitute for land reform: (i) Public work programs to establish and maintain surface and subsurface irrigation systems. (ii) Consider the introduction of farmer user fees with water rights and develop markets in irrigation water, with conflict resolution mechanisms.

¹⁴ At the time of writing, ADB's Agriculture and Social Department East was updating the Rural Development Policy of ADB. In part this subsection reflects developing policies, but recognizes that it is also work in progress.

¹⁵ World Bank/AusAID project in Thailand.

c. *Access to Financial Services*

(i) Develop different forms of collateral including secured transactions law (e.g., chattel mortgaging) and leasehold mortgaging. (ii) Private sector, including NGOs, has tended to be more successful than the public sector in reaching the rural poor with microcredit. (iii) While even group-based microcredit programs have difficulty reaching the very poorest, novel forms of rural financial instrument may be explored, e.g., weather-indexed insurance bonds.

Tackling low returns to assets:

a. *Agricultural Marketing*

(i) Complete the process of liberalizing and privatizing agricultural input and output markets to promote efficient and competitive markets. (ii) Provide greater stability and transparency of the “rules of the game” in agricultural markets. (iii) Promote knowledge empowerment by publishing and disseminating information on agricultural prices and markets.

b. *Access to Agricultural Technologies*

Recent empirical evidence unambiguously indicates that small farmers and landless/land-poor households have benefited from the Green Revolution. (i) Even when technology is available, it needs to be accompanied by adequate seed distribution channels, credit markets, and output market channels. (ii) The capacity of national and local agricultural research centers (NARCs) should be strengthened to improve technology transfer efficiently within national research and extension systems, including from neighboring countries and the global research system. (iii) The rationale and incentive for a mix of public and private sector funding of research and extension, with incentives for additional private sector investments must be explored. (iv) Partnerships with national and international private firms to access biotechnology should be encouraged.

c. *Increase Income of Agricultural Laborers*

(i) A competitive exchange rate and a positive real interest rate will encourage the adoption of labor-intensive technologies. (ii) Prohibitions against long-term labor contracts should be eliminated. If there is an effective minimum wage, the consequences on agricultural output, employment, wages and income distribution should be examined.

Tackling high variance of asset returns:

a. *Increase Food Security*

(i) Reduce ex ante exposure to food consumption risk: e.g., introduction of an early warning system module in “light” annual household surveys to identify vulnerability of individual rural communities and households. (ii) Improve ex post capacity of the poor to cope with food consumption risk: e.g., informal insurance arrangements, self-targeted public works, encouraging labor mobility.

b. *Allow Rural Poor to Benefit from Migration*

Unrestricted population movement should be accepted as the norm. Removal of formal barriers is appropriate because it benefits the rural poor more than the nonpoor. However, systems for facilitating and monitoring the flow of migrant populations in destination areas may be needed.

c. *Public Transfers*

Many cash and in-kind transfers need effective targeting mechanisms to ensure full coverage of relevant groups of beneficiaries, while minimizing leakage to other groups.

C. Financial Sector^{16,17}

The financial sector has indirect and direct roles in poverty reduction. Indirectly, promotion of sound and efficient banking systems and capital markets remains indispensable for macroeconomic stability. It is fundamental to increasing business confidence, facilitating borrowing by entrepreneurs, ensuring availability of long-term financing, mobilizing savings, and channeling financial resources into productive activities.¹⁸ Similarly, a well functioning stock market supplements unsatisfied funding requirements through the banking system, while a more transparent, informative, market-based evaluation exchange mechanism facilitates smooth functioning of the financial system. Combined, these measures provide the basis for employment creation and economic growth as an essential requirement for growth. The PRS indicates that promotion of financial sector reforms and market infrastructure development can encourage the emergence of sustainable financial institutions that are better geared to serving the needs of medium, small, and micro enterprises that can benefit the poor directly.

Urban banking institutions are likely to have a stronger connection with manufacturing and service type business, the growth of which creates urban employment. Production-oriented and labor-demanding activities financed by the banking system can have a more direct impact on the poor. Development of the rural finance structure probably has a more direct and measurable impact on the poor, especially as it can concentrate on particular groups and poor areas. Examples include poor-focused schemes such as microfinance program, rural finance development, and SME finance programs. They can support the development of access to financial sources for the rural poor, design appropriate financial products for specific beneficiaries, and involve them in both direct and indirect ways. In such cases, the measurable targets can be determined and incorporated in PBL. Complimentary nonfinancial elements of SMEs such as management, marketing, distribution, and employment skill development initiatives can be incorporated as part of or at least synchronized with finance sector PBLs.

¹⁶ This subsection was prepared by Vo Van Cuong, EDEV Economist.

¹⁷ For the purposes of this paper the financial sector is subdivided into capital market, urban banking institutions, and rural financial structure development incorporating public agricultural banks, rural finance support, and microfinance activities.

¹⁸ These are a result of (or combination of) one or several of the following: enforceable and pro-business legal environments, sufficient and functional financial infrastructure, right credit, interest rate policy and exchange rate level, enhanced business-driven credit allocation, increased financial and operating sustainability of all financial institutions and regulatory agencies, and strengthened efficiency and transparency of participating financial institutions.

1. Lessons Learned

ADB financial sector PBL operations have included: recourse to market pricing of funds and introduction of competition among lenders to reduce funding costs, decontrol of lending to allow funds to move to activities offering the highest returns, introduction of marketbased funding of public sector borrowings, expanding the range of mediation instruments between savers and borrowers, strengthening public supervision of deregulated markets, and improving DMCs access to global capital markets. ADB has made progress, albeit variable, in financial sector and capital market reforms in India, Pakistan, Philippines, and Sri Lanka. ADB activity in microfinance has increased since 1988.

The focus of ADB's microfinance projects have expanded over time from project-based lending that addressed financial needs to a wider range of institutional support, including greater attention to financial viability, introduction of more diverse products, and greater emphasis on market-oriented interest rates. Lessons learned in microfinance from ADB operations emphasize: (a) adoption of the financial system development approach, (b) understanding the clients' needs for gaining sustainable access to services rather than a focus on the cost of services, (c) provision of greater diversity in financial services, (d) creation of strong retail institutions committed to outreach and sustainability, (e) commitment to building capacity at an early stage, (f) understanding the demand for savings, and (g) role of women and social mobilization.

2. Current Strategy

The two existing strategies addressing the role of the financial sector in poverty reduction campaign are the Private Sector Development Strategy (PSD) and Microfinance for the Poor. The PSD focuses on public-private partnership initiatives, improved efficiency of essential services and potential reorientation of released public budgets. The financial sector interventions include program loans, sector development loans, or partial credit guarantees modality. Through catalyzing private investments including equities, partial credit guarantees, and co-financing, the role of the financial sector can be strengthened to address the poverty reduction objective in DMCs. The microfinance strategy aims to ensure permanent access to institutional financial services for poor and low-income households and their micro-enterprises. It focuses on (a) creating a policy environment conducive to microfinance, (b) developing financial infrastructure, (c) building viable institutions, (d) supporting pro-poor innovations, and (e) supporting social intermediation.

3. Other Perspectives

The evidence of the impact on the poor of financial sector PBL is less clear because of the indirectness of linkages, time lags, and multi-layer effects. Consequently quantification of the potential impacts is intrinsically difficult. Current practices for measuring financial and economic impacts of financial sector loans tend to be descriptive. There is a need to set up a well-defined and measurable set of targets and BME indicators as an urgent requirement. The World Bank's experience in the financial sector is to create the appropriate legal, regulatory, and supervisory structures to realize the full benefits of financial sector reform. It emphasizes the need for policy reform in conjunction with macroeconomic reform, improvements in the financial infrastructure, and strengthening of specific financial institutions. The European Bank for Reconstruction and Development's (EBRD) Banking Unit focuses its strategy on (i) supporting banks and other financial institutions that have an institutional commitment to SMEs, (ii) providing a full range of financial structures in infrastructure operations including private and public-private partnership, and (iii) continuing equity investment.

D. Physical Infrastructure

1. Water and Sanitation

An array of issues in the sector described in ADB's draft policy for the water sector arises from limited fresh water endowments, rapidly growing demand, poverty and the environment, with a rising real threat to life from water scarcity, water pollution and degradation of watersheds. The assessment that underlies the policy highlights the hardships that arise for the poor through lack of access to water including: the time and effort required to carry potable water from distant sources; lack of income to purchase high priced water from vendors; poor access to adequate sanitation and consequent low levels of hygiene; higher risk of poor health and lowering of the human stock; and the additional vulnerability of those whose livelihood depends on farming marginal rain-fed lands.

a. Lessons Learned

The principal lesson that emerges in the context of ADB investment in the sector is the need to move away from a disaggregated approach to water sector investments. An integrated approach is required in related sectors including water supply and sanitation, irrigation and drainage, hydro-power, flood control, and watershed management set in the context of managing water resources within river basins. Furthermore, competition for water resources requires the development of a legal and regulatory environment to settle disputes arising between water users. Efficiency can be promoted by addressing demand management and water pricing. ADB's assessment singles out the need to target the poor for equitable and rapid access to water.

The World Bank experience with government intervention in this sector provides a clear lesson that the poor rely much more than others on self-provision or other private solutions (World Bank 2001, Water/Sanitation Chapter). This indicates the need to first review the institutional and policy environment for such solutions. The World Bank further emphasizes water resources and environmental management as key determinants of the quality and quantity of raw water resource on which the poor directly depend. International experience shows that governments need to work more on the facilitating role in a better policy and institutional environment. In the rural context, evidence points to avoiding government as a direct provider of water and sanitation services. Costs are simply too high in relation to local private provision and the willingness or ability of poor people to pay. Devolution of control to community groups or private providers is the favored strategy. In the urban context, inefficient publicly run water and sanitation utilities are also more common than efficient ones. A prudent approach in terms of poverty reduction entails rapid response mechanisms to address the immediate needs of the poor for the short run, and parallel design of a framework of medium and long-term policy changes.

Poor performance of public water and sanitation services, often plagued by needlessly high tariffs or equally needless subsidies, led to a recent increase in the use of concessions or private operators. Full cost recovery and sanitation suppliers need not conflict with poverty reduction. Many studies have found that poor people are willing to pay high prices, and a significant portion of their income, for water supply. However, ways should be sought to ensure that the poor have access to a minimum volume of water necessary to meet their basic needs at an affordable price, e.g., through lifeline tariff and subsidizing connection costs. Sanitation services pose a special challenge in designing financial policy. The poor may perceive improved sanitation services more in terms of convenience than the health benefits, leading to under-investment in sanitation. But experience has shown that subsidy programs for improved latrines benefit primarily a small number of wealthier households. Effective hygiene education campaigns may help close the demand gap and lower the subsidies. Lowering sanitation investment and operation costs may be more effective than demand subsidies. For rural and small town services, direct government

investment has a dismal performance record. The essential problem has been sustainability, an issue itself linked to initial technological choice and financing arrangements. Countries most successful in expanding urban water service provision are those that charge cost-covering tariffs. It allows ending general system subsidies from governments, going mostly to the nonpoor, and in turn facilitates the introduction of pro-poor policies, which could include nonnetwork water supply for the poor.

b. *Current Strategy*

ADB's strategy recognizes that water management and access to water involves "questions of allocation and distribution, equity, conservation, pricing, regulation, education, participation, and sustainable use." Consequently, the integrated and cross-sectional approach to water management and development seeks to promote water as a socially vital economic good that needs managing to sustain equitable economic growth and reduce poverty. Elements that specifically focus on poverty include their consideration in national policies and laws and regulations, equity in access to water services through improvement and expanded delivery of services, ensuring the poor are not excluded in programs that foster the conservation of water, and increasing system efficiencies. The poor will be indirect beneficiaries from improved governance arising from decentralization, capacity building, and improved monitoring.

c. *Other Considerations*

Government may financially support utilities during the reform process. A key issue is to establish financially autonomous utilities, as poor people are unlikely to benefit from system expansion unless steps are taken to tackle the financial and operational weakness of the utility as a whole. It should avoid grants that promote irresponsible pricing or excessive capital investment. The externality argument for subsidy can be made in some sanitation projects, but the challenge is how to target the benefit to the poor. The nonpoor who could afford improved sanitation without subsidies are often their main beneficiaries. Government should avoid blanket subsidies and look for ways to reduce input costs, increase private demand for sanitation, and facilitate the extension of credit to the poor. It should promote links with municipal finance and fiscal decentralization reforms. A key challenge is to have banking and capital market resources available locally, and help utilities tap these local markets.

2. **Roads and Transportation**¹⁹

As transport is an intermediate service, interventions through investments or policy changes cannot by themselves reduce poverty. However, by fulfilling a pervasive and complementary role, transport can influence poverty reduction in both indirect and direct ways. Indirectly, transport development can contribute to poverty reduction by improving overall mobility within an economy and enhancing the performance of markets. Its direct contribution to poverty reduction comes through improving basic access for the poor to economic and social opportunities, such as product and labor markets, and schools and clinics.

a. *Lessons Learned*

Experience suggests that a number of conflicts can arise between the twin objectives of improving overall mobility and enhancing direct access for the poor. Commercialization of transport services is

¹⁹ This subsection was prepared by Nigel Rayner, EDEV Senior Economist.

often argued as being necessary to increase the overall efficiency of transport provision in the DMCs. However, commercialization often leads to higher passenger fares and freight rates than before and these can have an adverse effect of the direct access of the poor. One reason for such increases in fares and freight rates is often reductions in subsidies for transport operations. Transport subsidies are often used as a direct intervention to help improve the access of the poor, particularly in urban areas. The extent to which they contribute to this is questionable given that transport subsidies are difficult to target effectively, are vulnerable to misuse and to capture by the nonpoor, and are financially unsustainable. Although commercialization and subsidy reduction are likely to have an initial adverse impact on the poor, there is evidence that the more commercial and competitive transport markets are, the easier it is to effectively target subsidies to the poor (Gannon and Liu 1997). Accordingly, commercialization and subsidy reduction may, in the longer run, prove beneficial in improving the direct access of the poor.

A second potential conflict between improving overall mobility and enhancing direct access for the poor can arise in relation to the interrelated issues of road user charges, road maintenance funds, and the sustainability of maintenance programs. In recent years the consensus among policymakers has been that road user charges should be increased so that users (eventually) pay the full costs of maintaining the road network. It is also often argued that this objective should be pursued through the use of a dedicated road maintenance fund, which would mean the costs of road maintenance would no longer be borne by the government's general budget. However, increases in road user charges are likely to result in increases on passenger fares and freight rates, which would impact adversely on the poor. However, in the longer term, removing the burden of road maintenance from the central budget will free up resources for other items of expenditure, such as health and education, which may be directly beneficial to the poor. Other policy issues which may lead to a conflict between the objectives of improving overall mobility within the economy and enhancing direct access for the poor include: preferences for motorized transport over nonmotorized transport, the extent of controls on service standards and entry into service provision, and land use zoning in urban areas.

b. *Current Strategy*

In the road sector, ADB continues to support interventions aimed at improving both trunk roads and access to/from rural areas. Investments in trunk roads and expressways are intended to reduce, or remove, the constraints on economic growth that can arise through inadequate transport links. Policy dialogue is aimed at improving the efficiency of use of such links by addressing regulatory issues, and at increasing sustainability of the road system through improved maintenance provision and funding. A particular focus of policy dialogue is encouraging increased recovery of the costs of providing and maintaining roads from road users, thereby reducing demands on the national budget for road sector finance.

ADB's interventions to support the development of access roads in rural areas is intended to improve the access of poor, rural communities to labor and product markets, and to human development services such as health and education. Improved access to markets and social service provision through improved transport links is seen as an important element in the process of reducing poverty in rural areas that are currently relatively isolated from local centers of economic and social activities. Increasingly, road sector interventions combine elements of trunk road improvement and provision of access to poor, rural communities. In the railway sector, ADB's interventions are designed to achieve similar objectives to those in the road sector. Railway investments are intended to increase the efficiency of medium and long distance freight and passenger movement, thereby enhancing the prospects for sustained economic growth. In addition, policy dialogue is intended to improve operational efficiency of rail operations, and to encourage railway operations to become financially sustainable, so as to reduce the demands that they may place on the national budget.

3. Energy

a. *Lessons Learned*

The 1997 OED Sector Synthesis found that electricity tariffs in many DMCs were generally too low, leading to perennial deficits in power utilities and their inability to satisfy relevant financial covenants. Tariff structures were complicated, with too many consumer categories and slabs of rates, and with significant degree of cross subsidization among user groups. In some cases, high demand for electricity could not be met by the low generating capacity of the power plant. In these cases, demand side management has been prescribed to close the gap. The 2000 Review of Energy Sector Policy include the following lessons. (i) By the mid-1990s state-owned entities in the energy sector, which functioned as monopolies, had become very large but had little prospect of incremental gain from economies with further growth. The 1995 Energy Sector Policy sought establishment of independent regulators to adjust electricity tariffs on the basis of transparently promulgated tariff principles. (ii) New investments and the responsibility for efficient operation should gradually shift to the private sector, while the government will continue to do long-term planning, policy formulation, and legislation; collection of rents and taxes; and evaluation of sector performance. (iii) The BOT approach has played a significant role in attracting private sector investment, but it has given rise to some questions on governance: e.g., a large number of projects were finalized by DMCs on the basis of unsolicited proposals without transparent international competitive bidding ; in many power projects, state-owned electricity utilities acted as the single buyer on the basis of a long-term contract. (iv) Off-grid electricity supply options are possible using renewable energy sources like mini and micro hydropower, biogas with turbine, and hybrid systems using wind or solar power with diesel engines. Such isolated systems can be owned and operated by cooperatives, private entrepreneurs, and energy service companies. But a level playing field will only be possible when subsidies for fossil fuel production and use are substantially eliminated and taxes, fees, charges, and royalties imposed on fossil fuels are rationalized.

b. *Current Strategy*

Increased emphasis will be given to rural electrification and renewable energy. Where feasible, this will be promoted in conjunction with microfinance access to provide affordable energy to isolated communities. The introduction of competitive markets through restructuring of public utilities and private sector participation will also be necessary to ensure energy supply to industry and households at most economic costs (ADB 1999, para. 73). More specifically, future ADB assistance will take into account the following points (Review of Energy Sector Policy, pp. 25-29).

- (i) To facilitate private sector participation, ADB will help increase the depth of domestic capital markets and improve availability of long-term finance for private sector investments.
- (ii) ADB will assist restructuring of different subsectors (oil, coal, gas, and power) and establishing competition where possible. Attention will be given to initiating a suitable consultation process and safeguarding the interest of small consumers. For the duration that SOEs continue to operate after restructuring, ADB will support reforms that improve their governance and efficiency, make their operations commercially sustainable, and help establish industry standards.
- (iii) ADB will encourage DMCs to withdraw subsidies in production and use of all energy products. However, recognizing the need of the poor and the possible recessionary impact of price increases, transparent and well-directed subsidies (e.g., lifeline tariff) will be considered over the short and medium term.

- (iv) When DMCs unbundle power utilities and create smaller successor public entities (e.g., to operate the transmission network or to provide off-grid power supply), ADB will assist such entities to improve their technical and financial management.
- (v) ADB will assist joint and private sector companies engaged in generation, distribution, and power supply that may need support during the initial years before they acquire managerial and financial strength and become capable of raising resources from international financial markets.
- (vi) Rural electrification projects will be designed as stand alone electrification projects for increasing access, or where possible, as integrated rural development projects wherein electricity supply will complement poverty reduction efforts in other sectors like agriculture, public health, education, rural development, and forestry.
- (vii) Recognizing that power transmission is a natural monopoly and a vital complement of competitive electricity markets, ADB will continue to assist in implementing transmission facilities.
- (viii) Gas transmission pipelines enjoy significant economies of scale. ADB will assist in the implementation of such pipeline projects that are beyond the interest of private sector and promote nondiscriminatory access to all producers.
- (ix) ADB will assist DMCs in introducing policy reforms, both in the conventional energy and nonconventional energy sectors, aimed at promoting renewable energy projects and making their financing possible with minimal recourse to subsidies.

E. Social Sectors

Policy interventions in social sectors can be seen to have broadly two justifications: human and social capital accumulation contributing to higher (total factor) productivity of the economy, and protecting the poor and socially vulnerable people from bearing a brunt of market failure and crises beyond their control. While the former aspect can be addressed typically through continued expansion of investment in education, health, affordable housing, etc., it is becoming increasingly clear that more quantity without quality improvement does not help the poor. Improving the quality of social services for the poor are better addressed through incentive reforms rather than increase in training. For example, evidence shows that reduction in pupil-teacher ratios has little impact on student learning. Education outcomes depend on both demand and supply factors, and thus on policies and incentive structures that affect the whole economy. On the demand side, as a country opens to international trade and investment, the rate of return to education rises. People demand higher quality education and are willing to pay more for it. Stronger demand, higher private investments, better paid teachers, and more motivated students produce higher educational achievements, with different time lags (World Bank 2000a, 53-54).

One important reminder for social sector interventions in general is that if social asset redistribution in favor of the poor comes at the expense of the other factors conducive to growth, especially macroeconomic stability, the gains from redistribution can be self-defeating. Investments in social capital are undoubtedly a necessary and complementary input to physical capital in support of economic growth. However, the gestation period for the former is much longer and there is an element of intertemporal trade-off in public spending decision. Provided that economic growth is sustainable, effective pro-poor social asset redistribution requires a willingness and capacity to raise revenues, especially from the nonpoor. Subsidies must be better targeted to serve the poor, and public spending and targeting of the poor must be underlined by cost-effectiveness of the delivery mechanism.

1. Education

a. *Sector Priorities*

ADB will provide strong and innovative support to expand access to and quality in basic and nonformal education and skills development, particularly for women, girls, and others excluded for social or geographic reasons. Special emphasis will be given to promoting gender equity in schooling. At the policy level, ADB will expand its support for equitable, cost-effective education by promoting better performance monitoring, decentralized management, demand-oriented curricula, and stronger linkage to civil society (ADB Oct 1999, para. 66).

b. *Lessons Learned*

According to the 1994 OED sector synthesis, most of the project implementation problems could be ultimately attributable to inadequate assessment of institutional capabilities, which led to disproportionate investments in education facilities and hardware. Stronger leadership and enhanced management capabilities at the district and school levels would have helped improve overall coordination and supervision of academic and administrative programs, including maintenance of buildings and equipment. A need was also identified for ADB to initiate policy dialogue with governments to improve mobilization of resources to address the financing of recurrent expenditures and cost-recovery measures. Furthermore, project experience confirmed the need for an institutional mechanism to foster closer linkage between technical and vocational institutions and local industries.

c. *Current Strategy*

The 2000 Education Sector Policy (ADB 2000a) indicates that relatively little attention has been provided to sector policy reforms designed to improve equity, efficiency, and quality. This pattern, coupled with a tendency to dilute project investments across a range of subsectors may well have had the effect of diminishing the development impact. The sector policy describes prerequisites for a policy-based approach such as: (i) greater attention to sector analysis and to policy dialogue; (ii) longer-term perspective of sector development and country-specific education sector strategy in collaboration with DMCs; (iii) coordination with investments in other sectors such as health and nutrition to maximize poverty reduction impact; (iv) support for innovative approaches and technologies such as ICT in schools and distance education; (v) greater donor coordination; and (vi) enhanced role of private sector, NGOs and local communities. To strengthen management and efficiency the ADB strategy now gives more attention to: (i) supporting the organizational restructuring, role redefinition, and capacity building of central education ministries to reflect changing responsibilities in a decentralized system; (ii) developing capacity at the provincial, district, and school levels in planning, administration, and financial management; and (iii) strengthening community participation in school management. To mobilize resources for sustainable financing ADB will assist governments to develop policies that increase local revenue generation, retention, and control of revenues for education through, for example, revised taxation codes. Active support will be sought from private sector education institutions and education-related industries and services.

Looking at public spending incidence across different households would provide information on the extent education spending is benefiting the poor. The examination of public spending patterns could well indicate whether reallocation among different levels of education and geographical areas could make the distribution of benefits more progressive. It is suggested that the incidence is not difficult to calculate if household level data (e.g., LSMS) are available (see for example, World Bank 2001, Public

Spending Chapter). Depending on the situation of donor coordination in the country, ADB could take a lead or coordinate with other donors in assisting with the creation of such public good data. To be rigorous, altering the allocations to different programs should require marginal public spending incidence analysis across levels of education, across different types of expenditure, and across geographical areas. It would ideally examine the links between spending on certain inputs (e.g., classroom size) and outcomes (e.g., test scores). Household surveys would also be useful in examining the distributive pattern of private spending on education: e.g., whether poor families paying more for their schooling in absolute or relative terms; whether poor households are paying for private schools, and if so, at what level.

2. **Health and Population**

a. *Sector Priorities*

ADB will increase its investments in primary health care, including preventive and promotive services targeted toward the poor. Particular attention will be given to reproductive health care and malnutrition because of its pervasiveness and significance in perpetuating poverty. ADB will continue to promote early childhood development because of its strong links to poverty reduction. At the policy level, the performance of the overall health system (especially health financing) in reaching the poor, especially women, will be closely monitored. Special attention will be given to involving the private sector and NGOs to increase efficiency and outreach (ADB Oct 1999, para. 67).

b. *Lessons Learned*

The 1997 OED sector synthesis of health sector projects indicates that service delivery could be made more efficient, effective, and equitable by linking to policy reform. Before committing investment loans, the study suggests adequate investigation of the following points: (i) priorities for public expenditure policy, including the medium-term investment program and repositioning of resources to attain efficiency gains; (ii) appropriate pricing policies to achieve the broad objectives of revenue generation efficiency and equity; (iii) promoting private sector participation through appropriate improvements in regulatory framework; and (iv) staff rationalization, deployment, and management strengthening. With minimal cost recovery rates in most of the projects, the study suggests a need to shift public subsidies to low-income groups and expand private sector service for the higher income groups. Furthermore, in view of declining health sector budget allocation in real terms and other constraints facing the health and family planning agencies, the privatization of some of the services is becoming an increasingly viable option in public health management, particularly in the semi-urban and urban areas. Nonmedical services can also be contracted out to the private sector. On the other hand, governments should establish acceptable schedule of user fees and premiums, in cooperation with the private sector, as well as monitor and maintain the quality of health care.

c. *Current Strategy*

The 1999 ADB Policy for the Health Sector aims to play a significant role in policy reform by encouraging DMC governments to take a pro-active role in the health sector that includes increasing public investment in primary health care, facilitating private sector involvement, and increasing the focus on public goods (ADB 1999a, 28). ADB's DMCs on average are underinvesting in the health sector compared to elsewhere in the world. Assistance to reform of government finances, state-owned enterprises, and publicly owned or subsidized utilities intends to ensure that some of the public resources saved by these reforms are used to promote basic human services such as PHC. ADB will also help DMCs test

various approaches to user charges and co-payments with the proviso that such cost recovery mechanisms will: (i) not decrease use of public hospitals by the poor, (ii) increase the proportion of the public subsidy that is captured by the poor, and (iii) improve the quality of care in public hospitals. ADB will continue to facilitate public-private partnerships in health as a way of increasing efficiency and building up the experience of DMC governments in working with the large and growing private sector such as private clinics and traditional healers.

d. *Other Considerations*

Similar to the education sector, examination of public spending patterns, or incidence analysis, could well indicate whether reallocation among different levels of health services and geographical areas could make the distribution of benefits more progressive. If government budget reallocation from other sectors is politically infeasible, health planners must consider reallocation within the sector based on social equity criteria as well as cost-effective health impact while piloting innovative financing mechanisms. Much evidence indicates that the poor have a willingness to pay for health services provided their qualities are improved. Monitoring and evaluation can have a tremendous impact on the quality and effectiveness of services if they are connected to quality improvement programs. Often the incentive structure needs realignment to improve services to poorer patients. The use of poverty mapping (e.g., see Appendix 3 of the *Handbook for Integrating Poverty Impact in Economic Analysis of Projects*; ADB 2001a) and monitoring systems to track health service are essential to sector planning and targeting of subsidies.

Given the importance of household behavior in determining health outcomes, high priority should be given to providing preventive health knowledge and information that can improve consumers' ability to choose providers and consume appropriate services. This points to the need to exploit complementarities with other sector interventions. For example, much evidence indicates that better-educated women tend to adopt behaviors that lead to better health outcomes. Improvements in water and sanitation are now accepted as an important determinant of health outcomes. It is also recognized that health improvement will be much greater if installation of medical facilities is accompanied by a hygiene education program to ensure their proper use and maintenance. This indicates a high degree of externalities gained from general education that includes basic sanitation programs especially for girls. Coordination between health and education ministries on health education can have substantial payoffs. Household and community surveys are an essential source of information for planning such integrated social services. They should be utilized to reveal the willingness and affordability of the poor to pay for different health services and their income and price elasticities (see, for example, *Handbook for Economic Analysis of Health Sector Projects* [ADB 2000b]).

3. **Urban Development and Housing**

a. *Sector Priorities*

Due to the continuous migration of rural poor to urban-based economies, millions of poor families now reside in squatter settlements. Many urban poor find their livelihood in the informal sector. When rapid and uncontrolled growth damages the urban environment, the poor are most affected. To address this situation, ADB will support the development of accountable local governments and improved urban management. Greater private sector and community participation and the use of market-based approaches will be essential elements of this strategy. ADB will support equitable, cost-effective and sustainable investments in microfinance, water supply and sanitation, upgrading of informal settlements, and innovative schemes for the provision of low-income shelter and basic services (ADB Oct 1999, para 69-70).

b. *Lessons Learned*

OED's Impact Evaluation Study of Bank Assistance to the Urban Development and Housing Sector (ADB 1997b) indicates that insufficient attention to institutional reform issues was largely responsible for compromising potential project benefits in the sector. Consequently, it suggested that a substantial part of the responsibility and authority for urban development needs to be decentralized to the local level involving devolution of functions, needs to be accompanied by reforms that extend from the enabling legislation to fiscal policy that determines criteria for allocating taxes to urban areas, and a greater emphasis on client-focused design of the institutional reform process.

c. *Current Strategy*

ADB's Urban Sector Strategy (ADB 1999c) emphasizes that cross-sectional institutional strengthening and policy reforms are critical for delivering better urban services. Issues needing attention include the role of the private sector and market-based reforms, horizontal and vertical coordination among agencies, community involvement, cost recovery, demand management, and innovative funding mechanisms. Greater reliance needs to be placed on market mechanisms for the delivery of urban infrastructure and services, especially in large cities. Despite increasingly relying on private capital and market mechanisms, policy frameworks, and provider agreements, the strategy indicates the need to ensure equitable and affordable access to basic services and infrastructure for the urban poor and vulnerable groups. An element of the strategy is to further develop policy-based lending, including the use of the sector development program modality. The scope for policy reform cuts across most subsectors, with common themes being (i) decentralization, increased community participation, and improved governance; (ii) institutional and financial management strengthening; (iii) facilitating, managing, and monitoring private sector provision of services; and (iv) interagency cooperation.

The World Bank (2001, 21-38) takes a similar approach based on its assessment that despite a desire to stimulate private sector activities, the response of many governments is to restrict informal sector sellers, prohibit selling altogether, or subject them to strict regulations. A pro-SME policy environment that provides advice and infrastructure can increase the productivity of urban informal and small enterprises and their ability to operate in accordance with the safety and hygiene regulations. Local authorities can collaborate with large companies and initiate SME training programs. Similarly, cities can support home-based production through changes in regulatory frameworks, information and advisory services on marketing, access to credit, and safety measures. Cities can organize job training programs and workshops in collaboration with the private sector and central government to improve employment opportunities for the poor. Cities can take a role in creation of short-term employment, for example, through public works programs. Public authorities need to establish systems to provide tenure security in the context of the country's culture and communities' particular needs. Systems should be flexible and may offer protected use rights, which can be gradually upgraded to full ownership rights.

4. **Social Protection**

a. *Sector Priorities*

Recent events in the region revealed the need for greater attention to social protection issues. For example, economies in transition or crises are finding it difficult to sustain the traditional and informal protection systems. In an increasingly market-oriented economic system, there is a need to prepare policies to effectively address the vulnerable segments of the population, ranging from labor market policies to social insurance programs, in order to protect the poor from bearing disproportionate

burden of adverse economic events beyond their individual coping capabilities. ADB will support programs to cushion the adverse effects of shocks (especially those affecting women). Support will be designed to bolster economic security for the poor through the development of social assistance for the vulnerable; social insurance against risks of unemployment, disability, work-related injury and old age; and labor market programs (ADB Oct 2000, para. 68).

b. *Current Strategy*

ADB's Draft Framework for Operations on Social Protection (ADB 1999a) addresses the complexity of developing social protection programs. First, since social protection systems serve multiple objectives, no single approach to a social protection problem is likely to satisfy all different objectives and assessments need to acknowledge and assess tradeoffs inherent in selecting any one approach to social protection. Second, social protection strategies will vary from one country to another as a result of differences in traditions, institutions, and environments. Country political preferences will also be influenced by the particular models and approaches imported in the past. The provision of adequate social protection needs to consider: sustainability of the program (except for certain temporary measures during economic crisis), coverage of labor standards and contributory insurance programs, and predictability about the conditions under which benefits are to be provided (protection systems will be viewed as unreliable where qualifying conditions change frequently or are unclear and subject to bureaucratic or political manipulation).

Social protection, however, is not a substitute for basic measures to promote growth and adequate living standards. Care must be taken to avoid excessive amounts of social protection, relative to a country's developmental stage. This can impede growth and create undesirable transfers from the informal to the formal sector. Since these interventions invariably cause changes in market incentives, even the best designed systems are likely to have at least some undesirable side effects. In constraining the fiscal impact of social protection programs, credible measures are needed to ensure that implementation will leave room for dealing with other priority government spending. Where services are available to potentially large client populations, it would be necessary to limit the demand and avoid oversubscription. Analyses of social protection policies frequently ignore the size and expected costs of contingent liabilities. Turning to NGOs or other private sector institutions as alternative service delivery mechanisms can be a successful strategy for dealing with unresponsive government agencies, provided there is sufficient political support to allow downsizing or eliminating the government agency. Care is required in designing the arrangements under which private firms will compete, particularly when they are delivering insurance-type programs.

The Framework goes on to outline the key operational issues that relate to the country's labor market standards and rigidities, coverage and sustainability of existing or emerging social insurance (wage replacement) programs, and the cost-effectiveness of its overall safety nets. This will involve working with country counterparts to examine:

- (i) effects on government policies on household consumption, with particular attention to vulnerable groups and the informal sector;
- (ii) effects of existing or proposed social protection initiatives on labor markets and work incentives, and financial markets in the case of interventions that rely on private sector intermediation to accomplish social objectives; and
- (iii) effects on public finances and a country's macroeconomic framework with respect to (a) explicit government spending obligations, including the long-term revenue and spending implications of contributory wage replacement schemes, and (b) contingent liabilities associated with interventions that are mandated on employees or households.

Again, incidence analysis of transfer spending would be useful in indicating the degree of social desirability of the current social safety incidence. In trying to formulate targeting criteria, the basic principle should be to target the risks that are not of household-specific (idiosyncratic) nature but of a meso or macro nature. The World Bank (2001,17-21) provides a number of considerations for social protection policy. An initial step in choosing an appropriate mix of social protection policies is to analyze the main sources of risk and vulnerability of the population and to identify the population groups most affected by these risks. This is followed by determination of the groups covered by existing social protection programs and policies, and assessment of the effectiveness of these instruments, individually and in combination. There is little international consensus on what share of a country's resources should be spent on social protection programs or how to divide the resources among different programs. While poorer countries do not spend enough to make their programs effective, in countries with the highest expenditure, the containment of social protection expenditures is often a central element of the social policy dialogue. While it is tempting to introduce a new social protection intervention to address a risk that is currently not covered, the value of the new program must be assessed against other use of funds. It is also tempting to establish new programs that address an issue already covered by other poorly performing programs, but this can prove costly in the long run. Replacing or removing existing programs may be desirable if they are ineffective and cannot be feasibly modified or if they address lower priority groups or risks. Should policymakers find that existing social protection programs are the best that can be in the country, further poverty reduction efforts should focus on other interventions.

APPENDIX 2: MACRO-MESO AND MESO-MICRO LINKAGES OF ADJUSTMENT PROGRAMS

This appendix relies heavily on, and is adapted from Behrman (1993). It provides an introduction to a potentially operationable analytical procedure of pinning down poverty impact of macroeconomic policies, by decomposing the impact transmission channels into broadly two analytical modules: macro-meso link and meso-micro link. The primary focus is rural poor households, but the framework and procedure are adaptable to urban poor households. This shares a similar preliminary modular approach presented by Ames et al. (2000). Much of the discussions of disentangling impact transmissions should be applicable to ADB's currently practiced poverty impact assessment (PIA) matrix.

A. **Limitations of Economic Theory and Caution Against Generalization**

1. **Reminder of Limitations of Economic Theory**

(a) There is a considerable controversy about which of several alternative models is most relevant, such as what extent private behavior offsets macroeconomic policies. An important source of different outcome is the private sector expectation. If short-run transitory stabilization policies are expected, private behavioral adjustments are likely to be limited to those for which the gains are fairly immediate and the adjustments themselves perhaps reversible. If longer-term adjustment policies are expected, private entities are more likely to make basic adjustments in their behavior, including longer-run investments. (b) Only by abstracting from relevant characteristics of the situation can economic theory lead to clear-cut predictions regarding the direction of changes in the meso setting. (c) Often the net effect depends on which of several counteracting responses is most important, which is an empirical question. Even if the direction of the effect is predictable, the magnitude is still an empirical matter. (d) Economic theory is most useful if applied to comparative statics between equilibrium outcomes, but has limited predicting power over the nature or the lag in adjustments between equilibria.

2. **Caution on Country-specificity of Differing Response to the Same Set of Macroeconomic Policies**

(a) Monetization and commercialization vary. In autarkic subsistence or semi-subsistence economies, many households primarily produce their own consumption goods, and with naturally limited monetary and commercial activities. (b) Financial market development varies. In many developing countries, the nonbank public holds a very small proportion of the public debt; the credit extended by the banking system to the government is a large part of total debt, and the market for short-term government paper is not well developed. This means open market operations have limitations. (c) Exchange rate regimes and regulation of foreign exchange market vary. If foreign exchange regulations are effective, there will be much less transmission into international financial markets of the impact of domestic macroeconomic policies, at least in the short to medium run. (d) Market structure in key industries varies. In some countries, the banking and insurance systems are state monopolies, so that the government has a direct means of influencing credit allocation and investment of insurance funds. This may mean that such governments can more effectively attain certain targets, such as those related to sectoral allocations of official credit, most likely at the expense of overall negative distortionary impact on the entire economy. Changes in such policy variables can be part of adjustment programs. (e) Tax system varies: e.g., between direct and indirect taxes. If taxes are changed from direct to indirect taxes and alter relative prices to induce production shifts, there may be also important effects on the government deficit in those developing countries in which such direct taxes account for a large share of government revenue.

B. Impact of Macroeconomic Adjustment and Stabilization Policies on the Meso Setting

Conceptually, an appropriately specified (including price rigidities) economywide model of a computable general equilibrium (CGE) class is an ideal tool for organization and analysis. Such models may be available to determine some variables of interest: e.g., Korean model in Dervis et al. (1982) and Adelman and Robinson (1988), enabling analysis on important variables regarding income distribution and factor and product markets. More recently, Thorbecke and Jung (1996) and Thorbecke (2001) suggest the way social accounting matrix (SAM) can be extended to CGE application that incorporates distributional effects and poverty sensitivity effects. But such models have limitations in incorporating features such as expectations, monetary phenomena, adjustment dynamics, fragmented markets, and quantitative restrictions. In the best of all cases, models currently available do not permit estimation of the impact of macro policies on the poor on all of the meso variables to be discussed here. Moreover, in most cases such models are not readily available at all. With this background on practical difficulty of complete modeling, we still need to consider cost-efficient ways of analyzing the distributional effects particularly of some major components of typical macroeconomic adjustment policies. In the following, small country assumption is applied throughout.

1. Currency Devaluation is Often a Key Component of Stabilization Programs

Its net impact, however, has been the subject of debate. The impact of devaluation on the balance of payments as well as on the poor depends upon the extent of expenditure switching (substitution effects) and the extent of expenditure changes (income effects). If the devaluation is perceived to be transitory (credibility problem) in real terms rather than more permanent, there is likely to be limited expenditure switching. Assuming there are some switching in the long run, the implication for the income of the rural poor depends on the factor intensity of their production and their consumption patterns. If tradable goods and services are largely produced in capital-intensive industries, then the factor intensity effect tends to disadvantage the poor in general. To the extent that tradables are basic foods produced largely by the poor, however, the factor intensity effect is beneficial to the poor. Likewise, the consumption effect depends on the nature of the traded goods and who consume them. To the extent that staple foods are an important part of the consumption basket of the poor, the consumption effect in itself is likely to worsen the position of the poor in general. However, poor farmers and landless rural laborers producing competing staples may be net gainers if for them the factor intensity effect outweighs the consumption effect.

The intended scenario for devaluation is that eventually exports expand and imports decline as a result of persistent induced relative price changes, improving the balance of payments in international currency and probably increases aggregate demand and income. However such a process may be slow (implying perhaps a prolonged J-curve effect), particularly if exports are goods for which gestation periods are long (such as tree crops like palm oil and rubber) and for which initial capacity is fully utilized, or if there are considerable doubts about the longevity of the real depreciation. There are also partially offsetting factors that may lead to devaluation being contractionary. On the demand side, the net trade component of aggregate demand in domestic currency may fall if there is an initial large deficit, consumption and investment may decline if wealth declines, or if real income falls (due to devaluation-induced inflation). If the contractionary factors dominate in the short run, the reduction in real expenditure is likely to reduce the real purchasing power of the poor. This may well happen as a result of reduced demand for services and products of the informal sector. Workers who otherwise might have been employed in the formal sector may move into the informal sector, reducing further the returns for the poor in the informal sector. Also, it is important to have a clear picture of transmission channels and the behavior of the economic agents that respond to relative price changes. For example, monopolistic buyers of export crops will respond differently than will producers' marketing cooperatives. Regulations

that fix market prices can completely block the transmission of price changes to the household level. If trade liberalization itself leads to the disappearance of market institutions, households can become completely isolated from the market and suffer substantial income losses. If official marketing boards provided credit for inputs and against future outputs, whereas post-liberalization private agents do not, no increase in output prices will benefit farmers unless alternative borrowing arrangements can be made (Winters 2000, 14-15).

a. *Contractionary Fiscal and Monetary Policies are Usually Applied to Correct Unsustainable Fiscal Balance*

Output reduction, and the related declines in labor demand, probably lessen the real income of the poor. The duration and extent of the negative impact on the poor's income depend on several considerations beyond the extent of the initial leftward shifts in aggregate demand and supply. One uncertain factor is the extent of and gestation required for a longer-run positive supply shift. The larger and the quicker the response, the lesser will be the toll on the real income of the poor. A second consideration is how the government cuts expenses and increases revenue, and how such changes affect the poor. Reductions in credit subsidies to capital-intensive manufacturers or increases in income taxes are not likely to have much negative impact on poorer households, but reductions in public health expenditures, food stamps, school lunches, or subsidies for inferior goods may have significant negative income and price effects on the poor, which may well be of long-run nature.

b. *Direct Wage and/or Price Policies Often are Part of Adjustment Programs*

If effective, such policies reduce the real income of individuals who would have been employed in the affected occupations without the wage controls. This may not likely have a strong negative effect on the poor because they are not likely to have been in such occupations if there were no wage policy enforced. Price policies are likely to involve increases in or freeing of previously controlled prices, e.g., on transport, fuel, and food staples, to induce supply expansion, reduce government subsidies, and discourage demand. If such price controls were effective prior to the adjustment program, such a policy shift means increased nominal prices for consumers of these items. This is likely to reduce their real incomes, and at the same time, increase the incomes of producers of these items, who are likely to include the rural poor.

c. *Policies to Limit Foreign Exchange Uses and to Encourage Foreign Exchange Generation are also Often Part of the Adjustment Package*

Commonly, imports are liberalized with reductions in quantitative restrictions and tariffs. Reduced import tariffs have at least three types of effects on income distribution. First, if reduced tariff rates do not encourage imports by much, government revenues fall and thereby increase the fiscal deficit, partially offsetting the intent of the contractionary fiscal policy. Second, within the simplest trade model, reduced import tariffs change the terms of trade to induce expansion of export goods which make the most use of resources that are relatively abundant in the country, presumably unskilled labor for developing countries. This may lead to income benefits for many rural poor. Third, there is an impact on the relative prices that consumers face that depends on the marginal propensity to consume importables relative to nontradables. If the importables whose restrictions are removed are mostly luxury goods, losses would incur on the recipients of such quotas, who are not likely to include many poor people.

C. **Assessment of Macro-meso Link**

Despite the difficulty of projecting the counterfactual of macroeconomic policies and the complexity of impact transmissions, it is desirable to proceed as effectively as one can with analysis of relations between macroeconomic policies and the meso setting for the determination of poor households' command over resources. A logical starting point would be an evaluation of the impact on the major economic variables: inflation, employment, unemployment, real income, exports, imports, real exchange rate, terms of trade between agriculture and manufacturing, interest rates, real wage rates, terms of trade between tradables and nontradables, real government expenditures and deficits, and real formal sector credit availability. In the absence of relevant economywide models of a CGE class, a second-best approach may be to examine time series for indicators of the major macroeconomic policies. The relevant questions to ask are: first, are there significant deviations in the major macroeconomic aggregates from their underlying secular trends, and if so, do they appear to suggest that they were caused by the deviations in the macroeconomic policies instead of by other macroeconomic shocks? Simple regressions of the major macroeconomic outcome variables on time trends and on indicators of major macroeconomic policy variables and shocks may permit the separation of the impact of the macroeconomic policies from other shocks and from ongoing trends. Therefore, it lessens the possibility of misinterpreting any ongoing deterioration due to the previous situation that called for a macroeconomic adjustment program as being due to the adjustment program. To remedy the scarcity of single-country time series data, some empirical studies (e.g., Garuda 2000) apply a statistical technique called "propensity score estimation" to cross-country data. The scores represent the probability that either program or nonprogram countries would have agreed to an adjustment program *ex ante*, regardless of whether or not they ultimately decided to do.

Such regression estimates basically are simple reduced-form estimates under the assumption that the macroeconomic policy and shock indicators can be treated as exogenous. Given the usual caveats regarding causality and endogeneity, the best procedure may be to see how sensitive the estimates are to different assumptions about the set of instruments used to treat such policies as endogenous, including the broader definition of the set of such instruments as past macroeconomic characteristics as in Corbo and Rojas (1992). In many contexts, looking at such reduced form regressions is a cost-effective way of evaluating the macroeconomic context and avoiding errors that can easily occur from proceeding with assessment on the basis of *a priori* suppositions or pure logic. Ideally, these reduced-form relations should include interactions among the macroeconomic variables since, for example, the impact of currency devaluation may depend on the nature of regulations and activities such as currency movements and capacity expansion. If this is not possible due to the limited degrees of freedom, there are several options. One possibility would be to summarize the information in the right-hand side variables through their principle components. A second approach would be to limit the right-hand side variables to those that on *a priori* grounds seem most relevant for each dependent variable. While none of these are satisfactory, the analyst should explore the extent of the correlation among the included and excluded observed macroeconomic policy and shock indicators in order to lessen biases in the estimated coefficients of those variables included.

D. **Meso Setting and Rural Households**

The meso setting relevant for the determination of the command over resources of rural households and other relevant micro institutions include two broad conduits for the transmission of macroeconomic policies to these micro institutions: markets and infrastructure services, summarized below.

**Suggestive List of Meso Variables for
Analysis of Impact of Macro Policies on Rural Poverty**

- I. Markets
 - A. Factors
 - 1. Labor
 - (i) Wage rates (low skilled; higher skilled as bases for expected returns to education; medical personnel, teachers, trainers; by sex, region, experience) for both rural and urban areas (wage differential is important in migration decision)
 - (ii) Employment/unemployment by skill
 - 2. Nonlabor
 - (i) Inputs for small-scale own-farms and other enterprises (prices and availability)
 - (ii) Inputs for human resource investment supply side (prices and availability)
 - B. Products
 - 1. Major products of farms and other rural enterprises—prices and quantities
 - 2. Major consumption items
 - (i) Staple and other food prices
 - (ii) Nonfood prices: e.g., clothing, housing, health inputs
 - 3. Prices and availability of human resource services
 - C. Financial
 - 1. Formal: interest rates, terms, availability
 - 2. Informal: interest rates, terms, availability
 - D. Risk pooling/shifting
 - 1. Formal: insurance, future markets
 - 2. Informal
 - E. Market substitute: remittances, employment diversification, product diversification, migration, interhousehold transfers.
- II. Infrastructure Services (current and longer-run expenditures, nature, access and quality)
 - A. Social
 - 1. Education: schooling and training
 - 2. Health and nutrition
 - 3. Transfer programs
 - B. Physical
 - 1. Energy
 - 2. Transport
 - 3. Communication
 - 4. Employment related
 - 5. Extension: agricultural, other

E. Rural Household Model

The standard economic conceptualization of household behavior includes a set of allocation rules such as maximization of household aggregate satisfaction, subject to household production functions, budget constraints, predetermined assets, and exogenous markets and infrastructure. An example of a household production would be that health of a child is “produced” by food, water, health care received, genetic endowments, community environment, and parents’ skills and time devoted to health care of the child. The budget constraint is a “full income” constraint that indicates that total available household resources (including the time of household members, as well as physical and financial assets and transfers to the household) must equal or exceed the total use by the household of such resources (purchased at market prices and time uses, including those related to human capital investments and to economic activities and household production and leisure, and transfers from the household). Solution of the household optimization problem gives reduced-form demand functions for each of the variables determined by the household, including the time uses of all household members.

$$Z_{ij} = f(A, P, I) \tag{1}$$

where Z_{ij} is the demand for j th outcome determined by the household affecting the i th individual in the household; A is a vector of all of the predetermined assets of the household for the period of relevance; P is a vector of all relevant product and factor market prices faced by the household; and I is a vector of all relevant infrastructure services faced by the household. The meso determinants of household behavior and of household command over resources are included in the vectors P and I . Income generation can be separated from the household consumption decision. If such separability holds, the household can be seen as first maximizing its income and then allocating that income among alternative uses to maximize its satisfaction. Where such separability does not hold, the so-called household farm model has been developed. It includes the farm production functions, farm purchases (including hired labor), and sales in the full income constraint. This implies that the RHS variables in (1) include all household-demand related outcomes and all household-farm production related variables; and that the LHS variables include all farm-related prices, assets, and infrastructure in addition to those for consumption demands.

The current income of the household is the sum of the labor earnings of the household members, their net return on assets, and their net receipts of private and public transfers:

$$Y = T \times W + r \times Anh + TR \tag{2}$$

where T is a vector of the time spent by different household members in various labor market activities, W is a vector of the wage rates obtained, r is a vector of returns obtained by the household from the nonhuman assets Anh that it owns, and TR is the total net transfers received by the household from all private and government sources. Regarding intrahousehold and intergenerational issues, unfortunately, there have emerged no robust and general approach to simplify the function yet as well as it is almost impossible to disaggregate consumption data across household members. It is likely that the best that can be done is to call on physical indicators such as health and nutritional status and time allocation data (e.g., Winters 2000, 12). But these issues will not be covered here.

The basic concern here is how macroeconomic policies, through meso variable conduits, affect the command over resources of rural poor households, as represented by their incomes or expenditures. The answer to this depends on household demand and supply decisions that affect the time spent in economic activities or in the utilization of social sector services. The following procedure could be followed to estimate such effects.

- (i) Obtain data from household surveys and other sources such as LSMS (including aggregate time series data) that permit estimation of a set of relations of the general form of equation (1) for as many outcomes related to rural household as possible.
- (ii) Estimate equation (1) from these data for all the relevant outcomes.
- (iii) Estimate the changes in RHS meso price and infrastructure variables that are due to particular macroeconomic policies for a given duration by relating the changes in the variables used to estimate the alternative versions of equation (1) to the estimates of the changes in the meso setting induced by the macroeconomic policies (simulation of comparative statics).

It is worth noting six important features of the above comparative statics. First, an outcome for a specific individual include on the RHS of equation (1) predetermined characteristics of all household members. That is, for the determination of the time spent in paid labor market activities by any given household member, the human resources of all household members are included. Second, for similar reasons, the prices include not only the direct prices of the time spent by the individual but all product and factor market prices affecting the household, and likewise for the infrastructure services. Third, note that income is not included explicitly in equation (1). However, income is the return on assets (including time) and is included implicitly in the relation but does not appear in the reduced form. This treatment avoids the estimation and interpretation problems that would occur if an income measure were included that reflected the endogenous choices of the household, such as the number of hours worked. (This also explains why expenditure measurement of poverty is preferred to income measurement in general.) It also allows the representation of the possibility that income effects vary depending on who in the household receives such income. For example, some conjecture that the income impact will be greater on children's education if mothers receive such income. Fourth, capturing time dimension will be an art rather than science. As the period is extended, the changes in RHS variables also differ. The pattern of such changes presumably depends critically on the time pattern and the success of the intention of the policy changes. For example, if budgetary constraints cause deterioration in infrastructure and reduce real wages initially but eventually lead to better infrastructure and higher real wages than would have prevailed without the adjustment policy, then the short-run and long-run impact of such policy changes must be considered separately. Fifth, estimation of relation (1) inevitably involves some measurement problems that may cause estimation biases: e.g., sample selection bias, omitted variable biases, etc.

F. Asset Determination and Relation to Meso Variables

Changes in physical, financial, and human assets held by the poor may occur due to savings/dissavings decisions that are related to their current real income, which in turn reflect in substantial part real price changes and the limited availability of credit. For example, there is considerable anecdotal evidence about farm households decumulating land, livestock, and other assets in times of local or more broad economic crisis, and thus lowering their income prospects and increasing the probabilities of remaining poor. Changes in human assets of the poor may be affected by income and prices broadly defined to include not only nominal prices but also the opportunity costs of travel and waiting time. The proximate determinants of these investments presumably include income and price variables that also determine other asset changes. The question of relevance here is how changes in real income, real demand, credit market, and insurance market that might induce changes in such household assets are related through meso variables to macro policy changes. The most effective approach, if data are available, is to estimate relations of the form equation (1) for relevant asset changes as dependent on the meso price and infrastructure variables through which the macroeconomic policy changes may affect asset

holdings decisions of the poor. While micro household level data would be preferred, the analysis of more aggregate time series data might also be fruitful.

There are some possible differences in degree from the relations that determine the changes in types of assets. First, one might expect greater effect of meso variables related to the quantity and quality of public health, education, and nutrition services on human resources changes than on physical and financial asset changes. Second, human capital investments in infants and children may be important factors on which to base judgment regarding whether and to what extent rural households live in poverty even though there is likely to be a substantial lag before such investments have much of an impact on measured poverty. Third, there is a growing emphasis on the critical role of resources under control of women having greater impact on human resource investments than those under the control of men. Therefore, to the extent that macroeconomic policies may have differential effects on the resources under the control of women, as might occur if there is occupational segregation by sex and related relative price changes, it may be important to attempt to separate the impact by sex.

G. Price Determination and Relation to Macroeconomic Policies

As seen in the table above, a number of prices enter determination of the real command over resources for households. Macroeconomic policies obviously can have an impact on these prices. There is a question regarding whether it is sensible to try to model the structural supply side and demand side relations within the resources of individual policy interventions. Instead, it may be desirable to estimate reduced-form relations in which the prices in a particular rural locale depend directly on the indicators of macroeconomic policies and shocks. Care must be taken in interpreting such reduced-form price relations since some policies may work through both the supply and demand sides and their impact, even in the perfectly competitive equilibrium case, and may depend on the exact location of the supply and demand curves. Nevertheless, this may be the best strategy within the limited resources. For such estimation it would seem that the use of time series data would be the dominant option since there is not likely to be enough variation in regional prices due to differential impact of macroeconomic policies to permit such exercise. There will be a basic time-dimension problem common to the determination of the meso variables of interest. This relates to how to represent the expected and actual longer-run impact of macroeconomic policies on prices. Even in the short run price expectations may be critical, especially in determining investment/saving/dissaving decisions, as mentioned above. It is hard to know how to represent either the expected longer-run effects on prices held in the short run or the actual longer-run effects on prices, though in some cases exploration with lags may lead to some insight. If there is no way to represent such prices, then it is important to realize this limitation and to speculate in as informed manner as possible about the implications.

H. Transfers and Macroeconomic Policies

In principle, transfers received by households (TR in equation (2)) may either be from government or private sectors. In fact, government transfers tend to be limited in rural areas except for some agricultural subsidies. For private transfers, there have been much analytical studies but there remains some ambiguity regarding whether the motivation for such transfers is altruism or insurance. Also a question remains as to what extent households potentially involved in such transfers are likely to be hit by correlated (meso) shocks. The more correlated are such shocks, the less likely is the flow of transfers to mitigate the severe hardship of rural poor hit by, say, bad weather. Perhaps for that reason, many of the observed private transfers in which rural households are involved are across space in both rural and urban areas. In that regard, many macroeconomic adjustment policies, to the extent that they have negative impact on some rural poor households, are likely to have correlated effects. In such a case, the

probability that private transfers would mitigate much of the hardship experienced by poor households would seem small. While changes in government transfers in response to macro adjustments may be predictable to a certain extent, say, from historical evidence or budget allocation formula, it is difficult to know how much data are likely to be available for examination of possible roles of private transfers. However, given the importance of such transfers, it would be desirable to be sensitive to the question of how correlated income shocks are, and whether data are available with which to assess the importance of private transfers in mitigating the negative effects of macro shocks.

I. Other Household Outcomes that may Reflect Macroeconomic Policies or Shocks

The set of rural households under examination may be changed due to macroeconomic policies in at least two major respects. First, there is the possibility of changing the distribution of a given set of individuals among households through the dissolution of existing households or the formation of new ones. Though there is little evidence for developing countries, a conventional wisdom for the United States is that women and their children often move into poverty status due to the dissolution of a marriage or a common law union. There is also some suggestion that such dissolutions are affected by economic conditions. Second, there is the possibility of changing rural poverty through migration. If a very poor rural household migrates to an urban area, for example, measured rural poverty may decline though total poverty may not. Macroeconomic policies a priori would seem to change relative expected benefits to the extent that they change relative wages by changing relative prices associated with products in which different regions or urban concentrations have different comparative advantages. For example, liberalization of trade regimes that have provided relative protection for manufacturing or devaluation may lead to an increase in the relative price of agricultural goods and therefore in expected relative agricultural wages and returns. As a result, rural-urban migration may be slowed down or reversed, with implications for the rural labor supply and therefore rural wages. Here again, it will be important to be sensitive to the duration for which a particular macroeconomic policy has been (will be) in effect in any evaluation (prediction) of its impact.

J. Empirical Evidence

Maasland and van der Gaag (1990), after careful cross-country statistical analysis of various indicators of living conditions in 25 developing countries supported by the World Bank's adjustment programs in 1980s, concluded that there is very little or no association between adjustment programs and poverty. Due to the difficulty of disentangling complex transmission channels and isolating the impacts associated with a particular set of macroeconomic policies or shocks, the available evidence is limited and needs to be qualified substantially. Also, the evidence may be specific in many cases to particular institutional settings, regional contexts or international market involvement. Nonetheless, to provide some insights into promising analytical models, it is useful to survey some selected empirical studies.

1. Agricultural Incentives: The Effects of Sectoral and Economywide Policies

Krueger et al. (1988) summarize some of the preliminary results of the World Bank comparative study of the political economy of agricultural pricing studies. They distinguish between sector-specific (direct) and economywide (indirect) policies in their investigation of the policy impact on agricultural incentives for 18 developing countries including six Asian countries (Korea, Malaysia, Pakistan, Philippines, Sri Lanka, Thailand) for the 1975-1984 period. They measure the direct effect by the proportional difference between the producer price and the border price (adjusting for distribution,

storage, transport, and other marketing costs). The indirect effect has two components: (i) the impact of the sustainable portion of the current account deficit and of industrial protection policies on the real exchange rate and thus on the price of agricultural products relative to nonagricultural nontradables; and (ii) the impact of industrial protection policies on the relative price of agricultural products to that of nonagricultural tradable products.

Their result indicates that the indirect effects on agricultural incentives to agricultural producers generally were larger than the direct effects. Moreover, for many countries, the effective taxation on agricultural products through indirect policies exacerbated the negative direct effects, resulting in very large total negative protection equivalents. The average levels of total nominal protection did not change much between 1975-1979 (-36 percent) and 1980-1984 (-40 percent): negative protection means discrimination against agriculture. There was some tendency for unfavorable indirect changes for agriculture to be offset by favorable direct changes, but the estimates for both periods point to the substantial degree of discrimination against agricultural products in developing countries, including Malaysia and Thailand. (The agricultural exportables studied here were rubber for Malaysia and Sri Lanka, rice for Thailand, cotton for Pakistan, and copra for Philippines.) At the same time, the authors also noted that in contrast to the discrimination against export products, there tended to be strong direct protection of import-competing crops (e.g., rice for Korea, Malaysia and Sri Lanka, wheat for Pakistan, and corn for Philippines) but with the similar negative indirect effects working against these crops and offsetting the direct positive effects. The authors speculate that the differences between the direct policy treatments of exportables versus importables are due to a combination of a desire for self-sufficiency in terms of basic staples and the use of international trade taxes (or their equivalents) for agriculture because of the difficulties in administering other types of taxes.

Behrman (1993, 174) draws some preliminary implications for Asian and other agriculture-dominant developing countries. First, the changes in the indirect policies are likely to be potentially as important or more important than the changes in direct policies in affecting agricultural product prices. That is, overall macroeconomic policies seem to matter a lot in many contexts, though both direct and indirect policies are likely to have less impact the less integrated into the market economy the rural sector is. Second, if adjustment policies were to eliminate all policy-related distortions, overall agricultural prices would tend to rise relatively. Third, the changes in the meso variables in response to the adjustment policies would tend to increase the real income in the agriculture sector because of the relatively large increase in agricultural product prices relative to consumption prices, perhaps reinforced by agricultural supply responses. Fourth, there would be variation in the extent of gains and possible losses among members of the agricultural sector, with the largest gains among those most involved in exportable production. Fifth, greater agricultural product price instability probably would tend to ensue, which would have some welfare costs to producers and to consumers. However, calculations such as those in Newberry and Stiglitz (1983) suggest that the producer welfare losses due to greater price instability would be much less than the gains due to higher prices at least for exportables because of the various ways in which producers diversify their risks.

2. Policy Response of Agriculture

Changes in such meso variables as agricultural prices do not necessarily mean that agricultural production will increase substantially. Binswanger (1990) stresses three points about the evaluation of aggregate response of agriculture to policy changes. First, substantial price responses for individual agricultural products should not be interpreted to mean that there is substantial response for aggregate agriculture. It should be noted that at least in the short and medium run the price responses primarily reflect changes in the composition of the use of relatively fixed agricultural inputs (such as land, labor, and water) and only limited expansion of aggregate production. The implied short-run supply response

would not in itself have an immediate large impact on real agricultural incomes, in fact, on the average, it would be about only a fourth as important as the impact of the induced change in agricultural prices if adjustment policies were to eliminate all of the direct and indirect distortions. Second, it is necessary to consider all factors that affect agricultural net revenues, not just product prices: e.g., input prices, stock of human and physical resources, and infrastructure. He argues that econometrically it is easier to show the effect of infrastructure, services, and human capital together affect aggregate agricultural output more than prices alone. Third, structural adjustment that eliminates price distortions are likely to have substantial short-run effects on agricultural exports, but not very much effect on importables. Balassa (1986) found that the elasticities of the share of exports in output with respect to the real exchange rate are higher than those for overall goods and services, and much higher for the net export share in output for agriculture than for other sectors. But the domestic food supply may not respond very much initially both because of overall aggregate demand reduction and because for many developing countries before structural adjustment, importable foods were relatively well-protected.

These results suggest that the rural poor will benefit more from adjustment in the short run the more that their income depends on the production of exportable agricultural products instead of importables, and the less that the products in the production of which they are involved face increased input prices and reduced public infrastructure and credit. Over the long run, Binswanger places considerable emphasis on the role of public infrastructure. However, he emphasizes that for growth, infrastructure should be concentrated in areas with high agroclimatic potential, while many of the poor are located in much poorer agroclimatic areas. Thus, to the extent that many of the rural poor are not engaged in exportable production and that many of the them are located in poor agroclimatic areas, they may not benefit from adjustment programs much in the short run, nor—unless they migrate—even in the long run.

3. Indonesian Adjustment Experience in the Mid-1980s

Indonesia was one of the oil exporters that least suffered from “Dutch Disease” in the oil market booms in the 1970s and the start of the 1980s, apparently due to skillful macroeconomic management of oil revenues compared to other oil exporting developing countries. But like other oil exporters, Indonesia then experienced various external shocks during the early and mid-1980s, which originated primarily from the weakened international oil market. The government in response undertook a rapid and voluntary adjustment program that included aggregate budgetary contraction (at a planned level of about one fifth), rapid and sizable currency devaluations, continuing monetary restraint, and trade, finance, and regulatory reforms. Growth in GDP per capita fell sharply over the adjustment period, though it remained slightly positive. The aggregate sectoral structure of output and employment remained fairly static, halting the historical decline in agriculture’s share. Ravallion and Huppi (1991) examined the evolution of aggregate poverty between 1984 and 1987 and found that it declined significantly despite the shocks and ensuing adjustments and that this result is quite robust to alternative measurements of welfare, poverty lines, and poverty measures.

Although the sectoral shares changed somewhat between 1984 and 1987, the rankings remained the same. Farming accounted for the main source of income of over half of Indonesian households in 1984 and for slightly less than half in 1987. In terms of average per capita consumption, the averages for all rural sectors (self-employed farmers, farm laborers, self-employed rural traders, laborers in rural services, laborers in rural construction, etc.) were significantly below those of the top four urban sectors (urban financial employees, urban mining employees, urban service sector employees, and self-employed construction workers) in both years. Within the rural sector, the highest average per capita consumption in both years was for service employees, and the lowest for farm laborers, self-employed miners, and self-employed farmers. On a cross-sector comparative basis, therefore, for the whole economy or for the

rural sector alone, the per capita consumption levels were relatively low for the relatively large numbers of households that obtained their income primarily from agriculture. A disaggregation procedure found that the vast majority of the poverty reduction could be explained by within-sector poverty reductions (about 90 percent) rather than across-sector ones. Furthermore, within-sector changes in rural agriculture by themselves account for the majority of poverty reduction (about 60 percent). Thus, reductions in the within-sector poverty in the initially relatively poor rural agricultural sector was a major factor in the substantial national and rural poverty reduction. Exploration of the details of changes in the rural sector leads to further insights. The gains to the rural poor largely were due to the relatively high growth in the sector than due to distributional changes that favored poorer population. Over half of the gain to rural poor farmers was due to gains in Central and East Java, where gains in both farm incomes and wage earnings contributed to poverty reduction. Elsewhere the patterns were varied.

Ravallion and Huppi (1991) conclude that their results suggest that any features of the government's adjustment program that favored rural areas (particularly in Java) were crucial in maintaining ongoing poverty reduction during adjustment. There is some evidence that the poor gained from expansion in agricultural exports (largely nonfood) and where there were sizable gains in cash crop incomes, such as in parts of Java, the poor participated in those gains. There is also evidence that adjustment cuts in government budgets tended to shelter consumption at the expense of investment. They add that an important factor in this adjustment result was favorable initial conditions. They suggest that the decade or so of sustained and fairly equitable growth had created conditions in which the momentum of poverty alleviation could be maintained at lower growth rates, and that some of the stimulus from earlier rural infrastructure investment began to yield substantial returns by the time of the adjustment period.

Regarding the currently unfolding social impact of the financial crisis in the late 1990s, it remains to be seen what implications can be drawn from the assessment of the adjustment program that ensued. As the nature of adjustment program and its austerity appears to have changed in the mid-course of conventional IMF program package, it may be difficult to isolate which adjustment measures have contributed to which outcomes. However, for the purpose of ADB operation, it would be imperative to take inventory of new empirical evidences and apply the best-informed counterfactual scenarios in assessing any further policy loans to be financed by ADB.

K. Conclusion

In conclusion, Behrman (1993) offers the following questions to be asked in country-specific analysis of macro policy evaluation. (a) What are the characteristics of the country with regard to such phenomena as market development, state monopolies, and government regulation, and how do these characteristics affect the likely impact of macro policies a priori? (b) Should a major aim of policy be to change some of these characteristics? Even if there are market failures, would it be desirable to attempt to coordinate government intervention closely with the signals emanating from world markets? (c) Exactly who are the rural poor and what are their sources of command over resources? (See the sections on agriculture incentives and policy response of agriculture.) (d) Are there sequencing issues with regard to undertaking macro policies so that they will be most effective? Policy changes should be undertaken where the rate of return (in terms of the country's objectives) to the resources devoted to the policy change are highest, which may not be where the distortions are greatest. (e) How critical are infrastructure improvements and maintenance in improving the command over resources of the rural poor? Are they critical in particular cases as Binswanger (1990) seems to argue for India? (f) What is the right balance between buffering the rural poor from short-run macroeconomic constrictions that often are part of stabilization programs and investments that affect the longer-run command over resources of the rural poor? (g) What are the activities in which the government, given the country's social objectives,

has a comparative advantage? How can government activities be made more responsive to changing circumstances and less captive to rent seekers? (viii) What is necessary to make a macroeconomic adjustment program sustainable? One of the arguments for sequencing so that the largest distortions are attacked first is that lessening such distortions may be a very visible sign and may increase the probability that longer-run changes in incentives are perceived by private entities. The pace of policy changes also seems critical in establishing the credibility of an adjustment program. The credibility of the government's efforts might be strengthened by success in lessening some perceived imbalances in the government sector such as fiscal deficits.

Berhman nicely dealt with analyses for which economic variables can be more or less empirically investigated. However, it is becoming increasingly clear that second-generation reform programs will have to analyze the poverty impact of institutional changes. Empirical studies in the area of institutional economics are still in their infancy and inevitably tend to be piecemeal and exploratory in nature. Evenson (1993) and Otsuka (1993) provide surveys of literature on rural-based institutions and poverty and point to the need for further empirical researches. Similar empirical efforts on the front of changes in governance institutions in general and their impact on the poor are warranted.

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