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Book Review — Digitized Version

[Book Review of] Bourguignon, François ... Adjustment and equity in developing countries: a new approach, Paris, OECD Development Centre Studies, 1992

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ciency and inequality. *Blanchflower* and *Freeman* ask whether there is now a higher transition rate from unemployment to employment which would mean a well functioning labour market. Their results give only little support for the assumption that the labour market is functioning better now than before the eighties. Furthermore they get the impression “that the reforms in fact brought the UK a mixture of the worst of two possible worlds: the massive wage inequalities of the decentralised US labour market together with high and lengthy spells of unemployment, European-style” (p. 75). This result is backed by *Gregg* and *Machin* who find that inequality in the UK is still less pronounced than in the English-speaking oversea world. They also state that during the eighties the tendency towards Australia, Canada and the US and away from the other European countries was rather strong. By surveying a number of studies *Metcalf* shows that there is no consensus concerning the extent and the consequences of change in British industrial relations.

The third section deals in two papers with some institutional problems. First, *Gregory* and *Sandoval* discuss the structure of minimum wages and their effects on low pay throughout Europe finding little evidence that minimum wages raise unemployment as long as they are discriminating between sectors, regions, and age groups. *Grubb* analyses the effects of active labour market policies which he puts in concrete terms in five areas: administration and public employment service work, training, youth measures, job creation, and measures to place the disabled. Although there are many problems with labour market policies they have a positive impact on the labour markets.

The last section with two papers by *Barrell/Pain/Young* and *Minford/Riley* deal with the macroeconomic performance. Both papers do not find many effects of the supply side policies on the macroeconomic functioning of the labour markets although they differ in estimating these policies. In general, the authors of this book come to the conclusion “that the changes to the UK labour market in the 1980s have not had much impact on macroeconomic performance” (p. 13).

Due to the main theme of the book the papers collected are well-ordered. They look on the labour market development from different point of views. The result is a rather consistent and complex picture of the UK labour market. In contrast to this, the papers presented by *Ulman*, *Eichengreen* and *Dickens* seem to be collected by chance. All in all the book edited by *Barrell* is more convincing and the reader has the impression that – because of the analogy of the development of the institutions and the discussion about deregulation – one can learn more about the future of European labour markets than by the book of *Ulman*, *Eichengreen* and *Dickens*.

Werner Sesselmeier

Bourguignon, François, Christian Morrisson, Adjustment and Equity in Developing Countries. A New Approach. OECD Development Centre Studies. Paris 1992. 111 pp.

Morrisson, Christian, Adjustment and Equity. OECD Development Centre, Policy Brief No. 1. Paris 1992. 38 pp.

Very often, adjustment in DCs is portrayed as a social disaster, imposed by the international organisations and the creditor banks seemingly in total disregard of the essential needs of the poor majority of the people. Whether such undesirable consequences are actually the result of wrong adjustment strategies or merely reflect the underlying economic crisis that ultimately caused the adjustment program, is open to debate, however. Besides this, it is important to ask whether the costs of non-adjustment would not be even larger, especially for those at the lower end of the income distribution.

The snag is that there is a fundamental methodological problem that bedevils any effort to assess the impact of alternative adjustment strategies just by comparing different countries' actual experiences. Countries are not assigned policies randomly, but in response to economic and political circumstances. Then, in assessing outcomes, it is not clear whether they should be attributed to policy choices or to the conditions that gave rise to those choices: the initial conditions, the parameters of the crisis, and the policies adopted all have historical and geographic dimensions that cannot be modified at will.

The OECD Development Centre has published a series of studies for seven individual DCs in key geographical areas which nonetheless try to disentangle the effects of the underlying economic crisis from the adjustment effects.¹ The DCs considered are Côte d'Ivoire, Ghana and Morocco; Chile and Ecuador; and Indonesia and Malaysia. These country studies provide a wealth of careful empirical analyses of the historical background, the institutional framework and the outcome of the adjustment process for each economy, which makes them fascinating reading for anyone interested in applied research on the economics of development in general. Only those readers who have been involved in similar work will be able to understand, at least tentatively, how much effort must have been devoted to conduct such a large research project.

What is even more impressive is that despite the very different economic situation of the countries considered, there is a common analytical approach applied to the various cases. A counterfactual analysis using a computable general equilibrium model is employed to study the *net* social costs of adjustment in terms of unemployment and declining *i.e.* the analysis is intended to measure the impact of a particular adjustment program remains when the influence of all other factors is eliminated. This approach is described, its results with respect to a wide array of adjustment programs are evaluated in a summary study and an accompanying "Policy Brief" which are discussed in this review.

As the title of the series suggests, the focus of the analyses is on the income distribution consequences of adjustment, or, in OECD jargon, on the most equitable adjustment programs. To assess the social consequences of actual and potential adjustment programs, detailed model simulations were conducted for Côte d'Ivoire, Ecuador, Indonesia, and Morocco. The available statistics for these countries allowed to calibrate the model to a so-called benchmark situation which is assumed to reflect an initial equilibrium of the economy. By "shocking" such an equilibrium by various adjustment programs, the results with respect to the income distribution (and other variables) can be simulated and compared. Despite a number of country specific differences reflected in the benchmark equilibria, the common principle of the models used is a more or less detailed microeconomic modelling of the sectoral structure of production and prices and the socio-economic structure of incomes, which is linked with a macroeconomic model capable of representing and analysing the effects of the main components of stabilisation and structural adjustment programs necessary to achieve overall adjustment together with their distributional consequences. Hence the models used should be able to reproduce the effects of alternative adjustment programs which typically include, *e.g.*, a cut in public expenditures, monetary contraction, devaluation of the exchange rate, and certain structural measures involving domestic taxation and tariffs.

If the results of the policy evaluations could be taken at face value, they would be extremely useful: for national governments, for international organisations, and for donor

¹ These studies are Demery, D., and L. Demery, *Adjustment and Equity in Malaysia*, Paris 1992; De Janvry, A., E. Sadoulet, and A. Fargeix, *Adjustment and Equity in Ecuador*, Paris 1992; Meller, P., *Adjustment and Equity in Chile*, Paris 1992; Morrisson, C., *Adjustment and Equity in Morocco*, Paris 1991; Roe, A., and H. Schneider, *Adjustment and Equity in Ghana*, Paris 1992; Schneider, H., *Adjustment and Equity in Côte d'Ivoire*, Paris 1992; Thorbecke, E., *Adjustment and Equity in Indonesia*, Paris 1992.

countries. This is why such analyses, like stock-market forecasts, are in high demand. But some doubts remain as to the empirical reliability of *quantitative* results derived from computable models. Therefore, a word of caution is necessary before considering the results in detail.²

Computable models typically use standard textbook specifications of supply and demand functions to be able to control the degree of complexity. Econometric analyses, say, of labour supply, consumption demand, savings behaviour, and production functions have shown that many of them are questionable, to say the least. More importantly, the simulation exercises cannot be considered to provide robust results. Many parameters are not observed directly but are imputed by the calibration technique. The identification of a benchmark year reflecting something like an equilibrium to allow for calibration is in itself a tricky issue. It may create a certain degree of arbitrariness with respect to the final outcome of the parameter structure of the benchmark model which is used as a yardstick for the simulations. With a drastic regime change such as an adjustment program, the further assumption of parameter stability is somewhat heroic. Taken together, the main value added derived from the application of computable models comes from the quantitative findings. But these findings mainly reflect assumptions which cannot be tested within the model, and, therefore, should not be confused with empirical results. Given these obvious limitations, one has to concede that only experimentation with *theoretical*, i.e., untested models of the economies considered may furnish some insights as to the “true” causes of observed social costs in the aftermath of adjustment.

One major result of the simulation exercises – confirmed by the actual experience of Ghana – is that all adjustment policies produce a smaller fall in economic activity and a smaller increase in poverty than non-adjustment. This basic finding should be borne in mind, especially by policy-makers: most political debates about adjustment are often misleading, because, first, the costs of the underlying crisis are often confused with the costs of adjustment, and, second, the costs of non-adjustment are often ignored.

A second intuitively plausible result is that the timing of adjustment measures has an impact on the emerging consequences: anticipated adjustment is not only beneficial in economic and political terms, but also reduces social costs. If adjustment takes place at an early stage, the imbalances to be corrected are naturally smaller. Most importantly, however, the major advantage of anticipated adjustment, as shown by the cases of Indonesia and Malaysia, seems to be that they may guarantee a substantial and continuing inflow of foreign capital before and during the adjustment period. Hence the likely short-run losses due to drastic expenditure cuts and unavoidable structural adjustment measures such as the reorganisation of public enterprises can be compensated for, with possible positive social consequences.

Disregarding the questions whether and when to adjust, the central question of the studies is *how to adjust at minimum social costs*. Despite the very different structures of the countries used for the simulation exercises, the results show that certain measures are always preferable, while others should be avoided. The two adjustment measures rated as most likely to have the least unfavourable social impact are a devaluation of the exchange rate and a change in the wage structure, namely a moderate reduction in public service salaries. A devaluation changes the relative prices in favour of those sectors which produce exportables, notably agriculture. Hence the rural poor may improve their relative position, especially if the devaluation is accompanied by a cut targeted at moderate reductions in public service salaries. Such a strategy largely avoids a decline in the supply of public services and a direct increase in unemployment.

² See Deaton, A. S. (1989). Reflections on Empirical Microeconomics. *Economic Record*, Vol. 65, pp. 66–76.

On the other hand, a cut in public investment is predicted to have both immediate and long-term costs which sharply contrast with the political feasibility of such measures. Yet if cuts in public investment are inevitable, the lesson from the country studies is that cuts in public investment should not apply to rural areas where they have the largest impact on reducing poverty and inequality. Furthermore, a restrictive monetary policy is found to have a favourable effect on the distribution of wealth, because poor households are most likely to be much more affected by the erosion of the value of money through inflation than wealthier households.

In summary, the findings from the simulation exercises support the more or less orthodox view that given the advantages and disadvantages of alternative adjustment measures with respect to the income distribution, the best adjustment program combines devaluation, a restrictive monetary policy, and a moderate reduction in public service wages. This optimal "cocktail" of policies could be extended by cuts in certain types of investments, especially if such investments were badly managed and expanding very rapidly in the years before the crisis. In the longer run, structural adjustment measures such as privatisation, deregulation, and the liberalisation of foreign and domestic trade should be applied to increase the role of market forces.

As the authors stress, this conclusion of the studies does not endorse the application of a standard program to different countries, however. Since every country has its specific characteristics, a special study needs to be made in each case to determine the best policy mix. In Chile, for instance, the majority of the poor live in cities and thus would not benefit from a change of the terms of trade in favour of the agricultural sector; in Ecuador, the majority of the poor lives in rural areas, but the small farmers do not produce for export, and a substantial fraction of their income comes from the non-agricultural sector; in Indonesia, prices for agricultural products had been liberalised prior to the adjustment program.

Nonetheless, the analysis of adjustment as presented in the OECD studies clarifies that, contrary to what is often heard in the public debate, adjustment is not an inevitable social disaster. By contrast, the simulation exercises suggest that the poor fared better on average in adjusting nations than in non-adjusting nations. This is not to deny that especially the urban poor are often hurt in the stabilisation phase when recession is largely unavoidable. While the rural poor should benefit from a terms of trade improvement of the agricultural sector in a "classic" adjustment program, the urban poor will be most likely hurt through rising unemployment in the formal sector and, hence, falling incomes in the informal sector. Here, donor countries could play a role by funding conditional compensation programs. According to the simulations, such payments would amount to 1 to 4 per cent of GDP if an increase in poverty through the adjustment program is to be avoided. Hence if there is a political will to adjust without making the poor suffer from the consequences, the studies conclude, then concerted action by the government, international organisations and donor countries should be able to reconcile the potential conflict between optimal adjustment programs and the feasibility of programs.

A minor quibble is that the title of the series is somehow misleading. Since any adjustment that restores external and internal balance is likely to go hand in hand with structural change, there will be a redistribution of income – between sectors, between the principal factors of production including capital, labor, and land, and also within labor. Given these alternatives, the OECD studies argue in favor of adjustment programs that are less harmful (or even beneficial) for the poorest groups in the population, and call the result equitable adjustment. The basic argument seems to be that a change in the income distribution towards the poor is likely to be compatible with efficiency considerations, and, therefore, may contribute to economic welfare. The problem is that the term "equity" has no independent meaning in the theoretical framework used. Put differently, with a standard formulation of preferences it is difficult to understand how alternative income

distributions can be rated in terms of equity. Hence "Adjustment and Income Distribution" would be a less attractive but more appropriate title.

If there is no conflict between efficiency and the resulting income distribution, i.e. if "true" prices ordinarily result in an "equitable" distribution as the OECD studies seem to maintain (see Bourguignon and Morrisson 1992, p. 102), the focus of adjustment programs should be on efficiency considerations, with benign neglect of the income distribution. But efficient adjustment is not enough. Countries must somehow move to a situation which produces strong incentives for investment in physical and human capital to initiate economic growth. The latter step is notoriously difficult to achieve, not least because the empirics of growth still raise some puzzles to be solved. The role of the income distribution may prove to be one of the shaping factors which has largely been neglected so far in this context. Thanks to the OECD studies which provide a major source of information and inspiration, this may change in the future as more resources are devoted to study the potential long-run conflict between growth and distribution.

Erich Gundlach

Dennis, Mike, Social and Economic Modernization in Eastern Germany from Honecker to Kohl. London and New York 1993: Pinter Publisher, St. Martins Press. 252 S.

Es gibt inzwischen eine große Anzahl von Büchern, die sich mit der deutsch-deutschen Vereinigung beschäftigen, und es werden ständig mehr. Die Spreu vom Weizen zu trennen fällt allmählich schwer.

Um es gleich vorwegzunehmen: Wer sich einen Überblick über das Thema verschaffen will, der ist mit dem Buch von Mike Dennis gut bedient. Es bietet mehr, als der etwas plakative Titel suggeriert. Der Autor, der sich mit früheren Veröffentlichungen als intimer Kenner der DDR-Wirtschaft ausgewiesen hat, versteht sein Handwerk. Er vermag sich auf das Wesentliche zu konzentrieren und gleichzeitig den Leser umfassend zu informieren. Er schreibt zudem einen flüssigen Stil, der das Buch für ein breites Publikum verständlich macht – und für dieses ist es auch in erster Linie bestimmt.

Das Buch ist weitgehend chronologisch aufgebaut. Es schlägt einen weiten Bogen von den siebziger Jahren bis zur Gegenwart. Das erste Kapitel schildert das Bemühen der DDR-Führung, die Wirtschaft aus ihrer Misere herauszuführen – durch Modernisierung des Produktionsapparates und Reformierung des Wirtschaftssystems. Ein zweites Kapitel behandelt die kurze Übergangszeit von der Öffnung der Grenzen bis zur politischen Vereinigung, insbesondere den untauglichen Versuch der Regierung Modrow, eine sozialistische Marktwirtschaft zu etablieren, sowie die Vorbereitung und Verwirklichung der Wirtschafts-, Währungs- und Sozialunion. Der Hauptteil des Buches besteht aus drei Kapiteln, die den wirtschaftlichen Neuaufbau in den neuen Bundesländern unter die Lupe nehmen. Den Schluß bilden einige Betrachtungen zur künftigen Rolle Deutschlands.

Der Autor macht den nicht einfachen Versuch, die dramatischen Geschehnisse der letzten zwei Jahrzehnte im Zeitrafftempo darzustellen. Über weite Strecken gelingt ihm das recht gut. Auch wer damals die Entwicklung aus der Nähe verfolgen konnte, wird sich an vieles inzwischen nur noch dunkel erinnern, oder er wird es nicht mehr so im Gedächtnis haben, wie es sich tatsächlich abgespielt hat. Zu den spannenden Passagen gehört ein Rückblick auf die Vorgeschichte der Wirtschafts-, Währungs- und Sozialunion. Wer weiß heute noch, wie Anfang 1990 die Fronten zwischen Befürwortern und Gegnern verliefen? Nach den Recherchen des Autors brachte nicht der deutsche Bundeskanzler Helmut Kohl die Bildung einer Wirtschafts-, Währungs- und Sozialunion in die Diskussion, sondern die Finanzexpertin der SPD, Ingrid Matthäus-