This chapter presents the main concepts underlying poverty and social impact analysis. It addresses seven key areas:

- What is being analyzed?
- What is the welfare measure being assessed?
- Whose welfare is being analyzed?
- How are impacts channeled?
- How do institutions affect outcomes?
- When do impacts materialize?
- What are the risks of an unexpected outcome?

Impact of what: What is being analyzed?

Poverty and social impact analysis focuses on the impact of policy change. The scope of the policy debate in the development arena has now broadened beyond macroeconomic stabilization and associated measures to also include specific structural and public expenditure reforms. This broader view is also implicit in the poverty strategies of developing countries. In fact, a review of fifteen Poverty Reduction Strategy Papers (PRSP) shows that poverty strategies commonly focus on enhanced expenditure programs (especially in health, education, water and sanitation, and roads and infrastructure); institutional reforms to improve governance (such as decentralization, civil service reform, and tax reform); and structural reforms (including trade reform, privatization, financial sector reform, and agriculture sector reform).¹ Tools for PSIA therefore must be able to address not just major macroeconomic reforms, but also the key structural and sectoral policy changes with which countries are currently contending.²

This shift from broad-based “stabilization and adjustment” suggests that PSIA should be undertaken on a reform-specific basis. Such an approach also makes the task of analyzing the impact of several reforms more manageable. While it would be conceptually preferable to assess the combined effect of a series of policy changes in a single analytical framework, few tools can accomplish this—and those that can tend to be complex and data-intensive. Therefore, it is often more practical to disaggregate expected overall impacts to individual reforms, and consider sequencing on a reform-specific basis. Consideration of the impacts of a “package” of reforms is still pertinent, however. Where they cannot be analyzed in a single analytical framework, their combined effects on various groups such as the poor may be most practically considered by independently assessing the impact of each reform set on each group. However, such an approach will tend to lose interaction effects.

Impact on what: What is the welfare measure being assessed?

PSIA focuses on assessing distributional impacts on welfare, or well-being, including both its income and non-income dimensions. With poverty now recog-
nized as multidimensional (World Bank 2000a), development efforts are being targeted to address both income and non-income measures of welfare and poverty, recently captured in part by the Millennium Development Goals. Until recently, the income dimension of welfare was the main focus of poverty and distributional analysis, and economic tools were most often applied in analyzing the money-metric welfare measure. Now, however, non-income dimensions of welfare and poverty—such as human development and social development indicators addressing risk, vulnerability, and social capital—are being given closer consideration. In undertaking PSIA, the analyst will need to choose appropriate indicators of welfare and poverty based on the country and policy context.

**Impact on whom: Whose welfare is being analyzed?**

PSIA is concerned with the distributional impacts of policy change on various groups, with a particular focus on the welfare of the poor and those vulnerable to impoverishment. Depending on country circumstance, groups may be defined in terms of income class, gender, ethnicity, age, geographic location, livelihood, or other such criteria. In practice, however, household members do not always pool resources or allocate benefits equally. When the impacts on different members within a household are likely to differ, it is important to also analyze intra-household effects.

PSIA is concerned with distributional impacts for two reasons. First, policy change can have a direct impact on the welfare of the poor or other disadvantaged groups. Understanding the impacts of policy change on these groups can inform the design of policy. Second, the distributional impacts of a policy, even among non-disadvantaged groups, are important for the effectiveness of that policy and its ultimate sustainability. Even if a policy change results in overall welfare gains, it is likely that some groups may experience losses, at least in the short run. While losers may not necessarily be poor, reduction in their welfare may not be acceptable for social or political economy reasons and may significantly affect the implementation and sustainability of the reform. For instance, business and union interests that fear the impact of competition on protected commodity and labor markets can derail liberalization. Similarly, vested interests within the public sector can also derail reforms. PSIA thus should identify and analyze the impact of policy on other stakeholders, beyond the poor, who are affected by or can influence reforms.

**Impact how: How are impacts channeled?**

Policy reforms can be expected to have an impact on various stakeholders through five main transmission channels outlined below: employment; prices (production, consumption, and wages); access to goods and services; assets; and transfers and taxes. Each policy reform is likely to have impacts through more than one channel. For example, utility reforms might result in changes in prices and access, but might also have an impact on the fiscal stance of a country, and hence on transfers and taxes. Further, different stakeholders are likely to be affected differently through these channels. For example, relative price changes will affect net consumers and net producers differently, and even among these groups the impact may vary. For example, consumers will be affected differently depending on their consumption patterns or their ability to substitute goods.

**Employment**

The principal source of income for most households is employment. To the extent that a policy change affects the structure of the labor market or the demand for labor, particularly in sectors that employ the poor (such as unskilled, rural off-farm, and agricultural labor), the welfare of low-income households will be affected. There may be direct transmissions through this channel in the case of certain policies: for example, restructuring of a state enterprise may lead directly to retrenchment of workers. In other cases transmission may be indirect. For instance, macro policies may stimulate faster growth, leading in turn to increased employment among the poor; an exchange rate depreciation or trade liberalization may result in contractions and layoffs in the nontradable sector. Alternatively, some policies will have different impacts on formal labor markets and informal labor markets.
that employ many of the poor. For example, expenditure increase, reduction or switching may have different impacts on formal sector employment and informal sector employment due to labor market segmentation (Agénor and Aizenman 1999).

Prices (production, consumption, and wages)
Prices determine real household income. Prices in the markets for goods and services differentially affect the real income of households to the extent that they consume or produce these products. How policy affects prices will have an important bearing on income and, directly or indirectly, on non-income measures of welfare. For all households, but especially for small farmers and the self-employed, price changes will affect both consumption and resource allocation decisions. On the consumption side, policies that cause an increase in the prices of goods consumed by the poor will have a direct negative effect on household welfare. These can include import tariffs on traded staples, or increased utility tariff rates. Consumer prices may be indirectly affected as well, for example through expansionary monetary policy that leads to general price inflation. Producers will also be affected by policies that cause relative price changes—particularly changes to the prices of their outputs or inputs. Producer incomes are further affected by the difference between farmgate and market prices, often conditioned by transport costs and the degree to which private markets are efficient and competitive, rather than monopsonistic. Wage changes will affect net buyers and sellers of labor differently, and policies that change relative prices will induce shifts in both demand and supply.

Access
Well-being will be affected by access to goods and services, whether through access to markets and service outlets or through improvements in the quality and responsiveness of public or private service providers. Policy can affect access directly by enhancing provision of the infrastructure or services in question, or indirectly by removing constraints to access by particular households or groups. For example, improved road infrastructure could dramatically enhance access to markets and services for groups in certain geographic areas. A policy that expands connections to an electricity grid, particularly among the poor, can also represent a welfare gain. In this regard, privatization of service provision could either increase or decrease access relative to public sector provision. Lack of access to key infrastructure or services, either because they do not exist or because they are of poor quality, can limit the intended benefit of a policy. For example, restructuring a marketing board may be fiscally desirable but may eliminate key market services where alternatives do not exist. Structural or cultural norms (such as restrictions on female mobility or female property rights) may also impose higher transaction costs or create barriers to access.

Assets
Changes in the value of households’ assets will affect income and non-income dimensions of welfare. Changes in asset values can be due to changes in their levels or their returns. Assets themselves can be categorized into five classes, all of relevance to poor households: physical (such as housing); natural (such as land, water); human (such as education, skills); financial (such as a savings account); and social (such as membership in social networks that increase access to information or resources). Policy changes can have a direct or indirect impact on these assets and their returns. For example, land reform may directly result in an increase or decrease in land assets of the poor. Policy changes can also impact assets through indirect channels. For example, inflationary policies will have a negative wealth effect on those with monetary savings, while participatory budgeting or community programs may increase social capital. Pricing or trade changes could affect the natural resource assets of households or groups (such as by increasing or decreasing deforestation or desertification) or even their human capital (such as by causing a deterioration in health conditions due to increased indoor air pollution as a result of energy price changes). In many cases, certain assets are also prerequisites to benefit from a reform. For example, if farmers cannot reach a market due to lack of transport, the benefits of price liberalization are likely to be realized primarily by middlemen and traders. It is important to take into account the legal and regulatory frameworks when analyzing this transmission channel; for example,
there are sometimes constraints on female land ownership.

**Transfers and taxes**

Household welfare, finally, is affected by transfers to and from the household. These transfers can take the form of private flows (such as gifts and remittances) or public flows (such as subsidies and taxes). Public finance has a direct impact on the welfare of specific groups through transfers and tax policy. Public expenditure programs may focus on granting additional resources to particular groups through transfer policies, which may be in the form of subsidies or direct, targeted income transfer programs. Social protection programs may be useful in protecting the poor against risk and vulnerability, depending on their targeting. Tax policy has direct distributional effects to the extent that the resources or income of a household are taxed. Regressive tax regimes disproportionately burden less well-off households. Subsidies may be captured by the non-poor or may simply be badly targeted. There may also be a conflict between strict progressivity and the political feasibility of policies (see Gelbach and Pritchett 2000). Poorer households may also be hurt in the long run if the funds for public expenditure are borrowed and must be repaid; they will suffer either from any attempt to “inflate away” the debt or from increased future taxes needed for repayment. In societies with high gender inequities, the intra-household impact of transfers may warrant special attention.

**Impact how: How do institutions affect outcomes?**

The impacts of policy reform on economic agents are mediated through institutions. Institutions are the formal and informal rules of the game in society; they are the shared understandings that allow organizations to interact. The impact of a policy reform is influenced by the behavior of organizations. Organizations, in turn, act in response to incentives created by the set of public, private, and civil society institutions whose rules mediate economic activity in the society (Rutherford 1994). These institutions include markets, legal systems, and the formal rules and informal behavior of implementing agencies, including government. Policy reform can affect institutions by changing organizational structures, roles, and responsibilities, or rules and incentives, as well as by altering market incentives—for example, by removing price distortions or encouraging competition. These reforms in turn affect the behavior of economic agents and interest groups, and thereby economic outcomes, including distribution and poverty reduction.

Many reforms depend for their implementation on institutional change. This may involve creating new organizations or changing rules and incentives to achieve new objectives through existing organizations (for example, improved cooperation among government agencies). Creation or modification of organizational structures does not in itself guarantee the institutional changes necessary for the reform to succeed. Changes in formal rules of the game often must be accompanied by changes in incentives in order to alter the behavior of agents. Moreover, it is often assumed that institutions (including markets) function smoothly and according to formal rules. In practice, high transaction costs, ineffective enforcement, or lack of competition or accountability can lead to suboptimal performance of government, market, or civil institutions. In some cases, institutional change accompanying policy reform is not internalized by key implementing agents, and the behavior of these agents can thus lead to perverse policy outcomes.

Understanding the impact of a policy reform requires an appreciation of the country’s organizational structures and the institutional rules governing them. PSIA therefore depends upon careful organizational and institutional analysis of the formal and informal rules, the behaviors of key stakeholders who can affect reform outcomes, and the underlying dynamics among them. This allows policymakers to determine whether and how the existing rules and informal practices will affect real costs and quality of goods and services for the poor and other stakeholders in the context of a specific policy change.

**Impact when: When do impacts materialize?**

A major challenge to PSIA is understanding that policies can affect different groups in very different ways.
This is in large part because some of the economic and behavioral responses to a policy change can take time. What is fixed in the short term may be variable in the longer term. Understanding and explaining how short-run losses may result in long-run gains for given groups, or how immediate gains may lead to eventual losses, is one of the challenges inherent to PSIA. For instance, trade liberalization may cause employment losses in the nontradable sector in the short term. However, increased efficiency may later result in economic growth, and some of the laid-off workers may find jobs in the expanding tradable sector. In addition, some consumers may switch to cheaper nontraded goods, thereby increasing consumption of these. The combination of all these effects will determine the net impact on different groups over the long term.

To take another example, a policy that pursues or results in an overvalued exchange rate will benefit some population groups in the short run (consumers and importers). But if the overvaluation proves unsustainable in the long run and devaluation occurs, those same groups will be negatively impacted. The net effect for these groups of having an initially overvalued exchange rate (a gain) followed by a devaluation (a loss) will clearly depend on the magnitude of the deviations. The international evidence suggests that sustained overvaluations may lead to abrupt currency collapses (as in Mexico in 1994, East Asia in 1997, Brazil in 1999, and Argentina in 2002) that are likely to generate net long-run losses. The issue becomes even more complex if one considers the impact on exporters. Unlike importers, exporters are harmed by an overvalued exchange rate and are likely to benefit from devaluation. Eventually it will be necessary to consider both the net effects across groups for a given time horizon and the net effects over time for a given group.

**Impact if: What are the risks of an unexpected outcome?**

The design of reforms is based on underlying assumptions about the context and the behavioral response of key institutional and human actors. If these assumptions are not realized, reform outcomes are at risk. A crucial element of PSIA, therefore, is understanding and (publicly) articulating ex ante the key assumptions for the success of the policy reform. Assumptions must be made explicit as to how economic agents and institutions are expected to act (for example, the sign and magnitude of an elasticity) and how policy impacts would be transmitted to households. A second set of assumptions concerns conditions exogenous to the policy that need to be in place for the reform to achieve its intended impacts. In addition to questions of direct relevance to a reform, risks from underlying country conditions (for example, ethnic tensions) need to be factored into the risk assessment. Clearly identifying and articulating critical assumptions will serve to sharpen the rigor of the analysis, increase its transparency, and facilitate its validation (and if necessary, correction) by knowledgeable stakeholders. The analysis will also permit the monitoring of, and hence improve the understanding of, transmission channels and impacts, with possible adjustments to the reform program over time.

**Notes**

1. Fifteen PRSPs were completed by end July 2002 and included those for Albania, Bolivia, Burkina Faso, Guyana, Honduras, Malawi, Mauritania, Mozambique, Nicaragua, Niger, Tanzania, Uganda, Vietnam, Yemen, and Zambia. Seven of these strategies call for utility reforms; 5 for reforms of public sector pensions; 6 for civil service reforms; 7 for fiscal decentralization; 11 for reforms in the tax system (incl. VAT and other consumption taxes); 11 for land reforms; 10 for trade reforms; and 6 for reforms of the macro-economic framework.

2. Of course, structural changes could have macroeconomic effects. For instance, trade liberalization could have serious consequences for the fiscal deficit, the current account deficit, and macroeconomic stability. Understanding how these impacts affect the poor is critical to PSIA.

3. This User’s Guide lays out existing economic and social tools and approaches for distributional analysis in order to give a broader picture of poverty to policy analysts and decisionmakers. Insofar as the economic tools draw on existing examples of such analysis, applications focus mainly on income/expenditure measures of welfare. Increased attention to assessing the impacts of policy on non-income measures of welfare is an
important priority for future work. The social development tools described in this User’s Guide are more focused on non-income dimensions of poverty, such as stakeholder interests, social capital, and vulnerability.

4. The World Bank’s Social Development Department has developed a new tool that provides data on these indicators from Bank- and non-Bank sources for country-level applications.

5. To the extent that increasing access is viewed as a reduction in transport and transaction costs, it is effectively reducing the “price” of the good or service in question.

6. Sometimes an increase in access may come at the cost of a higher price (or, where there was previously no access at all, access may be granted at a price that is prohibitive for the poor). In urban Peru, liberalization of telephone services led to greater access for the poor as well as lower prices. On the other hand, liberalization of electricity has led to greater access and reliability, but higher prices and lower overall consumption (Torero and Pascó-Font 2001).

7. Organizations are purposive entities (such as public agencies or firms) that have a formal structure and seek to achieve certain objectives within the opportunities and constraints afforded by the institutional framework of society (North 1990).

8. Formal changes in organizational structure are relatively easy to make but may take much longer to be institutionalized. In such cases, it is important to pay attention to the capacity and accountability of the concerned agencies as well as the power relations within them. Understanding these issues allows for the mobilization of existing capacity and for the tailoring of interventions to the institutional and organizational contexts in which they will be implemented.

9. Forecasting or simulating likely impacts of policy by definition presupposes a view of likely causality and behavior. Depending on the analyst’s information base these can be empirically “estimated” based on the past, derived on the basis of theory, or assessed on the basis of knowledge of the country context and discussions with key stakeholders and experts.