INTEGRATING MACROECONOMIC POLICIES AND SOCIAL OBJECTIVES: 
CHOOSING THE RIGHT POLICY MIX FOR POVERTY REDUCTION

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Abstract: Macroeconomic frameworks and social objectives need to be explicitly integrated at 
the conceptual stage. Macroeconomic policies aim at macroeconomic stability not as an end to 
itself, but as a necessary precondition for sustained growth, which is critical to poverty reduction. 
The range of available macroeconomic and social policy options may be constrained by a 
country’s situation, but the policies and reforms necessary for macroeconomic stability may 
themselves affect social and poverty outcomes, although there is always scope for increasing the 
pro-poor bias of macroeconomic policy through the choice of the appropriate policy instruments 
or the timing of reforms. However, integrating social and poverty reduction goals with 
macroeconomic goals is not simply about adding social policies to a pre-designed sound 
macroeconomic framework. It requires an full awareness of the tradeoffs and of both the short- 
and long-term impacts of macroeconomic policies on social outcomes and vice versa that can 
only be gained through an interdisciplinary approach that uses social, economic, institutional, 
and political analysis to identify the links and transmission mechanisms between macroeconomic 
policies, poverty, and livelihoods. This approach can contribute to enhanced public transparency 
and ownership, and identify the best policy combination for equitable growth, poverty reduction, 
and social justice.

Keywords: macroeconomic policy, social policy, PSIA, poverty reduction

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INTRODUCTION

1. The increased awareness of the need to scale up efforts to achieve the Millennium Development Goals (MDGs) has focused attention on the role on macroeconomic policy in achieving social as well as macroeconomic objectives. In this context, there has been much criticism of the macroeconomic policy stance espoused by the international financial institutions, primarily the IMF, as being too narrowly focused on achieving and maintaining macroeconomic stability, often limiting legitimate efforts by developing countries to step up their poverty reduction expenditures. This debate is in large part colored by the misconception that macroeconomic policy is driven only by considerations of macroeconomic stability. The preservation of macroeconomic stability is indeed important, not as an end to itself, but as a necessary precondition for sustained economic growth, which is the single most important factor influencing poverty reduction. Without a disciplined macroeconomic policy stance, the achievement of sustained economic growth and social objectives becomes much more difficult. However, responsible growth, embracing both environmental sustainability and social development, is needed to maintain the increases in human welfare through improved consumption, human capital, social equity, all of which are targets of the MDGs (see World Bank 2004). Moreover, the benefits of that growth must be shared, so that the social consensus around a country’s development and social objectives can be maintained.

2. Only recently has the focus of macroeconomic policies shifted to designing macroeconomic frameworks into which poverty outcomes are explicitly integrated, alongside the growth and stability objectives. For example, IMF policy advice and IMF-supported programs under the Poverty Reduction and Growth Facility now explicitly consider many of these social and political aspects. However, integrating social and poverty reduction goals with macroeconomic goals is not simply about adding social policies to a pre-designed sound

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2 In April 2001, Stanley Fischer, then the IMF’s First Deputy Managing Director, gave four clear reasons why the IMF should be interested in poverty in exercising its central mandate to provide policy advice aimed at achieving and maintaining a stable macroeconomic situation conducive to economic growth: (1) the IMF lends mainly to countries where poverty is an overriding problem; (2) IMF policy advice (for example, on fiscal spending, taxation, and inflation) affects poor people in different ways; (3) policies will not be politically sustainable unless they are equitable; and (4) there is a moral argument for the IMF to address poverty.
Formulating sustainable macroeconomic and social policies requires an understanding of countries’ diversity and social context and more explicit analysis of the links between poverty, livelihoods, and macroeconomic policies. Macroeconomic policies affect a wide range of diverse socioeconomic groups in different ways which vary across countries and across time. Assessing this multidimensional impact, particularly on poor people, implies understanding their transmission mechanisms, which in turn are affected by social, economic, political, and institutional structures. The integration of macroeconomic and social policies therefore requires an interdisciplinary approach that combines social, economic, environmental and political analysis.

3. This integrated interdisciplinary approach can contribute to a more informed public debate about macroeconomic reforms and social goals that can help identify the most appropriate macroeconomic and social policy combination to promote growth and reduce poverty. Such an approach can contribute to policy choices that are evidence-based, and both more relevant to the specific situation and more pro-poor. It can also enhance public transparency, and strengthen ownership, increasing the likelihood that policies will be implemented and reforms sustained.

4. The range of macroeconomic options open to a country depends in part on its macroeconomic situation and the constraints this imposes. Even within the most constrained environment, however, there remains scope for increasing the pro-poor bias of policy choices while respecting the imperatives of overall stability. Macroeconomic policy choices should be articulated not only on the basis of short-term impact—appropriate policies must be sustained over longer time horizons in order to achieve the desired social outcomes. This argues for careful consideration of the longer-term implications in making macroeconomic decisions, including the most effective use of external aid, the structure of taxation, the composition of public spending, and the level of external debt.

5. This paper explores the space available to formulate macroeconomic policies from a social perspective. Section II sets out a conceptual framework for integrating macroeconomic

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3 See Elson and Cagatay (2000).
policies and social objectives, based on a multidimensional analysis of the transmission mechanisms of macroeconomic policies and the assessment of their impact. Section III discusses some of the choices and trade-offs that face the macroeconomic policy maker, and the scope for affecting social outcomes positively even in constrained circumstances. Reducing instability can promote growth, but some of the necessary policies may have an unintended adverse impact that could undermine their effective implementation. Awareness of these possible impacts is essential. Section IV gives some examples of the trade-offs implied by these different policy choices. Section V examines how the policy making process can facilitate the integration of macroeconomic and social policies. Finally, Section VI looks at some of the key challenges in integrating macroeconomic and social policies looking ahead.

I. CONCEPTUAL STRUCTURE

6. The main message of this paper is that macroeconomic and social policies must be integrated. It provides a conceptual framework for making progress toward that objective. The analytical underpinning of this framework is an interdisciplinary approach to assessing both macroeconomic and social policy options. This analysis yields information on the impacts of reforms on different socio-economic groups that feeds into a more open, evidence-based policy-making process, in which the tradeoffs are explicitly discussed, and the most appropriate macroeconomic and social policy combination for equitable growth, poverty reduction and social justice can be identified. The rest of this section therefore focuses on these three interlinked issues: the conceptual framework; the methodological issues posed by multidisciplinary analysis; and the process of policy making and implementation.

A. Conceptual Framework

7. Macroeconomic policies and structural reforms can affect existing distributive relations and institutional structures and, as such, may have poverty and social outcomes. They should

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4 Under macroeconomic policies, one generally understands policies that have a direct or indirect impact on key variables, such as the inflation rate, the exchange rate, the external current account balance or the fiscal deficit, or (continued)
therefore be designed with a greater understanding of the country’s social objectives. In turn, social policies should be designed with a clear understanding of macroeconomic opportunities and constraints that affect their sustained implementation. A multidisciplinary approach is therefore necessary.\(^5\)

8. It is difficult, if not impossible, to analyze the poverty and social impact of the macroeconomic policy stance as a whole (see below), but individual policies must be examined in this light. This analysis should feed back into the overall macroeconomic framework, and inform the choice of policies. For example, it will be difficult to assess the effect of the present structure of taxation on poverty, or on the welfare of a particular group. However, it is possible to make that assessment for a planned change in that tax structure—an increase in a tax rate, for example, or a shift toward greater reliance on indirect taxes while reducing the importance of trade taxes. Key to this effort is understanding the transmission mechanisms of a given policy in a given country context, as these may vary across countries and over time.

B. Methodological Issues

Redefining poverty

9. In the past, poverty analysis was focused on a classic statistical approach based on indicators of income, health, and education; poverty was measured by an income-based poverty line derived from traditional household surveys. However, this simple economic analysis fails to capture the many dimensions of poverty that are revealed by a multidisciplinary approach. Direct consultations with poor people have demonstrated that vulnerability, physical and
social isolation, insecurity, lack of self-respect, lack of access to information, a distrust of state institutions, and powerlessness can be as important to the poor as low incomes. Maximizing incomes may be less of a priority to poor people than increasing the security of their livelihoods and decreasing vulnerability (Chambers, 1983). Consulting poor people can also provide insights into the nature of coping strategies, particularly the role of local networks/social capital as well as information on the effectiveness of public and private institutions.

10. The multidisciplinary analysis of the various dimensions of poverty illustrates that macroeconomic policies affect a wide range of diverse socioeconomic groups (for example, income, gender, spatial, generational, ethnic, religious, and livelihood groups) in different ways, as the examples below show:

(a) Gender. Some macroeconomic policies and reforms may mean that women have to work longer and harder, but much of women’s work is unremunerated, and more of women’s work than men’s left out of national accounts. This cost may not be visible in economic statistics since it is unpaid time, but it is revealed in statistics on the health and nutritional standards of women and children (Elson and Cagatay (2000)).

(b) Ethnicity. Some reforms could intensify regional and ethnic conflicts. For example, in Nigeria, the intensification of ethnic tensions and conflicts is dependent on the extent to which adjustment measures reinforced existing social, economic, and political inequalities or create new ones (Osahae, 1995, cited in Mohan, 2000).

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6 World Bank (2001) advances a three-pillar framework for analyzing poverty: opportunity, empowerment, and security. Macroeconomic and structural policies are folded into the first of these and governance issues into the second.

7 Further, the poor are not a static or homogenous group – people fall in and out of poverty depending on their vulnerability. The impact of policies will thus change over time.

8 In most African countries, for example, women are the agricultural producers; providers of care to children, elderly, and the sick; domestic workers; preparers of food; managers of the household budget; and community managers (see Moser, 1990). Most of this work is outside the formal labor market and based mainly in subsistence production, informal employment, domestic or reproductive work, and voluntary or community work (Blackden and Bhanu, 1999).
(c) **Livelihood** The importance of disaggregating by livelihood strategy emerges from the DFID-supported Mozambique study on petroleum price changes. In addition to the general effects on purchasing power of the poor (due to price rises), the study also found that particular livelihood groups, including artisanal fishing communities and low-paid casual laborers who rely heavily on commercial transport, are likely to be affected. This awareness helps in developing complementary or mitigating policies that can target specific vulnerable groups.

**Institutional, political and social analysis**

To find the right balance of economic and social policies, therefore, it is necessary to consider a country’s institutional and political context, social/cultural organization (Cernea, 1996), as well as the economic context. *Institutional analysis* is based on an understanding that the formal or informal “rules of the game” governing group behavior and interaction in political, economic and social spheres can mediate and distort, sometimes fundamentally, the expected impacts of policy reform. *Political analysis* of the structure of power relations and entrenched interests of different stakeholders that affect decision making and distributional outcomes recognizes that political interests underpin many areas of policy debate and economic reform. *Social analysis* looks at the social relationships that govern interaction at different organizational levels, including households, communities and social groups, including the degree of inclusion and empowerment of specific social groups.

**Transmission channels**

To understand better these diverse impacts, the World Bank and DfID (2005) identify six major transmission channels: employment, prices, access, assets, transfers and taxes, and authority. Table 1 provides a description of each channel. It highlights the importance of moving the focus beyond just economic concerns to also considering the social, political and institutional concerns. The table also underlines the importance of a less well-analyzed

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9 This section draws heavily on World Bank and DfID (2005).

10 See World Bank and DFID (2005, 10-13)
transmission mechanism – authority. Authority structures, decision-making processes and power relations can affect and are affected by policy reforms.

**Poverty and social impact analysis**

More recently, an approach called Poverty and Social Impact Analysis (PSIA) has been applied to reforms. PSIA is defined as the analysis of the positive and negative distributional and poverty impact of policy change on the well-being of different groups in society, with a focus on the poor and vulnerable. It supports country ownership and the legitimacy of policies by informing a public debate on the most appropriate policy mix for growth and poverty reduction, and by deepening the understanding of the tradeoffs between policy choices; it helps choose the appropriate timing and sequencing of reforms; and it helps define better appropriate compensatory and complementary measures. Most importantly, PSIA can help ensure that discussions of policy choices are based on sound and widely accepted evidence, thereby minimizing the effect of ideology or interest-group politics. Ideally, civil society groups should be partners in the process, increasing their understanding and ownership of the results. Stakeholder analysis can help identify key groups of people, including the poor (see below), who can contribute their views on the policy proposals as well as their varying interests.

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12 See also World Bank (2002, p.2).
13 For example, debate around PSIA can encourage the government and its external partners, including international financial institutions such as the IMF and the World Bank, to explain better the poverty impact and trade-offs of their policy advice.
### Table 1: Multidisciplinary Analysis of Transmission Channels

<table>
<thead>
<tr>
<th>Channel</th>
<th>Economic concerns</th>
<th>Social/institutional/political concerns</th>
<th>Privatization example</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Employment</strong></td>
<td>▪ Structure of the labor market</td>
<td>▪ Welfare changes may affect changes in status, self-esteem, access to social networks, which may lead to increased vulnerability</td>
<td></td>
</tr>
<tr>
<td></td>
<td>▪ Demand for labor</td>
<td>▪ Winners and losers of employment may be distributed unevenly across social groups</td>
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<td></td>
<td></td>
<td>▪ Women’s work tends to be outside the formal labour market and based mainly on subsistence production, informal employment, domestic or reproductive work, and voluntary or community work</td>
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<tr>
<td></td>
<td></td>
<td>▪ Some macroeconomic policies and reforms may mean that women have to work longer and harder. This cost may not be visible since it is unpaid time. However, the cost will be revealed in statistics on the health and nutritional standards of women and children</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>▪ Privatization may lead to job losses and retrenchment that are not accompanied by adequate compensation. Labor conditions may deteriorate. Reform of inefficient state-owned enterprises is necessary, but their rapid closure may generate high unemployment at a time when the private sector is often not able to absorb surplus labor.</td>
<td></td>
</tr>
<tr>
<td>Prices (production, consumption and wages)</td>
<td>▪ Direct negative effects on household welfare</td>
<td>▪ Gender issue (who controls what and who pays for what in the household)</td>
<td></td>
</tr>
<tr>
<td>Price changes will affect both consumption and resource</td>
<td></td>
<td>▪ In privatization of utilities, pro-poor pricing is not always considered. Shifts to market rates can lead to huge price increases and exclude the poor. The privatization of utilities can replace a state monopoly with a private one that can force prices up. If prices of clean water</td>
<td></td>
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<tr>
<td>Channel</td>
<td>Economic concerns</td>
<td>Social/institutional/political concerns</td>
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<td>---------------------------------------------------------------------------------------</td>
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<tr>
<td>allocation</td>
<td></td>
<td></td>
<td>increase, the health of poor people may be affected.</td>
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<tr>
<td>decisions</td>
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<tr>
<td><strong>Access</strong></td>
<td></td>
<td>Structural or cultural norms or rules</td>
<td>Privatization of utilities often leads to much more reliable service, and if properly</td>
</tr>
<tr>
<td>Access to</td>
<td></td>
<td>(such as restrictions on female</td>
<td>regulated, can lead to better provision of services to rural areas.</td>
</tr>
<tr>
<td>goods and</td>
<td></td>
<td>mobility or female property rights)</td>
<td>Privatization can also reduce the drain of public enterprises on government budgets,</td>
</tr>
<tr>
<td>services</td>
<td></td>
<td>may impose higher transaction costs or</td>
<td>freeing up resources for investment in social services.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>create barriers to access</td>
<td>Privatization of utilities such as water and electricity, and some aspects of social</td>
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<td></td>
<td></td>
<td></td>
<td>sector delivery, often have weak regulation with limited or no incentives for the</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>private sector to address needs of the poor and remote populations</td>
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<tr>
<td><strong>Assets</strong></td>
<td></td>
<td>Elite capture of assets</td>
<td>Access to utilities (for instance, electricity) can enhance the value of fixed assets</td>
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<tr>
<td>Changes in</td>
<td>Effect on</td>
<td>Differential impacts of various social</td>
<td>of households, e.g. by allowing houses to be used for small-scale business</td>
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<td>the value of</td>
<td>productive assets</td>
<td>groups</td>
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<tr>
<td>assets</td>
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<td>Institutional mechanisms in place to</td>
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<td></td>
<td>manage the policy change</td>
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<td></td>
<td></td>
<td>Systems to address adverse impacts</td>
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<td><strong>Transfers</strong></td>
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<td></td>
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<tr>
<td>and taxes</td>
<td>Household</td>
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<tr>
<td>Private or</td>
<td>income and</td>
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<tr>
<td>public flows</td>
<td>consumption</td>
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<td>patterns</td>
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<tr>
<td><strong>Authority</strong></td>
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<td>Changes in</td>
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<td>Will decision</td>
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<td></td>
<td>Privatization</td>
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<td>sales can be</td>
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<td>corrupt and badly</td>
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<td>managed, with</td>
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<td></td>
<td>reduced values of</td>
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<td></td>
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<tr>
<td></td>
<td>sales receipts.</td>
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<td></td>
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</tbody>
</table>
### Channel, Economic concerns, Social/institutional/political concerns, Privatization example

| structures, decision-making processes and power relations | transparent and is there greater accountability  
- Entitlements and obligations of various stakeholders will be affected | Both the reduction of public services and the privatization of public services may affect women more than men, given women’s lower incomes and their responsibilities in the household. |

PSIA should not be seen as an externally driven, one-off exercise, but as an integral part of the policy making process. It can be undertaken ex ante, during implementation, and ex post. It can make assumptions more explicit upfront (ex ante PSIA), and monitor whether or not public actions/choices are working, thereby testing original assumptions and taking midcourse changes if public actions are not succeeding (PSIA during policy implementation). It can also assess whether public actions were successful in using the information to influence future policy design (ex post PSIA).

The challenge for PSIA is to integrate existing data (such as household surveys, participating poverty assessments, end-user surveys, administrative data, national statistics, and census), and to analyze it in various ways. For example, PSIA can use data from household surveys to develop more complex models, benefit incidence analysis can be disaggregated by social group to better understand the impact of budget allocations, and data from PPAs can highlight changes in the intrahousehold allocation of resources that may have occurred due to a reform measure, such as agricultural liberalization.

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14 PSIA can utilize a collection of tools and techniques from a wide range of social sciences that include social/environmental tools (e.g., Participatory Poverty Assessments, social impact analysis, village-based studies, gender analysis, social capital assessment, willingness to pay for studies); economic tools (e.g., benefit incidence analysis, poverty mapping, public expenditure tracking), partial equilibrium tools (multimarket models) and general equilibrium tools (such as the Computable General Equilibrium (CGE) model and Social Accounting Matrix).
Integrating data sets

A lack of data has sometimes been used as a reason for not linking poverty outcomes to policy decisions. It is certainly true that many countries, especially in Africa, do not have data of the quality needed to construct a general equilibrium model. Further, the effects of many policies are complex and multidimensional, and the relationships are not fully understood by economists or sociologists. However, in most countries there is an untapped potential of information, knowledge, and data, and even in countries with limited data, it is possible to assess some of the potential poverty effects and, therefore, contribute to a more informed policy debate.

Social science data is always partial – an imperfect reflection of a more complex reality. As a result, it is important to be realistic and selective and to let key questions drive the choice of methods and tools, not vice versa. In the past, poverty analysis was dominated by quantitative data derived from nationally representative household surveys. More recently, qualitative methods (such as participatory research, including Participatory Poverty Assessments [PPAs]) have contributed toward a more multidimensional definition of poverty. Qualitative methods can be used to obtain information about non-income dimensions of poverty, including social and political processes and institutions, and improve the understanding of the non-economic processes that mediate group/individual control over resources. Existing qualitative data can present a more disaggregated picture of ex post policy effects, improve the understanding of hidden dimensions of poverty and of the processes by which people fall into and get out of poverty; and identify the priorities of the poor, thereby making possible new levels of analysis. If conducted interactively, qualitative methods and household surveys will enhance each other by

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15 See Woolcock (2001).
16 PPAs generally work with information from individuals, households, and communities, and study issues of gender, ethnicity, age, and the relationships and differences among various community groups. Some PPAs have focused on individual case studies of people, providing insights into the dynamics of poverty and survival strategies. At the household level, the focus on intrahousehold dynamics can reveal both the unequal allocation of resources among household members and the impact of power relations on the poverty of women, men, and children within the household. Most PPAs also adopt a community perspective to highlight the diversity of social or cultural groups and their wide-ranging coping strategies. They have also shown that people’s priorities and experiences are affected by such variables as gender, social exclusion, intrahousehold allocation of resources, the incidence of crime and violence, geographical location, access to networks of support, and relations with those in power.
17 Booth (1998) makes a connection between contextual methods (for example, qualitative analysis) that aim to capture social phenomena within their social, cultural, economic, and political context, and non-contextual methods (for example, household surveys) that are designed to collect information independent of the specific context.
providing and testing hypotheses. For example, the results of a PPA conducted after the household survey will explain, challenge, reinforce, or shed new light on household survey data, and vice versa (see Carvalho and White, 1997; and Robb, 2002). Best practice is to combine data from different sources for policy analysis, as in Uganda, Vietnam, and Mongolia.\textsuperscript{18}

C. Policy Design and Implementation\textsuperscript{19}

An approach by which alternative macroeconomic policy options are discussed openly and evaluated in terms of both their impact on key macroeconomic variables and their consistency with social objectives, would clearly highlight the implicit tradeoffs and facilitate the choice of the policy mix. The link between poverty analysis and policy choices and change has been weak in the past, with the consequence that the poverty impact of policies are not always known, not discussed in detail by policy makers when considering policy choices, and not debated in public. However, it is possible to undertake some form of analysis for a wide set of reforms and country circumstances.

In reality, the policy making process is not purely technical in nature – it is often about seeking a balance between the broader goals of equity and the welfare and interests of various groups since different groups with different interests can affect the reform process. The choice of policy therefore is often constrained not just by macroeconomic considerations but also by socio-political dynamics. As such, it is necessary to understand the rules and incentives that govern the implementation of policy reform, expressed both in price-based incentives and in less predictable organizational cultures and social norms. This can help to define more clearly the roles of the various actors—government officials, domestic stakeholders and interest groups, and external partners—in contributing to the analysis and providing inputs into the policy making process.

II. Weighing Macroeconomic Policy Choices

In most instances, weighing macroeconomic policy choices from the social policy perspective implies balancing the inevitable tradeoffs within the framework of the broad national consensus on the imperatives of development. The extent to which a country’s economic and


\textsuperscript{19} See Chapter V for more details on the policy making process.
social policy choices are constrained by economic factors depends in large part on its macroeconomic starting point. Countries with a stable macroeconomic environment (with relatively low inflation, and external current account and fiscal deficits), access to substantial concessional external financing, and reasonably strong financial sectors and regulatory frameworks will be able to pursue social objectives far more aggressively than countries in more limited circumstances. Countries still struggling to control key macroeconomic variables, like inflation or the fiscal deficit, will have less choice in how much or how fast to adjust to macroeconomic imbalances or to step up poverty reduction efforts (see Table 2).

Table 2: Assessing the Scope for Macroeconomic Policy Choices – Country Typology

<table>
<thead>
<tr>
<th>Type of Country</th>
<th>Characteristics</th>
<th>Macroeconomic Choices</th>
<th>Social Policy</th>
</tr>
</thead>
</table>
| Post-conflict/Fragile States Example: Sierra Leone, Bosnia | £Politically sensitive  
£Social stability objectives predominate  
£Institutionally weak  
£Limited technical capacity  
£Financially constrained | £Limited range of macroeconomic choices  
£Focus usually on the most fundamental macroeconomic objectives, such as reducing deficits and inflation to more manageable levels | £Limited scope for implementing wide-reaching social policies  
£Must be very sensitive to the country’s social/political context |
| Stabilizing Example: Guinea | £Many constraints – e.g. high debt, deficits  
£Vulnerable to shocks | £Limited objectives  
£Mixture of instruments but limited choice of targets  
£Need to decrease the deficit | £Adjust more slowly and protect expenditures in the social sectors |
| Mature stabilizer Example: Senegal, Uganda | £Macro framework under control  
£Still vulnerable to exogenous shocks  
£With access to | £Wider choice of both instruments and targets  
£Scope to absorb higher inflation or larger deficits without endangering stability | £More scope to pursue social objectives  
£Challenge of managing the macroeconomic impact scaling up aid and the poverty reduction effort |
### Emerging market Example: Brazil,

- More sophisticated macroeconomic policy formulation and effective institutions
- Well-developed financial sectors
- Access to international capital markets
- Diversified structure of economic production reduces vulnerability to exogenous shocks

<table>
<thead>
<tr>
<th>significant external financing</th>
<th>Fewer constraints on policy</th>
<th>Can pursue more ambitious social policies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mobilize resources both domestically and externally. Different set of questions facing the policy maker</td>
<td>Often more difficult to access concessional external financing to scale up to meet the MDGs.</td>
</tr>
</tbody>
</table>

A macroeconomic policy stance can be considered stable at different levels of key variables—e.g. inflation could hold steady at 10 percent or at 5 percent, and a fiscal deficit can be held to 2 percent or 3 percent a year. What is important is whether the macroeconomic stance is sustainable over time. While most macroeconomic policy choices focus primarily on short-term outcomes, a longer-term perspective is necessary for the assessment of sustainability. For example, higher aid could finance an immediate increase in poverty-reducing spending, but policy makers must also assess the ability to sustain the scaled up efforts through domestic resources after the increase in ODA flows tapers off (see Section VI).\(^{20}\) They must consider the implications of higher short-term spending on expenditure composition over time—for example, major new investments in the economic infrastructure raise the required spending for operations and maintenance. Of course, if the external resources are loans, not grants, their implications for longer-term debt sustainability also become critical.

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\(^{20}\) Moreover, how quickly the scaling up can be achieved depends not only on the availability of financial resources, but also on how quickly existing capacity constraints can be overcome, such as the lack of trained personnel for effective service delivery. A more measured ramping up that allows the time for these capacity constraints to be alleviated may generate better social outcomes over the longer term.
Moreover, within the range of sustainable outcomes, it is possible to choose between different levels and speeds of adjustment for certain key variables. For example, one level of the fiscal deficit may imply an increase in the level of public indebtedness from 30 to 35 percent of GDP over five years; another, slightly smaller deficit, might limit the increase in indebtedness to 33 percent of GDP. The choice between these two alternatives will depend in part on other considerations, such as the use to which the extra public spending under the higher-deficit scenario is put. Similarly, the decision on how quickly to adjust to the level of the deficit considered sustainable over the long term may depend on how fast different categories of spending can be reduced, how much additional revenue can be mobilized, or what sources of additional financing are available, at what terms.

The choice of policy instruments and the timing of any given macroeconomic adjustment or reform also depend on the country’s ability to absorb, or finance, the adverse impact of the macroeconomic imbalances that need to be addressed. For example, a country with a low and stable inflation rate may be better able to absorb the possible inflationary impact of monetizing an increase in the fiscal deficit; and one with low public debt is better placed to borrow resources to finance a more gradual adjustment. Within the constraints of even the most difficult macroeconomic environment, however, countries still have scope to make some choices. Moreover, some of the same considerations hold when the issue is stepping up the poverty reduction effort.21

A. Instruments

In principle, a given degree of adjustment of a macroeconomic variable can often be effected in a variety of ways—for example, lowering the fiscal deficit by one percent of GDP can be achieved by reducing expenditure or raising revenue by that amount, or by some combination of the two. However, the social consequences of these choices vary. Revenue increases may have direct and indirect distributional consequences, depending on what taxes are changed, and spending cuts may affect the ability to deliver key social services. Also, which

21 For example, a country with a low fiscal deficit and low public debt is in a better position to increase priority spending on social services or essential economic infrastructure, and to finance the resulting increase in the fiscal deficit in a sustainable manner, than a heavily indebted country that is already running a significant deficit.
social expenditures are adjusted may have a differential impact on social outcomes. For example, the social impact of a reduction in current expenditures in primary education will be different from that of an equivalent cut in tertiary level spending.

Moreover, the evaluation of the social impact of a given adjustment should be made in “net” terms. For example, the direct adverse impact on some socioeconomic groups of an increase in the rate of the value-added tax (VAT) may be attenuated somewhat if the additional revenues are used to finance effective delivery of services that benefit these same groups. Both positive and negative effects must be weighed in choosing the appropriate policy mix.

B. Timing

The pace of adjustment toward a given objective can also be varied to mitigate the social impact. Adverse effects of a rapid adjustment path can sometimes be alleviated by compensatory social safety net measures. However, the scope, effectiveness, and sustainability of these measures are often limited, particularly in low-income countries, by the ability to finance, formulate, effectively target, and sustain them. It may thus be preferable to introduce necessary policy reforms more gradually to permit the absorption of social costs, or to redesign them completely. There can also be purely economic reasons to implement reforms gradually, to allow an economy the time to adjust to, and to prepare to take full advantage of, new opportunities—trade liberalization is a good case in point.

The decision to accept the consequences of a slower pace of adjustment may be justifiable from the shorter-term social perspective, but it should also take into account the cumulative adverse effects over time of partial adjustment, or of not adjusting at all. For example, the government may find it preferable to keep the rate of inflation at a somewhat elevated level, but that decision should also assess the erosion of purchasing power of the poor that will likely result.

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22 See Barden (1997) and Subarao et al. (1997).
C. Stability versus growth

An appropriate macroeconomic policy stance is not the same as a rational and sustainable growth strategy. A full growth strategy would require the specification of sectoral policies in areas particularly important to the overall growth of the economy. Moreover, since the poor are not distributed evenly throughout the economy, the sectoral and geographic distribution of a given amount of growth can help determine its overall impact on reducing poverty.

Macroeconomic policies can be used to pursue the ultimate objective of growth more aggressively. In such cases, there must be due consideration of potential downside risks. For example, reducing interest rates to ease access to credit for private sector investment may spur growth, but if quality controls and prudential supervision are too lax, financial sector distress could result, undermining longer-term growth perspectives. Similarly, the maintenance of an undervalued exchange rate may artificially enhance export competitiveness and fuel growth, but at some risk of overheating, or of introducing an unsustainable bias in the structure of the economy. It is also difficult to use macroeconomic policy instruments to target growth in specific sectors, without distorting resource allocation decisions or the proper functioning of markets.

D. Pro-poor growth

Increasing attention is being paid to the role of policy and economic factors as well as social and institutional structures, in translating growth into poverty reduction. Social/cultural factors prevent the benefits of growth from being shared equitably; in turn, unequal social relations, such as gender inequality in education and access to assets, can reduce growth below its long-term potential. Temporary social safety nets cannot resolve problems of structural inequality. Thus, growth without policies that reduce inequality and improve the distribution of income and assets within a society—such as land tenure reform, pro-poor public expenditure,
and measures to increase the poor’s access to financial markets—will only be partially successful in reducing poverty, and structural poverty may remain.\footnote{Kanbur (2001a) argues that, “Equitable growth is obviously better for the poor, and inequitable growth carries with it the seeds of its own destruction as social tensions undermine the climate of investment and cooperation.”}

Two factors that determine the impact of growth on poverty are its sectoral composition and its distributional patterns (Ames et al., 2001). Growth that is focused on the sectors where the poor are concentrated—often, the agricultural sector—and is based on labor-intensive patterns of production, is more likely to generate a faster and more durable reduction in poverty. Macroeconomic policy makers need to be aware of how any given policy would impact these key sectors.\footnote{For example, some studies have shown that the income of the poor is generated more often in the tradable goods sectors, while their consumption is concentrated primarily on nontradable goods. A depreciation or devaluation of the domestic currency could enhance export competitiveness and raise the incomes of the poor by stimulating external demand for the production and export of the county’s tradable goods. Higher incomes could stimulate higher consumption of the nontradables, though their relative price would be somewhat higher, increasing overall welfare.} Growth can also be rendered pro-poor “indirectly”, through public redistributive policies (predominantly, the tax system, public spending on goods and services or infrastructure; and public transfers and social safety net outlays). The macroeconomic policy stance can thus be rendered more pro-poor, even within the most stringent economic and financial constraints.

Another important policy consideration is the trade-off between short-term growth and longer-term environmental impacts and sustainability.\footnote{For more details on this topic, see the IMF and World Bank, (2000), chapter on environment, at \url{http://www.worldbank.org/poverty/strategies/chapters/environment/environ.htm}.} Natural resources contribute to economic growth (e.g., water and soil fertility as agricultural inputs, and fuel wood as an energy source for small-scale production) and environmental goods and services are important to poor people’s health and quality of life (and, by inference, their productive capacities). However, it is difficult to measure the importance of the environment, or assign a monetary value to its use and preservation.

There is thus need for closer reflection on (1) the impact of distributional patterns on growth and poverty; (2) the links between a country’s social fragmentation, social exclusion and democratization, and growth (see Ravallion, 2002); (3) the sources of sustainable growth and alternative policy options to achieve it; and (4) the role of private sector investment in promoting
pro-poor growth. Other important areas include estimating the impact of exogenous factors, such as HIV/AIDS, on growth and hence on growth predictions; the role of remittances; and improvement in understanding how fiscal and monetary policies can take into account the unpaid domestic economy that centers on welfare, as well as the market-based economy.

III. EXAMPLES OF MACROECONOMIC AND STRUCTURAL POLICY CHOICES

The “best” macroeconomic policies will fail to realize their full potential contribution to stability, growth and poverty reduction, if not supported by effective legal and regulatory frameworks, well-functioning markets, contract enforcement, and transparent, accountable governance. The overall effectiveness of macroeconomic policies also depends crucially on the efficiency of its formulation and implementation, and the quality of the management of public resources. This underscores the importance of institutional and technical capacity building. For example, the ability to use additional aid resources productively may hinge upon improving the overall absorptive capacity of the economy (see Section VI), and effective systems are needed to target and deliver key services, and to account for, track, and measure the impact of the use of these resources.

The range of available instruments of macroeconomic and structural policy may be limited. However, policy makers should consider the timing of reforms, as well as the use of complementary measures, or the redesign of policies, to attenuate unintended adverse impacts on particular groups. This would enhance the sustainability of policy implementation, but requires an awareness of how transmission mechanisms impact different groups.

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27 A key issue not discussed here is that of corruption and its impact on poverty. Corruption reduces the amount and efficiency of public expenditure and it increases the cost of doing business for the private sector. The first effect reduces the resources available for poverty reduction, while the second reduces the incentive to invest and, therefore, the potential for growth. Corruption can also increase transaction costs that are often not captured in policy making. For example, electricity privatization may aim to increase poor people’s access through an official price structure. However, poor people may be forced to pay bribes (for connection, for example). Another example is local-level tax collection where tax collectors force poor illiterate people to pay more than they are supposed to. Corruption is an area that will require further research in order to identify more clearly the links to poverty and policies to reduce it.
A. Macroeconomic Policies and Poverty Goals

Inflation

It is widely agreed that high and fluctuating inflation harms the poor more than the rich and can undermine economic performance, and that it should thus be kept to relatively low levels, although opinions vary on what is an acceptable level of inflation and how rapidly inflation should be reduced toward the target rate. However, the policies for curbing high inflation (such as tightening the stance of monetary policy), may have adverse short-term effects on real interest rates, and thus on the real cost of borrowing, consuming, and producing. Moreover, targeting very low inflation could also harm the poor if the required adjustment restricts pro-poor spending and slows output growth.

Policy makers also need to take account of the differential impact of anti-inflation policies across socio-economic groups. For example, high interest rates diminish women’s already scarce access to credit for production and household emergencies more than for men; in some countries, women workers may be more likely to fall victim to unemployment because they predominate in small and medium-sized enterprises hardest hit by high interest rates and overall economic slowdowns, and are often laid off before men in both public and private downsizing.

Exchange rate policy

Allowing an overvalued currency to depreciate can enhance export competitiveness and raise the local currency income of exporters. However, the cost of imported inputs and consumables (and, possibly, of services such as urban transport) will also rise, leading to an erosion of the real purchasing power of household incomes. Changes in exchange rates will thus have both income-raising and price-raising effects, giving rise to net benefits or detriments that differ across socioeconomic groups. Key factors that determine the net impact are the

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28 Cashin and others (2001) present a useful overview of the research on macroeconomic policies and poverty reduction. Also see Stewart (1995) and Killick (1999).

29 In general, the IMF’s PRGF-supported programs emphasize the protection of pro-poor spending in situations where public expenditures have to be reduced in order to help monetary policy contain inflation.
composition of the consumption basket and who purchases what within the household. For example, women may not benefit as much as men from a depreciation/devaluation.\textsuperscript{30} Real earnings in the informal sector (where more women than men are employed) and nontraded sector may fall, affect overall consumption and welfare. The urban poor may be more adversely affected as consumers, but may also benefit if their output is exportable or is an import substitute.

The social impact may also be more indirect. In the area of health care, for example, increased costs of imported medicines may lead poor people to use more traditional local medicines or go untreated. These differential impacts mean that attenuating measures may be necessary to protect some vulnerable groups, even though the net benefit for the society as a whole remains positive.\textsuperscript{31} The judgment on the overall impact of the measure must thus take these positive and negative effects explicitly into account.

B. Fiscal Policies and Poverty Goals

Revenue raising

It is clear that a sustained effort to reduce poverty cannot be funded by external resources alone. A substantial improvement in domestic revenue mobilization is needed in most developing countries, but there may be a tension between this need and the social imperative of an equitable (progressive) tax system. Taxing well-off groups may help redistribute wealth and promote greater equity, but can also increase incentives to tax evasion and fraud. By contrast, tax cuts or other tax benefits to investors may reduce revenue while doing little to spur new investment, with a negative impact on pro-poor spending over the long term.

\textsuperscript{30} Women are often involved in the food crop sector and will have to face higher costs of transportation, fertilizers, and other imported inputs. These higher costs may also raise food prices, again affecting women, who are responsible for feeding the family within the household. Thus, a currency depreciation may make export crops, usually under the control of men, more profitable, but may not benefit the household as a whole since income may not be pooled. Meanwhile, women are responsible for buying food and medicines with their own resources, which may not have increased in value.

\textsuperscript{31} These may include temporary and well-targeted subsidies of key staples; more gradual pass-through of the exchange rate-related increase in key commodity prices through adjustment of the tax component; or a differentiated wage policy in the formal sector.
Progress in raising revenues in many developing countries is slow, reflecting both the limited tax base and shortcomings in tax administration. Many governments are shifting to reliance on the VAT, for example, which is easier to implement and for which it is easier to ensure compliance. However, the VAT can be regressive if it is extended to items consumed by the poor. In weighing the social burden of taxation, policy makers must consider not only these immediate tradeoffs, but also the ability to design and implement tax policies that are more pro-poor, including through the use of exemptions, zero ratings, or lower tax rates for the items used by the poor. Other important issues are finding the right balance between taxes on consumption (especially the VAT and excise taxes) and taxes on labor and income, and reducing the reliance on trade taxes in the context of trade liberalization (see Table 3).

Table 3. Examples of Poverty-Focused Taxation Policies

<table>
<thead>
<tr>
<th>Country</th>
<th>Poverty-Focused Policy Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senegal 2001</td>
<td>• A single VAT at a unified rate was introduced in September 2001, to replace the current dual-rate system, with a few untransformed goods of primary necessity (such as rice and fish) exempted.</td>
</tr>
</tbody>
</table>
| Zambia 2002 | • All antimalarial supplies (including bed nets and insecticides) were exempted from VAT and customs duty.  
• The government introduced a number of tax reforms to improve income distribution. The basic PAYE tax credit, which was adjusted for inflation for several years, was increased by 25 percent, giving direct relief to the poorest formal sector workers. Some of the revenue losses associated with this reform were offset by replacement of the 10 and 20 percent bands with a flat 30 percent rate, which increased the marginal rate of taxation over some middle range of income; however, every taxpayer’s total tax liability still falls because of the rise in the basic tax credit. |

32 Countries that rely more on broad-based consumption taxes tend to save more and grow faster, but taxes on personal income can be an important element in an equitable tax system. For a discussion of these issues, see IMF (2005a, 49-52).
Source: IMF Staff Reports

**Public expenditure**

The poverty and social impact of a given level of spending, or of any upward or downward adjustment of the overall spending envelope, depends on both its composition (the extent to which resources are allocated to pro-poor spending programs) and its efficiency (ensuring that the allocated resources are spent on well-designed, well-targeted, and efficiently delivered essential social services). The *World Development Report 2004* (World Bank, 2004) presents cross-country evidence showing that public expenditures have no significant effect on health and education outcomes (while pertain to five of the eight MDGs), when the country’s level of per capita GDP and a small number of socioeconomic variables are controlled for. The report identifies four main reasons for this: governments may be spending on the wrong goods or the wrong people; the money often fails to reach the frontline service provider; the incentives to provide the services are often very weak; and households may not take advantage of the provided services for social or economic reasons. This latter “demand-side” failure often interacts with the first three “supply-side” failures to generate a low-level of public services and outcomes among the poor.

Thus, the emphasis is now on enhancing the quality and efficiency of government spending. This can be improved by concentrating on pro-poor budgets, flexible fiscal targets, strengthened public expenditure management systems, accountability, and a gender-equitable focus in public expenditure management and the budget process (see Norton and Elson, 2002). Identifying pro-poor expenditures linked to the MDGs; developing medium-term expenditure frameworks (MTEFs) that translate the poverty reduction focus into budgetary allocations, and systematic public expenditure reviews; and making gender analyses of budget allocations are key to this effort.

**C. Deficit Financing**

The size of the fiscal deficit and how it is financed can also have direct and indirect effects on social outcomes. Financing by domestic government debt instruments may have less
of an impact on interest rates and private sector access to credit that recourse to bank financing. One-off sales of public assets can also provide a temporary source of financing, avoiding the monetary effect. However, debt financing will inevitably affect the government’s current budget through interest liabilities. These take up an increasing share of available revenues as the debt stock grows, limiting the ability to fund social and poverty reducing expenditures. An evaluation of the social impact of the government deficit must thus go beyond consideration of the first-round effects of additional spending, and of deficit financing on monetary aggregates to include an assessment of the longer-term sustainability of the government debt, and its impact on the sustainability of fiscal programs.

D. Structural Policies and Poverty Goals

As noted above, the overall impact of changes in macroeconomic policies depends in part on complementary structural reforms. For example, structural fiscal reforms in budget and treasury management, public administration, governance, transparency, and accountability can benefit the poor in terms of more efficient and better-targeted use of public resources (Ames et al., 2001). In many respects, such structural reforms have elicited far sharper criticism than pure macroeconomic policies, in part because their direct social impact is often more readily observable. Yet even in this area, policy choices, and decisions on the timing and of scope of interventions, must take into account a range of different trade-offs.

Privatization

Privatization can improve welfare by raising the efficiency and effectiveness of delivery of key social services and utilities such as water and electricity, and reducing the drain of public enterprises on government budgets. However, it can also lead to job losses and retrenchment, or replace a state monopoly with a poorly regulated private one that pays no attention to legitimate social concerns or addressing the needs of the poor and remote populations. Shifts to market-based pricing of utilities rates can improve service provision, but may also exclude the poor, with
direct adverse effects on their health and welfare. Moreover, in many cases, the privatization of public enterprises that provided ancillary or social services directly to the employees or workers in the pertinent sector has led to a deterioration in the availability of these services.

The issue, therefore, is ensuring that privatization does generate the expected fiscal savings and efficiency gains without undermining the delivery of services to the poor. PSIA of privatization operations should examine whether they lead to extended coverage, as well as to improved management, reduced public debt, and more cost-effective service delivery. It should also assess the impact on access to affordable utilities, especially water, and the extent to which poor people are expected to contribute to full cost recovery (see Table 4).

**Table 4. Examples of Poverty-Focused Privatization Operations**

<table>
<thead>
<tr>
<th>Country</th>
<th>Poverty-Focused Policy Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senegal</td>
<td>The realignment of the groundnut producer price to the international price and the reduction of the quantity purchased by the public enterprise, SONACOS reduced household income in rural areas. However, the new groundnut policy also ensured more sustainable production levels, lessening household vulnerability to income fluctuations. In addition, not all farmers benefited from previous system, as the producer price set by government did not apply to total production of groundnuts. Moreover, the privatization of SONACOS was expected to strengthen its weak financial management, promote greater equity, and free government resources for poverty reduction.</td>
</tr>
<tr>
<td>Cameroon</td>
<td>The privatization program in the water and electricity sectors aimed at both increasing production and enhancing efficiency, and expanding the scope of basic services vital to the poor. As regards the electricity company (SONEL), efforts were made to limit labor shedding and negotiate compensation packages. In addition, the privatization of the agribusiness sector was expected to be instrumental in enhancing the participation of the private sector in the management and production of agricultural products.</td>
</tr>
</tbody>
</table>

Source: IMF Staff Reports

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33 Both the reduction of public services and the increase in the price of public utilities may affect women more than men, given women’s lower incomes and their responsibilities in the household (see United Nations, 1997; and Moser, 1990).

34 For example, the agricultural marketing agencies in many African countries provided essential inputs and extension services, crop credit, and transportation services to private farmers; while in the transition economies, large state-owned enterprises were responsible for delivering a wide range of essential social services directly to their employees. In most cases, the provision of these services fell away after privatization.
Trade liberalization

Overall, trade liberalization can generate growth and reduce poverty, but in many cases, transitional costs heavily affect the poor through three channels: price transmission (depending on whether the poor are net consumers or producers of products whose prices change); enterprise profits (and hence, employment and wages); and taxes and spending (changes in the government’s fiscal position). Disaggregating the impact of trade liberalization may reveal other transmission mechanisms that affect the choice of policy mix. Through reform, many agricultural commodity markets in Africa now rely more on market forces and open competition and less on government marketing boards, official monopolies, and state-determined domestic prices. Such reforms can increase investment and growth, reduce rent seeking and increase incomes for farmers. Nevertheless, the benefits of market reform and trade liberalization are fully realized only when supporting factor markets and institutions work (Akiyama and others, 2002; and McCulloch and others, 2001).

Too rapid liberalization could also increase poverty and inequality. In many cases, poor countries have been opening up their markets more quickly than rich countries and the effects have not always been positive (Oxfam, 2002b). For example, changing incentive structures in Africa encourage farmers to switch to the production of a single cash crop, decreasing crop diversity, heightening their vulnerability to crop disease, climatic variations, and declining world market prices, and possibly threatening household and national food security. Such considerations argue in favor of a more managed process, with full liberalization delayed while

35 See McCulloch and others (2001). “Protectionism” can also deny certain groups of poor people cheaper and more affordable goods, forcing them to spend more on inefficiently produced local goods or pay more for the imported item. A good example in Uganda was the banning or heavy taxing of used clothing (extremely cheap and used mainly by the poor) in order to protect the garment industry. Sugar is another example, where protectionism resulted in the poor being forced to consume more expensive locally produced sugar since the market was closed to sugar imports.

36 The North American Free Trade Association ensured that the price of maize in Mexico was liberalized over a longer period of time to allow markets to adjust, since the rural poor relied on maize for both subsistence and income and the price of maize from the United States was very low.

37 The switch to export crop production may have forced women to reduce time tending food crop plots, which are the basis of food security, and spend more time as unpaid laborers in export crop production. Liberalization may also reduce economic activity in the “nontradable” sector where women are concentrated.
social safety nets are put in place (see Kanbur, 2001a), or until necessary changes in production structures are underway. Complementary policies, such as improved extension services, transport, and access to water (to reduce women’s time in water collection) could also be considered. However, gradualism should not be an excuse for postponing needed reforms indefinitely. Ex ante analysis can help determine the need for slower implementation of reforms or for such complementary policies. The direct links between absolute poverty and trade reform and predicting the (very country-specific) effects of agricultural liberalization on the poor, also need further analysis (Cashin and others, 2001, and McCulloch and others, 2001).

**Banking sector**

Banking sector reforms in low-income countries—restructuring bank balance sheets to reduce the burden of non-performing loans; eliminating unproductive directed lending by state-owned banks; and reinforcing prudential regulation and banking supervision—increase efficiency and promote confidence, and could increase the amount of credit available to the private sector to stimulate growth. However, they may also eliminate, or substantially reduce the size of, large state-owned banks that provide banking service to rural areas and, to some extent, to the poor. More stringent prudential regulations may lead to prohibitive collateral and guarantee requirements that effectively exclude small businesses and private individuals from access to bank credit (especially women who often do not own land, a primary source of collateral); and the high transaction costs of rural banking may lead to substantial cutbacks in rural coverage.

A better understanding of the links between banking reform, microfinance, savings, and access to credit for poor people is needed. While such an analysis is unlikely to alter the nature of required banking sector reforms, it can identify complementary measures to improve access to credit by the poor, such as strengthening the supervision of microfinance institutions to facilitate a closer interface between these and the formal banking sector.

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38 In the privatization of the Zambia National Commercial Bank, for example, it was explicitly recognized that while the operation would improve the soundness of the banking system and reduce possible contingent demands on the budget, it would also adversely affect rural branches. A committee was therefore established to identify options for dealing with rural branches of the ZNCB, including the creation of a rural finance institution.
Petroleum prices

Reducing government subsidies on petroleum product prices is a frequently recommended expenditure reduction measure, particularly in times of rising international oil prices. Taxes on petroleum products are also usually an important and secure source of revenue. However, rising prices (whether because of reduced subsidies, the pass-through of international price hikes, or taxation) can affect the poor disproportionately, both through their fuel consumption, \(^{39}\) and more indirectly, through higher input and transportation costs. The impact on the poor could be mitigated to some extent through differential taxation of petroleum products used by the poor and by non-poor groups, and the provision of cross subsidies for the former groups of products. PSIA of petroleum price adjustments could be used to analyze both the first-round effects (petroleum prices) and second-round effects (transport and food prices) across social groups and region, and in determining what types of compensatory measures could be envisaged (see Table 5).

IV. THE POLICY MAKING PROCESS

Opening up the public dialogue on macroeconomic and social policies increases the face-to-face interactions between diverse groups—such as NGOs, local community groups, and local and central governments—and depends the understanding between civil society and the state (McGee and Norton, 2000). It promotes a two-way information flow—about government policies and about their impact on the ground—that can also strengthen policy making. Participation by civic groups and the poor in monitoring and evaluation of policies promotes transparency and accountability and enhances people's awareness of their rights—and, in the long run, may encourage them to demand better governance. Direct consultation with communities can present opportunities for a more open dialogue and greater understanding between those in power and the poor.

\(^{39}\) Moreover, when prices of petroleum products used as fuel by the poor rise, the rural poor, in particular, often resort to using wood/charcoal as a substitute, with negative long-term effects on the environment. More generally, if petroleum products are a major input in sectors central to overall growth, the potential impact of petroleum taxation on growth and incomes also should be assessed.
Table 5. Country Comparison of Poverty-Focused Policy Responses: Petroleum Prices

<table>
<thead>
<tr>
<th>Country</th>
<th>Poverty-Focused Policy Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senegal 2001</td>
<td>Full pass-through for petroleum products reinstated. The decline in the world market price of oil was passed on to consumers. The automatic adjustment of the prices of petroleum products protected petroleum tax revenue and provided additional resources for social sectors. However, a flexible price of retail petroleum products would lead to a higher cost for consumers when the world price of oil increases. Government maintains price of butane gas—predominantly used by the poor—below the world market price. The government distributes butane gas widely, even to rural areas, with the objective of reducing the use of firewood as fuel and, therefore, decreasing deforestation.</td>
</tr>
<tr>
<td>Ghana 2002</td>
<td>When raising domestic petroleum product prices in 2001 to reflect the rise in import costs and new taxes, the impact on the poor was mitigated through cross-product price subsidization and the staggered implementation of the taxes. Although gasoline consumption accounts for a higher share of expenditure in better-off households, kerosene consumption is heavily concentrated in the lower income brackets. Recognizing this, the government tapered the increases implemented in February 2001 by product: gasoline prices were increased by 61 percent to help contain the increase in kerosene price to 45 percent. The reintroduction of the ad valorem and specific petroleum taxes was staggered to August and October, respectively, to take advantage of the fall in world oil prices that allowed these taxes to be implemented without further increases in retail prices. The new petroleum price adjustment formula will preserve the cross-subsidization of kerosene prices.</td>
</tr>
</tbody>
</table>

Source: IMF Staff Reports

A. Policy making context

Many factors affect policy makers’ decisions to create, sustain, alter, or reverse policies. Rules, legislation, traditions, networks, ethnic alliances, patronage, political allegiances, donor influence, technical advice, and bureaucratic structures all interact to form a complex and fluctuating policy environment. Policy making is a negotiation between groups of unequal power and influence – the poorest people usually having the least power to influence policy. An appreciation of the unequal underlying power relations can lead to a better understanding of how
such policy choices are made and of how different groups are affected by them. In this context, it is important to clarify the roles and responsibilities of the various groups involved in the policy making process, and to both define an appropriate institutional setting for the policy dialogue, and the accountability of the various actors in the process. For example, issues include whether external partners, such as the IFIs, should be directly involved in the process of consulting with the poor; and whether their involvement in technical analysis and the identification of tradeoffs, such as through the PSIA of a given reform proposal, should be extended to the essentially political choice of policies.

There are many complexities of the policy making process. First, political structures can determine (a) the extent of participation around policy choices and which policy options can be discussed in the public domain, and (b) the macroeconomic policy content. The existing political context and institutional framework through which consultation takes place that can be built upon to promote a more open process of decision-making. Second, successful implementation of reforms will require social consensus, bargaining among social groups, and country ownership, none of which are easy to achieve when stakeholders have varying interests. Opening up the space for broader public participation in the formulation of macroeconomic policy could further entrench the dominant position of certain groups and power brokers seeking benefit from the budget and other reforms. Moreover, some national assemblies may not be prepared to lose their prerogatives in budget formulation. Third, with increased globalization and liberalization, decisions affecting policy interventions are increasingly linked to global developments and may need to be taken promptly, often without adequate time for wide-ranging public consultations. Fourth, some policy measures, such as devaluation and bank closing, need to be handled with sensitivity since public disclosure could induce preemptive behavior. In all such cases, however, the poverty impact can still be considered.

B. Including the poor in the policy making process

In many countries, the poor are excluded from the policy making process, often marginalized, and even disenfranchised. During the last ten years, the World Bank in partnership with governments, civil society organizations, academic institutions and donors has developed tools to enable policy makers to consult directly with poor people and to ensure that these views are reflected in a national public dialogue around the impacts and trade-offs of various policy
reforms. This enables a better understanding by policy makers and stakeholders of the synergies between macroeconomic goals, growth, and poverty reduction objectives.

There are three main reasons to include the poor in the policy dialogue. Inclusion leads to improved technical diagnosis of problems, and better design and implementation of solutions, based on the analysis by the poor themselves of their situation and the expression of their priorities, which can differ fundamentally from those assumed by policy makers (see Box 1). Opening up the policy making process to include the voices of the poor and other stakeholders widens the constituency for reform, deepens understanding and ownership of policy choices, and enhances the likelihood of choosing the right policy mix and implementing it successfully. Finally, enabling poor communities to participate in the formulation and implementation of policy can empower them; they cease to be merely the passive recipients of (sometimes-misguided) state benevolence and donor assistance. Consultations with communities have shown that the poor have the capacity to appraise, analyze, plan, and act to a far greater extent than had heretofore been acknowledged by many development experts.
Box: 1. Direct Consultations with Poor Communities Can Reveal the Many Dimensions of Poverty

- **Vulnerability.** Vulnerable groups are not always identified in household surveys, nor is the fact that their access to productive resources might be constrained by political, cultural, and social factors. In Armenia, single pensioners were consistently ranked by the communities as the poorest not because they had the least income but because they were isolated and socially excluded. In many countries, poor people's access to the labor market is restricted, forcing them into low-paid, insecure, often dangerous occupations, many of which are illegal, simply because no other options for earning a livelihood are open to them. In many African countries, the HIV/AIDS crisis is putting pressure on already strained networks of support; in Zambia, it has led to an increase in the number of particularly vulnerable households headed by children.

- **Gender differences.** In Tanzania, men identified lack of transportation, farming conditions, and drunkenness as the three most important problems, whereas women identified food shortages, lack of clean water, and illness. In many PPAs, women complained of a lack of time to engage in activities other than working in the fields or the home.

- **Crime and violence.** Some PPAs have highlighted the relationship between poverty and illegal activities, such as child prostitution (Zambia), drugs (Jamaica), and domestic violence (Mexico and Vietnam). Household surveys often are not able to obtain information on such sensitive topics because of respondents' mistrust of interviewers. Ecuador's PPA revealed that street crime and violence deter women from working outside the home, and safety concerns discourage women and the elderly from using public transport, particularly at night.

- **Seasonality.** Many PPAs, including those in Ghana, South Africa, Togo, and Zambia, have revealed great seasonal differences in poverty (for example, food security, access to water, and health). When people are forced to sell their assets, seasonal poverty can turn into long-term poverty.

- **Powerlessness.** In The Gambia and Uganda, the poor expressed frustration about their lack of influence on government policies. Ugandans also expressed concern about government corruption and distrust of state institutions, especially the police and the judiciary. In Vietnam's PPA, people said they lacked information on their entitlements, rights, and the activities of local government. In Brazil, Bangladesh and Uzbekistan, police harassment, corruption and general unresponsiveness were reported. The lack of protection from violence and crime coupled with a lack of trust of the police in general was reported in many PPAs as an important factor affecting poor people’s security.  

1/ See Narayan et. al., 2001, pp 162-166 for more details on the role of the police.
C. Linking the macroeconomic and social policies through the budget process

Macroeconomic policies influence the amount of resources available for implementing translating social objectives. These social priorities must effectively be translated into budget allocations. To encourage a public debate, various aggregate spending scenarios could be presented (in national strategies such as poverty reduction strategies) to reveal trade-offs between different macroeconomic, fiscal and social policy options. With this information, groups can bargain over the allocation of resources. Elected assemblies (national and local) and domestic interest groups can be included to scrutinize plans and budgets. Further, medium-term expenditure frameworks, which should frame the influence annual budgets, should be based on poverty reduction priorities. The expertise of parliamentary committees can be built to examine budgets with an understanding of trade-offs. Where possible, budgets could be published – even at the local level (for example, Uganda). This could give people an understanding of what they should expect and demand.

There is a growing recognition of the need for citizens to make their voices heard, and to demand accountability of government. However, many formal accountability mechanisms, such as elections, legislative oversight, and financial reporting mechanisms have limitations. Over the last few years, an approach called social accountability has been developed in many countries to complement and enhance conventional “internal” mechanisms of accountability. Social accountability refers to the broad range of action and mechanisms that citizens can use to hold the state to account beyond the formal mechanisms. Social accountability mechanisms both complement and enhance conventional “internal” mechanisms of accountability. They often focus on influencing and improving public expenditure management process by demystifying and disseminating budget information, increasing people’s awareness of their entitlement to services and information, and analyzing implications of budgetary allocations for disadvantaged groups (see Table 6). This promotes the “demand-side” of governance, and can help identify the most appropriate ways to increase citizen voice in public policy and budget processes.

40 In surveys, poor people often cite a lack of government accountability (defined as the obligation of “power-holders” to account for or take responsibility for their actions) as a major reason for their poverty (such as in Vietnam, The Gambia and Uganda).
### Table 6: Citizen participation in the budget cycle

<table>
<thead>
<tr>
<th>What civic groups can do</th>
<th>How</th>
<th>Example</th>
</tr>
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</table>
| **Formulation**
As revenue and expenditure estimates are being prepared
Government can present policy and resource options to the public |
- Connect people’s priorities to budget allocations
- Help identify priorities
- Present alternative budgets |
- PRSs; Participatory Poverty Assessments |
| Porto Alegre Brazil |
| **Review and Analysis**
Involves review of the impact and implication of different policy proposals and allocations |
- Assess proposed allocation vis-à-vis governments social commitments and other equity concerns
- Demystify the budget process
- Present information on the impacts of the budget on the poor
- Inform/train parliamentarians to pressure the executive for pro-poor changes
- Influence parliamentary debate |
- Impacts of the budget on the poor |
| South Africa and India Benin |
| **Evaluation**
Performance of selected public agencies is assessed |
- Assess quality of, access to, and satisfaction with performance of government agency in relation to funds received and services provided
- Provide direct feedback on delivery of services |
- Report cards; PPAs; BA; CWIQ Community score cards |
| Armenia and Malawi (Community score cards) |
| **Tracking**
After budget is debated and approved by parliament, allocations are disbursed to ministries and tiers below |
- Raise concerns that disbursed amounts may not reach beneficiaries
- Track how government spends the money. Require data on budget allocations and consumer perceptions of service delivery
- Identify bureaucratic channels through which funds flow; highlight bottlenecks and leakages in resource flows; cross check with information from independent enquiries, from finance ministry and accounts submitted by line agencies |
- Public Expenditure Tracking Surveys; Participatory Social Auditing: PPAs: Beneficiary Assessments (BA) and Core Welfare Indicator Questionnaires (CWIQ) |
| Uganda (PETS) Benin |
V. CHALLENGES LOOKING FORWARD

This paper highlights some of the challenges of better integrating macroeconomic and social policies. Macroeconomic and financial policies and programming need to be formulated with an understanding of the institutional and social contexts, as well as the economic situation, but the analysis of and understanding of these linkages must still be deepened, both globally and in the specific country context. Looking ahead, there are several areas for moving this agenda forward. Three of these—effectively managing large aid inflows; opening up the policy dialogue around macroeconomic policies; and better analyzing the poverty and social impacts of macroeconomic and social policies—are touched on below.

A. Managing Increased Aid Inflows

The pledges of substantial increases in ODA and multilateral debt relief offer low-income countries the best prospects in recent memory to improve their social outcomes. However, managing these increased aid inflows poses several challenges for macroeconomic policy that illustrate how macroeconomic and structural constraints can affect policy choice and the timing of reforms; and how the assessment of the social impact of policies requires a careful consideration of both the immediate and the longer-term tradeoffs.

The first of these challenges is increasing absorptive capacity. This is broadly defined as the amount of spending that can be effectively undertaken owing to macroeconomic and microeconomic constraints, such as weak budgetary planning and public expenditure management systems; weak project selection processes and poor implementation capacity;

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41 This section draws heavily on two recent papers by IMF staff prepared as part of the Review of PRGF Program Design. See IMF (2005a and 2005b).

42 It is presumed that available aid will be accommodated. The issue then is not whether additional aid should be accepted but how it can best be managed so as to minimize any macroeconomic disruption and optimize the efficiency of its use for poverty reduction. This abstracts from considerations of whether the aid is predictably committed and can thus be included in government budgets; whether it is subject to feasible disbursement conditions that are aligned with the country’s development priorities; and most importantly, whether the increased aid volume is enough to ensure that the MDGs are achieved.
limited skilled labor and sectoral administrative capacity;\(^{43}\) as well as poor incentives to good policy and to raising domestic revenue.\(^{44}\)

In addition to these more microeconomic constraints, macroeconomic (fiscal, monetary and exchange rate) policies must be formulated to minimize any adverse effects of the aid inflows. For example, policy makers must balance the benefits of higher aid-financed spending against the possibility of a real exchange rate appreciation.\(^{45}\) The most effective way to ensure that the positive effects of increased aid outweigh the dampening effects of a real exchange rate appreciation (and attendant loss of competitiveness) is to ensure that aid improves overall productivity, but this depends in part on how effectively the microeconomic constraints on absorptive capacity can be alleviated. However, the right balance must also be sought between fiscal, monetary and exchange rate policies in response to the aid inflow.

The typical response to higher aid is to absorb it and spend it—the government increases its spending on investment or social services, and the aid inflows finance the corresponding rise in imports, so that the rise in aggregate demand (absorption) does not create balance of payments problems.\(^{46}\) But different combinations of absorption and spending are possible.\(^{47}\) The choice of

\(^{43}\) The 2005 Global Monitoring Report, referring specifically to the need to improve outcomes in health, education and water and sanitation services, identified three major constraints to scaling up service delivery—increasing the availability of skilled service providers; ensuring sustained financing of the higher recurrent costs associated with expanded services; and improving governance and accountability to ensure that additional resources are translated effectively into expanded service delivery. See IMF/World Bank (GMR 2005a).

\(^{44}\) See in this context IMF/World Bank (2005b, 83-85).

\(^{45}\) Aid allows more domestic resources to be devoted to domestic investment and consumption, as less of the available domestic resources are needed for producing exports or import substitutes. If aid-financed projects have a reasonable rate of return, the reallocation of resources to domestic uses can increase growth. A real exchange rate appreciation may be a necessary part of the adjustment process. However, if the aid-induced real exchange rate appreciation shifts resources away from the traded goods sector (often a source of productivity gains), growth may be reduced (Dutch disease).

\(^{46}\) In this context, spending is the widening of the fiscal deficit (excluding aid) that accompanies the aid inflow, while absorption measures the real resource transfer through higher imports or a reduced use of domestic resources for producing exports—it is thus reflected in an increase in the current account deficit (excluding aid) that is due to the aid increase. If the aid is in kind, or is used to finance imports directly, then spending and absorption are equivalent.

\(^{47}\) There are three basic possibilities: First, the aid is neither spent nor absorbed. In this case, the aid is “saved” in the form of higher international reserves. Second, the aid is absorbed but not fully spent. Here, the aid is used to finance a larger share of the unchanged government deficit, allowing a reduction of domestic deficit financing and of domestic debt. Finally, the aid is spent but not absorbed, whereby the aid goes into reserves (since the central bank does not mop up the injection of liquidity resulting from the higher fiscal deficits through sales of foreign (continued)
response to the aid inflows depends in part on the macroeconomic situation. “Saving” the aid may be the appropriate policy choice if reserves are precariously low, where aid inflows and/or export earnings are particularly volatile. Also, if the aid surge is expected to be temporary, this response could smooth the adjustment of the real exchange rate. “Absorbing but not spending” the aid would be appropriate if a reduction of domestic debt levels or a “crowding in” of private sector access to domestic credit to finance productive investment are targeted. Alternatively, if inflation needs to be reduced, the monetary authorities could sell the foreign exchange brought in by aid to mop up the monetary impact of domestically financed fiscal deficits. The last scenario (aid is spent but not absorbed) could result inadvertently through the absence of coordination. This underscores the need for careful coordination of fiscal, monetary and exchange rate policies to ensure the desired outcome.

Longer-term considerations must also play a role. Higher aid inflows cannot be expected to continue forever. If countries are to maintain their development efforts while reducing their aid dependency, higher domestic resources are needed. The extent to which a government takes immediate advantage of available external resources, particularly grant financing, to ramp up poverty-reducing expenditures should take into account the country’s projected ability to meet the recurrent costs of such scaled up programs (like operations and maintenance outlays and wages and salaries) out of its own resources over time.48 From this perspective, reducing the stock of domestic debt and the government’s debt servicing liabilities would enhance the ability to meet these recurrent costs over time.49 Scaling up expenditures by somewhat less than the full amount of the available aid might thus be an appropriate policy choice over the short term.

Evaluating these tradeoffs in order to formulate a macroeconomically and socially sustainable response to higher aid inflows is complicated by the difficulty of projecting exactly exchange), and the higher deficit resulting from the additional government spending is effectively financed by printing money or domestic borrowing.

48 Some of the present spending on economic infrastructure and human capital formation may be expected to raise growth rates over time. However, it is difficult to predict this improvement with certainty, and to project how higher growth will translate into higher fiscal revenues.

49 Assessing longer-term fiscal sustainability is important, irrespective of whether the external resources are in the form of loans or grants. It is, of course, politically difficult to limit the recourse to available external resources on highly concessional terms or in the form of grants, particularly in the context of wide-reaching debt relief and in view of the pressing needs.
how the economy will respond to the different stimuli, now and in the future. This complexity underscores the need for more detailed analysis of the sources of growth and a better understanding of how the structure of the economy affects the transmission mechanisms. This will enable policy makers to determine whether their approach to managing higher aid inflows is consistent with the objectives served by the aid.

B. Opening up the Policy Dialogue

Since the introduction of the poverty reduction strategy approach, many governments, in concert with the international financial institutions and other development partners, are attempting to open up the policy dialogue around alternative policy options for promoting growth and reducing poverty.\(^5\) However, despite the greater flexibility in the design of macroeconomic frameworks “…the debate on what macroeconomic framework is most suited to reduce poverty is still lacking as a systematic part of the PRS process,” (IMF/World Bank (2005b, pp 30)). In part, the institutional framework for such discussions may be inadequate; the necessary information may not be available to stakeholders in accessible form; and potential participants in such debate may lack the technical or institutional capacity to evaluate macroeconomic tradeoffs and formulate feasible alternative policy options. Also, some macroeconomic and structural policies (such as, exchange rate changes or bank closures) are not suitable for open public dialogue.

The challenge is to form a new set of relationships at the country level where citizens are able to demand a more transparent policy making process from their governments. External donors, including the IFIs, can then become partners in that dialogue. Better information sharing, capacity building, and an improved institutional setting are all necessary elements of this effort.

The dialogue on policy options should take place among all those concerned with formulating and implementing policy—representatives of the key ministries and agencies responsible for macroeconomic and social policies, the poverty reduction strategy, and PSIA, for example, as well as stakeholder groups that are involved in these activities. The policy priorities

\(^5\) The efforts by the IFIs to increase the transparency of their policy advice and operations contributes to this process by increasing the volume of pertinent information available to the public.
and financing constraints of each group, as well as the core benefits costs, and tradeoffs of planned policies and reforms, should be discussed openly, and influence the positions of other groups. This process cannot not be linear—rather, it will go through several iterations, and it is possible that discussions between certain groups will be more intensive than between other. Nor should such exchanges occur only once during the year, say at the budget preparation stage. Ideally, the institutional framework for consultation discussed above should provide for regular interaction between these various groups, and these should be part of the country’s overall poverty reduction strategy process.

C. Improving the Analysis

Understanding the impact of macroeconomic and structural policies on poor people is complicated and multidimensional, and relationships are often difficult to establish in definitive terms. However, as this paper argues, since the methods and data exist, it is now possible to make explicit the assumptions underlying their programs and to use some country knowledge, as a first step towards PSIA.

In most non-crisis countries, reforms usually have lead time. It is possible for the World Bank and other donors to help governments prepare necessary data and analyses for discussions in country on policy trade-offs and options as part of a country’s poverty reduction strategy. The IMF could then base its macroeconomic policy discussions with governments on the results of this analysis. However, there is still an analysis gap. Policies are being formulated and implemented without adequate PSIA. Agreement is required on improved donor coordination and clearer lines of institutional responsibility. Further, many countries and donors lack of capacity and experience to conduct a comprehensive PSIA of policies and reforms, while most donors still focus on assessing the impact of projects as opposed to policies.

VI. CONCLUSIONS

The objectives of this paper are threefold. First, it underscores that macroeconomic and social policies need to be fully integrated at the conceptual stage, in full awareness of the tradeoffs and of the impacts of macroeconomic policies on social outcomes and vice versa. Second, it demonstrates that this awareness requires a full understanding of transmission
mechanisms of policies and of the differential impact given policies can have on different socioeconomic groups, which can only be achieved through a multidisciplinary analysis that takes into account the economic, social, institutional and political context. And third, it illustrates that it is possible to improve the pro-poor bias of macroeconomic policy even in the most constrained macroeconomic environments through the choice of policy instruments, timing, compensating measures, or policy redesign.

This agenda now needs to be taken forward by focusing analytical efforts on previously neglected areas, so as to better understand both the short- and long-term effects of policies. More coordinated and timely analysis can help the governments, the IFIs, and other development partners collaborate more effectively to design sound macroeconomic frameworks that also serve the ultimate objective of equitable development and social justice.
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