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The Implications of Fund-Supported Adjustment Programs for Poverty Groups: Country Case Studies 1/

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Contents

1/ This study is a background document related to the forthcoming Board discussion on the implications of Fund-supported adjustment programs for poverty. As per the Secretary's Circular No. 86/96, this paper is issued in the DM series since it contains sensitive material that for reasons of confidentiality cannot be circulated outside the Fund. The study benefited in its early stages from the advice of senior staff members of the Fiscal Affairs Department and subsequently from the comments and suggestions of staff in the area and functional departments. Any errors that remain are solely the responsibility of the authors.

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I. Introduction

This paper provides the background case studies underlying a forthcoming Executive Board paper on the poverty implications of recent Fund-supported adjustment programs. The case studies represent an empirical extension of an earlier related study, 1/ which analyzed the channels through which typical policy instruments used in Fund-supported adjustment programs influenced income distribution. The present study is based on ten recent programs in eight countries.

The case studies seek to identify the socioeconomic characteristics of poverty groups in the sample countries and to analyze the implications for poverty groups of the specific policy instruments adopted in the programs. A basic typology of the socioeconomic characteristics of poverty groups is described, encompassing, in the absence of more detailed data, the broad locus of their production activities, their consumption patterns, landholdings, accessibility to government services, and other relevant information. On this basis, it is shown that a given policy instrument can have different implications for poverty groups in different country settings.

Each of the case studies initially provides a description of the salient features of the economy concerned and of the principal poverty groups. The arrangements with the Fund are described, as are the economic policies adopted in each country under the program. The poverty effects are then discussed under two general headings: first, general macroeconomic policies other than fiscal policy and, second, fiscal policy measures. The first heading comprises money and credit, pricing, labor market, exchange rate, and other external sector policies. The second heading includes detailed government revenue and expenditure measures.

The choice of sample programs and countries was based on a number of criteria, including the desire to have a diverse sample in terms of regional composition, economic structure, and socioeconomic characteristics, as well as a varied mix of observed policy instruments. The sample programs, therefore, do not necessarily cover the broad spectrum of Fund-supported adjustment programs. The ten sample programs, implemented during 1983-85, the post world recession period, consist of both stand-by and extended Fund facility (EFF) programs with the following countries: Chile, the Dominican Republic, Ghana, Kenya, Morocco, the Philippines, Sri Lanka, and Thailand.

1/ International Monetary Fund (1986). In addition, the paper relies on a number of recent studies dealing with the channels through which adjustment policies could affect income distribution and related methodological issues.

II. Chile: The 1983-84 Program: The Implications for Poverty

The stand-by arrangement supported a medium-term adjustment program that was adopted by the Chilean authorities near the end of 1982. The Executive Board approved the two-year stand-by arrangement in January 1983 in an amount equivalent to SDR 500 million (EBS/82/227, 12/13/82) (154 percent of Chile's quota at that time). In July 1983, the Board granted a waiver of the observance of the net international reserve target for June 30, 1983, and approved some minor modifications to the stand-by arrangement (EBS/83/184, 6/28/83). Chile utilized the entire amount under the program and successfully completed three reviews (EBS/84/50, 3/9/84; EBS/84/179, 8/20/84; EBS/84/238, 11/26/84).

1. The economy, the poor, and the institutional setting

a. The economy

Chile is a middle-income country, which in 1982 had a population of 11.5 million, growing at an annual rate of about 1.7 percent during 1980-85. Its per capita income amounted to SDR 1,901 in 1982 (Table 1). The services sector is the dominant productive sector and accounts for over half of employment and about half of the total value added (Table 2). The agricultural and mining sectors each provide about 9 percent of GDP, while industry and manufacturing represent about 20 percent of GDP. The agricultural sector accounts for about 16 percent and industry and manufacturing for about 14 percent of employment. The construction sector provides about 5 percent of GDP and 4 percent of employment.

Exports of goods and services accounted for about one fifth of GDP in 1982. Chile's exports are dominated by copper, which represented 45 percent of total exports in 1982. At that time, other mineral products accounted for 19 percent of exports, while industrial products and agricultural and fishing products represented 25 percent and 10 percent of exports, respectively. Foodstuffs accounted for 15 percent of imports.

b. Socioeconomic characteristics of the poor

In 1982, 81 percent of the population and about 70 percent of the two poorest quintiles lived in urban areas. 1/ 2/ The poorest segment

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1/ The poorest quintile of the population represents the "extreme poverty" sector. Several social fiscal programs are directed toward this sector. The average income in the next to the poorest quintile is barely enough to satisfy nutritional requirements in FAO/WHO terms.

2/ The definition of poverty in terms of nominal income could be improved upon. An extensive government-sponsored study on poverty, which was prepared by ODEPLAN in 1976, adopted a comprehensive definition of poverty that accounted for differences in food costs and public services in various regions. This ODEPLAN study found that in 1975, 67.8 percent of the poor lived in urban areas.

Table 1. Chile: Area, Population, and Income, 1982

Area	756,626 square kilometers
Population	11.5 million
Population growth	1.7 percent (1980-85)
GDP per capita	SDR 1,901

Sources: SM/84/66 (3/20/84), p. v.

Table 2. Chile: Sectoral Origin of GDP and Employment, 1984

(In percent)

	GDP	Employment
Agriculture, forestry, and fishing	9.5	16.4
Mining	9.0	...
Construction	5.3	3.7
Manufacturing	21.4	14.2
Energy and transportation	8.2	...
Commerce	17.5	19.1
Other services	29.1	36.5
Total	100.0	100.0

Sources: SM/84/165 (7/8/84), p. 81; and Torsche (1986).

in the urban areas consists of the unemployed, those in employment programs, and the "self-employed" in the informal sector rather than wage earners in the formal sector. Among wage earners, the poorest are unskilled workers in the construction industry.

The rural areas have relatively more poor people; 49 percent of the rural population belonged to the poorest quintile and 24 percent to the next to poorest quintile in 1982. 1/ The rural poor are mostly landless laborers who purchase all or a large part of their food on the market. The ownership of land is concentrated.

This paper examines how the program affected the welfare of the poor in absolute terms rather than how it affected the welfare of the poorest groups relative to that of others.

Social indicators show that Chile had one of the lowest infant mortality rates in Latin America (22 per thousand live births) by 1983 (Table 3). The life expectancy was almost 68 years. At the same time, coverage of primary education was close to 100 percent. As regards secondary and higher education, coverage amounted to 52 percent and 9 percent, respectively, in 1984. The proportion of illiterate adult Chileans declined from 10 percent in 1974 to 5 percent in 1984.

c. Institutional setting

The public sector accounted for about 17 percent of consumption and 32 percent of investment in 1982. Public sector demand represented about 20 percent of GDP.

Open unemployment in Chile was one of the highest in Latin America. The unemployment rate rose from 10 percent in 1980 to almost 20 percent in 1982 (Table 4). Chile has two publicly funded employment programs. The PEM (minimum employment program), which was introduced in the mid-1970s, uses the unemployed in public works at the municipalities. The POJH (employment program for household heads) was introduced in October 1982 and provides employment for household heads who have not been able to find a job after a given search period. The employment programs pay very low wages even when compared with wages for unskilled manual workers. 2/ According to a survey by the University of Chile, about 45 percent of the PEM participants belong to the poorest quintile of the population and 7 percent to the next to poorest quintile. If 61.7 percent of beneficiaries of the employment programs

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1/ Thus, slightly less than three fourths of the rural population belonged to the two poorest quintiles, although the absolute number of rural poor was only half that of the urban poor.

2/ At the end of 1982, monthly payments under the PEM amounted to Ch$2,000. The corresponding POJH payments were Ch$4,000 for unskilled and Ch$8,000 for skilled workers, compared with average earnings of unskilled workers of almost Ch$20,000.

Table 3. Chile: Welfare Indicators, 1974-84

	Mortality			
	General rate	Infant rate	Life Expectancy	Adult Illiterate Rate
1974	7.8	65.2	65.4	9.6
1975	7.3	57.6	65.7	9.3
1976	7.8	56.6	65.9	9.0
1977	7.0	50.1	66.2	8.7
1978	6.7	40.1	66.5	8.4
1979	6.8	37.9	66.7	8.2
1980	6.7	33.0	67.0	7.4
1981	6.2	27.0	67.3	6.6
1982	6.1	23.6	67.5	5.8
1983	6.4	21.9	67.8	5.6
1984	6.3	20.0	68.0	5.4

Source: Torsche (1986).

Table 4. Chile: Labor Market Developments, 1977 and 1980-85

(End of year; in thousands)

	1977	1980	1981	1982	1983	1984	1985
Labor force 1/	3,199.7	3,634.7	3,688.0	3,661.5	3,768.0	3,798.0	4,018.7
Employed	2,821.0	3,257.0	3,271.0	2,943.9	3,215.8	3,268.0	3,537.4
(Percentage)	(88.2)	(89.6)	(88.7)	(80.4)	(85.4)	(86.0)	(88.0)
Unemployed	378.5	378.5	417.0	717.6	551.9	530.4	481.3
(Percentage)	(11.8)	(10.4)	(11.3)	(19.6)	(14.6)	(14.0)	(12.0)
Jobless	259.9	273.9	321.3	563.6	437.1	411.1	...
(Percentage)	(8.1)	(7.5)	(8.7)	(15.4)	(11.6)	(10.8)	(...)
Search first	118.6	104.6	95.7	154.0	114.6	119.3	...
(Percentage)	(3.7)	(2.9)	(2.6)	(4.2)	(3.0)	(3.1)	(...)
PEM + POJH	183.0	207.0	171.0	404.0	500.0	346.0	...
(Percentage)	(5.7)	(5.7)	(4.6)	(11.0)	(13.3)	(9.1)	(...)
Rate of unemployment	11.8	10.4	11.3	19.6	14.6	14.0	12.0
Rate of unemployment 2/	17.5	16.1	15.9	30.6	27.9	23.1	...
Rate of unemployment 3/	15.4	13.9	14.2	26.4	22.8	19.6	...

Source: Torsche (1986), and SM/87/166 (7/17/87).

1/ Up to 1981, population of 12 years and over. From 1982, population of 15 years and over.
2/ Considers all PEM and POJH beneficiaries unemployed.
3/ Considers 61.7 percent of PEM and POJH beneficiaries unemployed. Estimates from a survey on PEM participants conducted by the Department of Economics of the University of Chile estimated that 38.3 percent of PEM beneficiaries do not belong to the labor force.

are included as unemployed, 1/ the rate of unemployment peaked at 26.4 percent in 1982 (Table 4).

The Chilean labor market had been characterized by a tradition of government intervention. Together with the existence of powerful unions and employers, this gave rise to two segments in the labor market. In the first segment (the protected or formal sector), wages were set above their market clearing level for a number of institutional reasons, such as the existence of labor unions, large monopolistic firms, minimum wage laws, and indexation mechanisms. 2/ The other segment (the free or informal sector) comprised employment in those sectors where wages adjust more freely to market conditions.

2. The 1983-84 program and outcome

a. Background: Economic developments prior to adoption of the program

After Chile experienced a severe financial crisis in 1973, the Government implemented a far-reaching stabilization program together with deep structural reforms directed at transforming Chile from an economy that was semi-isolated from the rest of the world and characterized by strong government intervention into an economy integrated in the world economy with a broadened scope for private initiative. The privatization of state-owned enterprises played an important role in the creation and expansion of large conglomerates (the so-called "grupos") that controlled banks and major firms in many different sectors of the economy. 3/

The liberalization policies contributed to a strong economic performance during 1977-81. Real GDP grew rapidly, the rate of inflation decelerated from over 600 percent in 1973 to 10 percent in 1981, and the large fiscal deficits that had emerged at the beginning of the 1970s were brought under control.

On the negative side, open unemployment remained stubbornly high (Table 4), while the external current account deficit rose to 14.3 percent of GDP by 1981, reflecting high and rising real wages and a deterioration of external competitiveness as the real exchange rate appreciated sharply. In 1979, the authorities had fixed the nominal exchange rate as an anti-inflation measure. The decline in inflation, however, was not accompanied by a corresponding deceleration in nominal wage increases because an indexation mechanism, which was enacted in

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1/ A survey on PEM participants conducted by the Department of Economics at the University of Chile suggests that 61.7 percent of the participants belong to the labor force.

2/ Most indexation mechanisms were abolished in mid-1982.

3/ For more information on the grupos, see Edwards and Edwards (1987), Chapter 4.

mid-1979, linked wages to past rates of inflation. At the same time, the financial system became increasingly vulnerable; banks were prepared to provide additional loans as a means of averting bankruptcies that would have adversely affected their parent holding companies.

During 1982, the Chilean economy experienced a deep recession, with real GDP falling by some 14 percent and the open unemployment rate (excluding the employment programs) reaching about 20 percent (Table 4). The sharp drop in economic activity reflected a drastic deterioration of the external environment in late 1981 and in 1982. The economy was hit by the recession in the industrial countries, declining prices for Chile's main export commodities (including copper), and higher world interest rates. The combination of an indexation mechanism, which linked wages to past price developments, declining inflation, and a fixed exchange rate, had resulted in a sharp real appreciation of the exchange rate, and forced the economy to adjust to the adverse external shocks through a severe stagnation of economic activity rather than through adjustment of real wages and other relative prices. These conditions triggered a loss of domestic and external confidence in economic management, a sudden reduction in net capital inflows, a further rise in interest rates, and a high rate of business failure. The bankruptcies together with a lack of supervision of the liberalized financial system, which had allowed banks to accumulate a large proportion of "bad loans" and uncovered foreign liabilities, led to difficulties for many financial intermediaries. At the same time, the public sector moved into financial deficit owing mainly to a sharp fall in revenue from import duties and income taxes.

To deal with the problems that had developed, the authorities depreciated the peso and abolished their policy of indexing wages to past inflation in mid-1982. Interest rates remained high because the devaluation was generally perceived to be insufficient. Depositors were also reluctant to hold financial assets because banks continued to accumulate bad loans and the financial structure weakened further as many debtors could not service their debts at the new exchange rate. The Chilean peso was depreciated by an additional 30 percent in the following three months, and in September 1982 the authorities adopted a crawling peg policy aimed at maintaining the real external value of the peso. Following the depreciation of the peso, the rate of increase of consumer prices rose sharply, from about zero in the first semester of 1982 to an annual rate of 40 percent in the second half of the year. A major collapse of the financial system was avoided only by injections of funds to banks by the Central Bank and by the introduction of a preferential exchange rate for debtors with foreign liabilities. Net credit expansion of the Central Bank contributed to a loss of official international reserves during 1982 that amounted to 40 percent of the stock at end 1981.

b. Major features of the program and outcome

(1) Program

The basic objective of the stabilization program was to regain confidence and set the basis for economic recovery within a framework of a satisfactory balance of payments performance and a gradual reduction in the rate of inflation. The program anticipated that the GDP growth in 1983 and 1984 would recover to an annual rate of 4 percent, compared with a decline of almost 15 percent in 1982. Inflation, as measured by the increase in the consumer price index, was projected to slow to 25 percent in 1983 and 20 percent in 1984. As a share of GDP, the external current account deficit was targeted to decline from 9.6 percent in 1982 to about 7 percent in 1983 and 6 percent in 1984 (Table 5).

The major element of the original program's demand management was a targeted reduction of the deficit of the nonfinancial public sector from 4 percent of GDP in 1982 to 1.7 percent of GDP in 1983. Projected revenue measures did not offset the adverse impact of the recession on estimated receipts from income taxes and import duties. Current expenditures as a share of GDP were originally envisaged to decline by more than 7 percentage points. Later in 1983, additional revenue measures partly financed additional expenditures on employment and health programs and on support of the financial system. In 1984, the targeted fiscal deficit was allowed to increase to 4.5 percent of GDP, mainly on account of a planned increase in public investment, from 4.9 percent of GDP in 1983 to 6.8 percent of GDP in 1984. The second-year program allowed the fiscal stance to ease moderately in order to provide some stimulus to aggregate demand and to help reduce unemployment. The maintenance of fiscal discipline, however, continued to be a principal element of the program, envisaging an improvement in the savings performance of the public sector owing principally to restraint in current expenditure.

The program projected net domestic credit to the public sector to remain constant in 1983 and to increase by 9 percent in 1984. Credit to the private sector was to expand at 56 percent in 1983 and at 34 percent in 1984. 1/ The monetary program incorporated measures aimed at strengthening the financial system, such as the introduction of a deposit insurance scheme, a rescheduling of domestic bank debt owed by the productive sectors in the economy, and a preferential exchange rate for debt service payments on foreign loans. The authorities stated their intention of reducing the scope of the subsidy on foreign debt service payments when the situation of the debtors improved.

1/ These changes are expressed in relation to the outstanding stocks of liabilities to the private sector at the beginning of the period.

Table 5. Chile: The 1983-84 Program

	Original Program				Second-Period Program				Actual			
	1980	1981	1982 Estimate	1983 Program	1981	1982	1983 Estimate	1984 Program	1981	1982	1983	1984
	(Annual percentage change)											
Real GDP	7.5	5.3	-12.8	4.0	5.7	-14.3	-0.8	4.0	5.5	-14.1	-0.7	6.3
GDP deflator	29.0	13.6	8.6	37.8	13.4	11.2	27.3	20.4	12.2	13.3	26.6	14.3
Consumer prices (annual)	35.1	19.7	9.4	28.3	19.7	9.9	27.3	21.5	19.7	9.9	27.3	19.9
Consumer prices (Dec.-Dec.)	31.2	9.5	19.6	25.0	9.5	20.7	23.1	20.0	9.5	20.7	23.1	23.0
Trade volume												
Export	8.6	-4.3	5.6	7.0	-7.0	17.2	2.8	6.0	-4.0	14.6	3.1	4.2
Import	10.9	18.1	-44.3	-11.0	18.0	-41.9	-20.6	7.0	24.0	-39.4	-14.6	20.1
Terms of trade	-4.0	-13.5	-9.1	4.3	-13.2	-14.6	3.4	-1.7	-12.9	-9.5	9.8	-7.5
Effective exchange rate 1/												
Nominal	8.7	27.7	-38.8	-17.5	29.9	-25.5	18.1	-15.1	30.2	-25.3	18.7	3.0
Real 2/	16.9	13.5	-29.7	--	13.5	-28.9	6.6	--	13.2	-29.0	6.4	-12.0
Money and credit												
Net domestic assets 3/	81.2	69.9	29.8	40.2	55.7	82.6	56.1	48.0	63.5	24.6	43.4	60.1
Public sector	-24.2	-11.3	5.2	--	-10.2	9.6	23.1	8.7	11.8	5.7	5.5	2.6
Private sector	109.2	95.3	14.9	56.1	53.0	80.5	19.3	33.8	83.0	25.8	24.0	45.7
Broad money	70.6	41.9	1.8	30.0	32.2	23.8	28.1	24.8	35.6	10.9	15.5	31.4
	(In percent of GDP)											
External current account deficit	7.2	14.2	10.3	7.2	14.3	9.6	5.4	6.0	14.3	9.5	5.4	10.7
Fiscal accounts												
General government												
Current revenue	32.9	31.7	31.4	26.1	31.7	30.2	27.8	27.3	32.1	29.9	27.7	28.7
Current expenditure	24.5	26.3	32.5	25.4	26.3	32.2	30.7	29.3	26.6	31.9	30.5	30.7
Net surplus public enterprises	2.2	0.3	0.6	1.5	0.1	1.2	2.9	2.8	0.1	1.3	2.9	2.6
Public sector												
Savings	10.6	5.5	-0.4	2.2	5.5	-0.8	--	0.8	5.6	-0.8	-0.1	0.6
Net capital expenditure	5.0	4.3	3.6	3.9	4.7	2.6	3.0	5.3	4.8	2.6	2.9	5.0
Overall surplus	5.6	1.2	-4.0	-1.7	0.8	-3.4	-3.0	-4.5	0.8	-3.4	-3.0	-4.3

Sources: BES/82/227 (12/13/82); EBS/84/50 (3/9/84); and SM/86/165 (7/8/86).

1/ Nominal exchange rate index adjusted by a trade-weighted index of the exchange rates of Chile's 16 major trading partners.
2/ Based on consumer prices.
3/ Changes as percent of liabilities to the private sector at the beginning of the period.

Other elements of the program included a flexible exchange rate regime in order to shift resources to the tradable goods sector and to help ensure the orderly servicing of Chile's sizable external debt in future years. The program also relaxed certain regulations governing the foreign exchange market and the determination of domestic interest rates that had been imposed in 1982 to help ease the pressure on official reserves. In addition, it included provisions on the maintenance of a liberal trade system.

(2) <u>Outcome</u>

Economic performance deviated from the financial program when several bank failures caused a further crisis of confidence in January 1983. Foreign banks stopped all lending to Chile in order to force the Government to nationalize the outstanding foreign liabilities of liquidated banks, which had been obtained without government guarantee. In these circumstances, the Central Bank extended substantial amounts of support to the banking system. Consequently, the net international reserves of the Central Bank declined sharply. The authorities announced an emergency plan aimed at regaining control of the financial situation, stemming the loss of international reserves, and returning to the path of the original stand-by program by September 1983. On the basis of the performance under this plan, the Executive Board approved a modified financial program. In addition, the authorities completed negotiations with foreign banks to obtain the financing that had been initially contemplated in the original program.

The financial crisis in January 1983 contributed to a delay of the economic recovery that had been anticipated in the original stand-by program. Real GDP fell by 0.7 percent in 1983, whereas the program had envisaged a 4 percent increase. Weak domestic demand helped to keep inflation and the external current account deficit below their programmed levels. As the economy strengthened significantly in the second half of 1983, the open unemployment rate declined to 15 percent by the end of that year. On an annual average basis, real wages dropped by 10 percent.

The deficit of the nonfinancial public sector for 1983 amounted to 3 percent of GDP. The larger-than-programmed fiscal deficit reflected an increase in fiscal spending in the last quarter of 1983 to help ease the high level of unemployment. Until that quarter, the authorities had cut spending and taken additional revenue measures in order to offset both the adverse effects of the smaller-than-anticipated growth of activity on the fiscal balance and additional expenditures on health programs and the financial system.

In 1984, Chile faced adverse external shocks as copper prices on world markets declined and foreign interest rates rose sharply. Notwithstanding these adverse external developments, economic growth in 1984 was stronger than expected in the program. Although productive employment grew rapidly, the total unemployment rate declined only moderately, to 14 percent in the last quarter of 1984, because the special employment programs were reduced (Table 4). 1/

The external current account deficit worsened in 1984 and reached 10.7 percent of GDP, reflecting the unanticipated large decline in copper prices, higher-than-expected foreign interest rates, and surging imports in response to strong economic growth. In view of the worsening external situation, the authorities devalued the peso and raised import duties. These measures raised the rate of inflation above the program target. The devaluation together with the strong economy put a heavy burden on monetary management, and the credit target to the private sector was exceeded.

As regards fiscal policy, the deficit of the nonfinancial public sector was broadly in line with the program, although current government spending exceeded earlier estimates by 1.4 percent of GDP.

3. Implications for poverty groups

a. Overall macroeconomic and other nonfiscal policy measures and implications

(1) Overview

The main macroeconomic policies were the flexible exchange rate and wage policies. These policies reversed the unsustainable levels of real wages and the real exchange rate that had contributed both to a collapse of confidence and economic activity and to a dramatic increase in unemployment. The flexible policies helped to restore confidence in economic management and to contain the adverse employment effects of both adverse external shocks and reduced net capital inflows.

(2) Monetary and credit policy

The measures aimed at strengthening the financial system were an important part of the program. The distribution of the benefits associated with these expenditures is difficult to determine. On the one hand, the preferential exchange rate for foreign currency debtors and the assumption of private foreign loans by the Government benefited those with higher incomes, who had been in a position to assume foreign currency debt. On the other hand, small depositors with lower incomes, who did not move their capital abroad, took advantage of the deposit insurance scheme. Moreover, the improvement in the financial system encouraged capital to return to or stay in Chile, thereby shifting the benefits to other factors of production, including labor.

1/ During 1985, the total unemployment rate dropped further, to 12 percent at the end of the year.

The program contained some measures to improve the functioning of the financial system. These measures aimed at avoiding the inappropriate supervisory policies that had preceded the program and had had a regressive impact because the foreign banks had forced the Government to nationalize private foreign liabilities of liquidated banks. Insufficient bank supervision, in combination with a highly concentrated ownership of banks and firms, had resulted in an exceedingly fragile financial structure during the 1979-82 period; banks were allowed to provide additional loans to nonviable firms that were part of the same holding company without hedging exchange rate risks. The higher-income groups were able to shift the burden of the tax obligations that were implied by the nationalized external debt and by the implicit subsidy on external borrowing by moving their assets abroad. 1/

(3) Labor market policies

A flexible wage policy alleviated the negative effect of such adverse external shocks as declines in capital inflows and external terms of trade on employment in the formal sector. Before the program was implemented, the poorest segments with the least skills had been hardest hit by the inappropriate policies, including the rigidities in the labor market, that had contributed to higher unemployment and a larger labor supply in the informal sector. Unemployment was clearly the most regressive legacy of past wage indexation mechanisms because the degree of inequality of income distribution is closely associated with the unemployment rate. Moreover, the people who were rationed out of the formal sector put downward pressure on earnings in the urban informal sector. Thus, the rigid wages in the formal sector widened the gap between the earning levels in the formal and informal sectors (the "insiders" and the "outsiders"). To the extent that the program contributed to the strong employment performance in the formal sector and a reduction in the wage gaps between the formal and the informal sectors, it had a significant progressive effect. 2/

In addition to improving the operation of the labor market by supporting the abolition of wage indexation, the program limited the damage caused by earlier policies to the human capital of the poorest by using the unemployed in emergency employment programs. Unemployment is

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1/ The Chilean Government did not explicitly guarantee foreign loans to private banks. However, under pressure from foreign banks, the Government took over these obligations when several domestic banks failed. It also imposed a lower exchange rate for foreign currency debtors.

2/ For evidence on, and analysis of, the effects of wage policies in the formal sector on wages in the informal urban sector and unemployment during the period 1970-83, see Edwards and Edwards (1987), Chapter 6.

particularly serious because it may cause structural damage to the human capital of the poor; it harms the skills, motivation, and reputation of the unemployed, who tend to be poor. Despite some shortcomings, 1/ the employment programs constrained the adverse effects of the recession on the poor and may thereby have protected the human capital of the poor. In 1984, the authorities took further steps, such as enforcing more strictly the work requirements for the employment programs, in order to raise the efficiency of these schemes as a means of encouraging occupational and geographical labor mobility as well as human capital formation of the poor.

(4) Exchange rate and other external policies

The program supported the real devaluations of June 1982 and September 1984 in the overall framework of a flexible exchange rate regime. 2/ The flexible exchange rate policy improved the administrative efficiency and decreased rent-seeking behavior, thereby freeing resources for more productive activities. It also reduced the opportunity for politically powerful groups to appropriate scarcity premiums on tradable goods.

The real devaluation favorably affected the real value of assets used in the production of tradables. The exchange rate policy, therefore, benefited the rural and mining sectors because these sectors are engaged in the production of tradables.

Whereas the exchange rate policy helped the rural sector as a whole, the positive effect on the rural poor may have been mitigated because of two factors. First, the rural poor, who are mainly landless farm laborers, had to pay higher real prices for the food they bought in the market. Second, the lack of employment opportunities in nontradable activities in the urban sector contributed to the supply of rural labor because of urban-rural mobility of labor. These developments, while allowing the urban poor to share in the improved employment opportunities in the rural sector, limited the positive effect of devaluation on rural wages. Accordingly, most of the benefits of devaluation were likely to fall on the landowners. On the positive side, however, poor farmers were often able to respond faster to the improved price incentives than richer farmers and large agroindustries, because they had assumed fewer foreign liabilities. On balance, the depreciation appears to have benefited most poor primarily by increasing

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1/ Some programs degenerated into de facto income transfers because work discipline was extremely lax.

2/ When assessing the impact of the program on income distribution, it should be noted that some of the policies were not supported by the recommendations of the Fund. The Fund would have preferred an earlier devaluation of the exchange rate in the second quarter of 1984 when the spread between the official and parallel market exchange rates widened sharply. See EBS/84/179, p. 15 and p. 18.

the demand for labor in the agricultural sector, which is quite labor-intensive.

As regards the mining sector, which is almost entirely publicly owned, the depreciation helped partly to offset the adverse effects of declining mineral prices, and, in particular, falling copper prices. The depreciation did not result in a large direct increase in employment because the mining sector is not labor intensive. However, the better performance of the mining sector indirectly contributed to employment and growth by improving the public finances and by financing imports.

The depreciation inevitably imposed some immediate costs on the urban poor engaged in the production of nontradables. However, it moderated the increase in unemployment that would otherwise have followed from the adverse external shocks and declining capital inflows.

A devaluation redistributes wealth away from those holding domestic capital toward those holding capital abroad. Thus, the rich may have benefited from the real devaluation because they were in a better position to move their capital abroad in anticipation of the devaluation. In fact, the authorities gave the capital owners ample time to shift their assets abroad by delaying real depreciations in both June 1982 and September 1984 because of their policy of adopting the exchange rate as an instrument to achieve disinflation. The delay of measures aimed at external adjustment in mid-1984 also provided the rich with the opportunity to hoard imports in anticipation of either a devaluation or an increase in import duties. This illustrates how the wealthy are often able to protect themselves against the effects of unsustainable policies by shifting their assets, thereby eroding the tax base. The less well-off, in contrast, cannot move their assets (including their human capital), and thus bear the implicit and explicit taxes associated with unsustainable policies. 1/

a. Fiscal policy measures and their implications

The original program aimed at achieving fiscal adjustment mainly through cuts in current expenditure. Subsequently, the authorities adopted additional revenue measures partly to finance expenditures on public investment employment and health programs, which were explicitly aimed at protecting the poor, as well as expenditures on support of the financial system.

1/ This illustrates how consistent, credible, and sustainable policy regimes tend to protect the poor, while inappropriate policies are rapidly transmitted to the poor--particularly in open market-oriented economies; the poor are relatively immobile and are misled by inappropriate policies to invest and lock themselves into inefficient activities.

The following two subsections analyze the microeconomic effects of the revenue and expenditure measures, respectively. To the extent that the measures reduced the fiscal deficit, they shifted absorption to the future. In particular, a lower deficit reduced the future burden of debt service on the budget. Therefore, it allowed a sustainable and higher level of noninterest public expenditure in the future or a lower future tax burden, thereby contributing to a higher sustainable level of growth and employment.

(1) Revenue measures

The authorities adopted tax measures several times during the program period. In late 1982, the tax measures included the introduction of a gambling tax, surcharges on income and property taxes, higher excise taxes on tobacco products, and an increase in the automobile road tax. These measures, although taken before the adoption of the program, were incorporated in the program. In March 1983, the authorities took additional revenue measures as part of their emergency plan to contain the fiscal deficit at a time when the recession and the crisis in the financial system were adversely affecting public finances. The main revenue generator was a flat import surcharge of 10 percentage points, which raised the effective tariff to a uniform 20 percent and yielded the equivalent of about 1.5 percent of GDP. Another revenue measure linked the reimbursement of the value-added tax on exports to exchange surrender. This measure effectively delayed reimbursement of the tax by an average of two months and yielded about 0.1 percent of GDP. As the last measure adopted in March 1983, the Government raised the price of petroleum derivatives. In late 1983, higher tax rates were enacted on luxury goods and property.

In 1984, the authorities implemented the first stage of an income tax reform aimed at stimulating saving and investment. This decreased revenue by 0.3 percent of GDP and reduced the tax burden on productive enterprises, provided tax benefits for reinvestment of earnings, reduced personal income tax rates, and permitted a deduction for personal savings from taxable income up to a maximum of 20 percent.

In late July 1984, the authorities implemented a 15 percent import surcharge on luxury goods. Simultaneous with the devaluation in September 1984, import duties were raised to a uniform rate of 35 percent. Although a new drawback system for exporters was announced to mitigate the adverse effects of the higher duties on exports, technical difficulties delayed the implementation of the scheme.

These tax measures had a number of distributional effects. They contributed to increasing the revenue shares of taxes on goods and services and taxes on international trade at the expense of the share of taxes on income and property (Table 6). This shift in tax structure

Table 6. Chile: General Government Revenue, 1981-84

(In percent of GDP)

	1981	1982	1983	1984
Total revenue	32.1	31.7	29.6	29.5
Current revenue	32.1	29.9	27.7	28.7
Taxes on income and property	5.8	5.7	5.0	4.7
Personal and business income tax	5.4	4.6	3.0	3.2
Copper companies' income tax	0.2	1.0	1.9	1.2
Property tax	0.1	0.1	0.1	0.2
Real estate	--	0.1	0.1	0.1
Other	0.1	--	--	--
Taxes on goods and services	13.2	13.5	13.5	14.3
Value-added tax	11.0	10.6	10.0	10.8
Excise tax	1.4	2.0	2.7	2.8
Stamp tax	0.8	0.7	0.6	0.6
Other	--	0.2	0.1	0.1
Taxes on international trade	2.3	1.4	2.3	3.3
Other taxes, net of IVA rebates	-0.7	-1.2	-1.2	-1.3
Social security tax	4.7	3.3	2.8	2.8
Nontax revenue	6.9	7.2	5.3	5.0
Profits transfers from government enterprises	1.3	1.6	0.9	0.7
Sales of goods and services	2.2	2.4	2.2	2.5
Other revenue	3.4	3.2	2.2	1.8
Net capital revenue	--	1.8	1.9	0.7
Revenue	2.8	7.5	4.0	3.2
Less: financial investment	-2.8	-5.7	-2.1	-2.5

Source: SM/86/165 (7/8/86).

suggests that, on balance, the tax measures were regressive. However, the higher taxes on luxury goods and petroleum fell mostly on higher-income groups because the taxed goods are income elastic. To the extent that petroleum products are used as an intermediate input and that taxes on nontraded goods are shifted backward to the production factors supplying those goods, it is difficult to judge the equity effects.

The income tax reform to encourage saving and investment may have been regressive in the short run; the poor pay very little, if any, income tax and have a relatively low propensity for saving. However, the lower taxes on capital income could have been partly shifted to labor, particularly in the longer run, as international capital flows responded to the tax incentives.

Import duties were the main source of additional tax revenue. 1/ From the uses side, these taxes hurt the consumers of imported goods. The higher-income classes tend to devote a larger share of their incomes to imported goods with high tariffs than the poor. Import duties, therefore, generally have a progressive element. The timing of the implementation of import duties and data on imports suggest, however, that the higher-income groups initially had been able to escape part of the burden of the import duties as they increased their imports in anticipation of the implementation of the duties.

From the sources side, import duties redistribute income away from export-oriented activities toward production factors used to produce import substitutes. Import duties may have favored the rural sector to the extent that they encouraged import substitution in the agricultural sector. The effect on the income distribution within the rural sector is more difficult to determine. The landowners may well have absorbed most of the benefits--particularly in the medium to long run when migration flows could positively affect the supply of rural labor.

(2) Expenditure measures

The letters of intent did not provide much detail on how expenditure would be allocated. When evaluating the distributional consequences of ex post expenditure, it should be borne in mind that the details of expenditure policy were decisions of the authorities rather than an integral part of the adjustment program.

The classification of expenditure by economic purpose provides information on how expenditure policy affected the income distribution from the sources side (Table 7). The only category that exhibited a persistent rise relative to GDP during the program period was interest payments. The rising trend in this category was mainly due to rising external public indebtedness as the real exchange rate depreciated and the Government was forced to take over most of the foreign debts of the

1/ During 1985, the uniform import tariff was reduced to 20 percent.

Table 7. Chile: Economic Classification of General Government Expenditure, 1981-84

(In percent of GDP)

	1981	1982	1983	1984
Total expenditure	29.2	34.0	32.6	33.0
Current expenditure	26.6	31.9	30.5	30.8
Wages and salaries	7.8	7.8	6.7	6.4
Purchase of goods and services	2.9	3.3	3.2	3.3
Social security payments to private recipients	8.2	10.8	9.6	10.1
Transfer and subsidy payments to private sector	6.9	9.0	8.9	8.2
Interest on public debt	0.4	0.6	1.8	2.4
Other	0.4	0.4	0.3	0.2
Capital formation	2.5	2.1	2.1	2.3

Source: SM/86/165 (7/18/86).

private sector. The increase in international interest rates, which represented a redistribution of wealth away from debtor countries to creditor countries, also played a role.

Expenditures on wages and salaries showed the largest decline of all economic categories of expenditure. During the program, civil servants suffered a large cut in real wages (about 15 percent in 1983 and 6 percent in 1984). In early 1984, the Government cut the salaries of top management in the principal state enterprises by 15 percent as a further signal of public wage restraint. In addition, instead of expanding the civil service, which tends to benefit the middle class, the authorities chose to employ temporarily some of the poor and unskilled unemployed in the employment programs. Although these measures imposed some hardship on people employed in the formal sector, the civil servants--as part of the middle class--were in a better position to absorb real cuts in wages than the unemployed and those working in the informal sector. Moreover, although the initial effect on real wages of the public servants was adverse, the medium- to long-term effects on these wages may well have been positive because the initial wage restraint contributed to an improved growth performance.

The reduction in real wages in the public sector dampened real wages in the private formal sector, contributing to higher demand for labor, lower unemployment, and protection of wages in the informal sector. To conclude, the effect of reducing expenditures on wages and salaries may have been progressive, particularly because the reduction of real wages was skewed toward the higher paid. 1/

The relative decline in wages and salaries provided room to keep essential nonwage current outlays, such as medicines and educational materials, as well as transfer and subsidy payments, relatively high during the adjustment period. These expenditures stemmed not only from unemployment benefits and family allowances but also from the employment programs and subsidies to schools. These latter expenditures are likely to have benefited the poor not only from the uses side but also from the sources side by protecting the human capital of the poor.

Whereas it is difficult to assess how social expenditure policy affected the poor from the uses side, the Chilean authorities seem to have been successful in focusing social spending on the poorest segments of the population (Tables 8 and 9). 2/ Expenditure policy has contributed to continuous progress in general mortality and infant mortality as well as to a declining trend in malnutrition among children under six years old (Table 3).

1/ The higher-paid employees, however, are the most mobile. Thus, they may have shifted the burden of lower wages by leaving the country.

2/ World Bank (1987a) and (1986a); Addison and Demery (1987); and Pfeffermann (1987a).

Table 8. Chile: Social Fiscal Expenditure, 1974-84

(In millions of 1976 U.S. dollars)

Year	Health	Social Welfare 1/	Housing	Social Security	Education	Regional Devel- opment 2/	Total	Social Expenditure per Capita
1974	220.0	51.8	206.0	246.8	454.1	32.2	1,211.0	120.8
1975	159.7	105.6	84.2	254.7	341.9	35.6	981.7	96.3
1976	134.3	150.0	74.2	223.8	345.3	56.9	984.5	94.9
1977	154.6	136.5	81.2	299.4	422.2	48.8	1,142.7	108.3
1978	161.3	173.6	62.6	318.5	426.1	48.0	1,190.0	110.9
1979	152.9	113.2	68.6	347.5	444.9	45.5	1,172.5	107.4
1980	196.8	201.1	76.7	415.1	471.9	45.5	1,407.1	126.7
1981	208.2	389.0	73.9	558.5	567.4	49.2	1,846.2	163.5
1982	196.9	478.0	27.0	648.2	579.8	23.2	1,952.4	170.0
1983	162.6	540.6	41.4	628.8	497.2	18.0	1,888.7	161.6
1984	160.7	487.1	75.20	801.20	501.2	14.1	2,048.5	172.5

Source: World Bank (1986a).

1/ Social welfare includes contributions to the Ministry of Labor institutions (excluding social security funds) such as the Regional Development National Fund, National Scholar Aid and Scholarship Council, National Kindergarten Council, National Emergency Bureau, and Minimum Employment Program. It also includes contributions to firemen's units.

2/ Regional development expenditure includes resources assigned to regions and intended basically for health, housing, and education and the alleviation of extreme poverty.

Table 9. Chile: Incidence of Social Programs, 1985

(In percent)

	Share Received by Lowest 40 Percent	Share Received by Highest 20 Percent
Selected cash subsidies		
Emergency employment programs	81.4	1.3
Unemployment insurance	71.0	8.0
Unique family subsidy	77.0	3.0
Family allowance	42.0	17.0
Social security pensions	13.4	32.0
Selected noncash programs		
Basic education	59.0	9.0
Secondary education	49.4	12.2
Higher education 1/	17.0	52.0
School lunch program	72.0	5.0
Health and nutrition	63.7	5.2
Total social outlays	40.0	26.4
(Total, minus social security pensions)	(56.6)	(12.9)

Source: World Bank (1987a).

1/ The exclusion of university fees significantly exaggerates the skewness of university subsidy incidence.

The program allowed an increase in the public investment program in 1984 while it cut current expenditures. The bulk of the larger investment, which related to the electricity and mining sectors, would contribute to an improvement of the trade balance in future years. Another part was directed toward labor-intensive low-income housing projects aimed at alleviating unemployment and poverty. The public investment screening process is relatively efficient in Chile. 1/ When it was necessary to reduce public spending, the authorities halted work on the expansion of the Santiago metro and slowed down the construction of the access road to the Fjords region. At the same time, they continued to improve the productivity of the state-owned copper mines so that they remained profitable. By raising efficient investment spending at the expense of current spending, 2/ the program redistributed income from the current generation to future generations. At the same time, it enhanced the productive assets of the current generation. The labor-intensive projects on low-income housing benefited the poor from both the uses side (by providing better housing services) and the sources side (by increasing demand for low-skilled workers). These projects also brought Chile's factor allocation more in line with its factor endowment of labor. Capital-intensive projects, in contrast, are costly in terms of external indebtedness and do not help to reduce unemployment or raise real wages. 3/

The authorities succeeded in continuing to provide the most urgently needed social services in the midst of the severe economic crisis by shifting resources to primary education, primary health, nutrition, and basic sanitation. At the same time, they raised the efficiency of the delivery of social services and allowed the market to take up the needs of better-off groups, including the lower middle-income groups. 4/ Chile's performance in targeting social spending offers an important lesson. Stabilization and structural adjustment can act as an opportunity for government to re-evaluate its spending. It can be a catalyst for focusing public spending on the poorest segments of society rather than responding to middle-class demands to subsidize products or services demanded by their group and to expand public employment for their class. 5/

1/ EBS/85/122, p. 19, and Pfeffermann (1987b).

2/ Note that some of the current spending may have the character of investment spending.

3/ This explains why strategies that are costly in terms of external indebtedness are often not successful in generating employment.

4/ To illustrate, the authorities increased rates and tariffs on goods and services sold by public enterprises. Consequently, the contribution of public enterprises to public savings rose during the program.

5/ It can be argued that government spending in many Latin American countries has not reached the poor. Instead, the middle class benefited from greater public spending through both sales to government and services received.

To illustrate, Chile has been able to cut real expenditure on health by making substantial economies in programs that largely serve middle- and higher-income groups and by reducing real wages of public servants. 1/ At the same time, the Government expanded the National Food Program (PNAC), which has been one of the main factors in the rapid decline in infant mortality rates. The PNAC, which is administered by the Ministry of Health, distributes enriched food through health clinics to pregnant women and young children. 2/ When food is distributed, pregnant women and young children are checked for malnutrition and if undernutrition is detected, additional food is given to the family. This program not only targets food subsidies to the poor but also improves the productive capacity of the poorest segments of society. On the negative side, Chile's health infrastructure in urban areas has gradually deteriorated because of investment reductions. 3/

Education expenditure can be a high-yielding investment in the productive capacity of the poor. Although real public spending on education fell during the program period, these expenditure cuts were offset by a better targeting of spending on the poorest sectors and by an increase in efficiency. In particular, the Government increased the role of private education by offering educational services and increased tuition fees at the university level. These measures aimed at allowing public resources to focus on the educational needs of the poorest by reallocating resources to primary education 4/ and providing student loans to needy university students. However, the implementation of the reforms has been difficult. In the absence of data, the impact of the reforms cannot be evaluated. 5/

4. Summary, overview, and conclusions

The experience in Chile illustrates that poverty groups suffered more than others from the combination of inappropriate macroeconomic policies and adverse external shocks that preceded the stand-by arrangement. In particular, the suffering of the poor was exacerbated by the postponement of measures to deal with the underlying causes of unsustainable macroeconomic imbalances. Vulnerable groups were hardest hit by wage policies that decreased employment in the formal sector and increased both labor supply in the informal sector and unemployment. At the same time, most of the poor were not sufficiently mobile to shift their assets, including their human capital, abroad. The more affluent

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1/ Castaneda (1985).

2/ World Bank (1986a).

3/ World Bank (1987a).

4/ A study financed by the Inter-American Development Bank (1986) argues that expenditures on primary education have the greatest redistributive impact of all social expenditures. According to this study, expenditures on secondary education are slightly progressive, while expenditures on higher education are regressive.

5/ Castaneda (1986).

groups, in contrast, took advantage of the disorderly adjustment and the associated distortions.

The stabilization program that was supported by a stand-by arrangement was a necessary condition to protect a sustainable and higher level of welfare for the poor by restoring confidence in economic management through the implementation of credible economic policies; employment in the formal sector increased and capital flight was halted.

This study has shown that appropriate policy measures can cushion the impact of stabilization. Emergency employment programs, as well as targeted health, nutrition, and investment programs, limited the damage caused by previous inappropriate policies to the assets of the most vulnerable groups.

Furthermore, the period of adjustment encouraged the authorities to direct public resources toward the most vulnerable groups and to reduce the role of the public sector in providing goods and services to the middle class. The authorities allowed the private sector to serve the needs of those who could stand up for themselves and deliberately limited the role of the public sector to ensure that certain minimum standards were achieved.

The supply-side elements of the program incorporated positive steps to alleviate poverty by improving the productive capacity of the poor. To the extent that macroeconomic equilibrium could be gained through structural adjustment measures that enhanced the productive resources of the poor, the program was able to rely less on demand restraint, which may have adverse supply-side effects, and could be more consistent with the objective of poverty alleviation. To illustrate, the flexible wage policy and Chile's investment program increased the access of the poor to productive employment and enhanced the value and quality of their human capital, which was often their only productive asset.

The Chilean experience also shows that particular elements in stabilization programs may not always be effective in improving the relative position of the poor. Different ways of adjusting have differential effects on the poor: given concentrated landownership, devaluation may have widened inequalities within the agricultural sector. Inappropriate timing of both exchange rate adjustments and tariff measures gave the wealthy the opportunity to shift part of the burden of adjustment to the other segments of the population.

III. Dominican Republic: The 1983-85 Program: The Implications for Poverty

The program studied was supported by an extended Fund facility (EFF) arrangement with the Fund in the amount of SDR 371.25 million (450 percent of quota) for the three-year period 1983-85 (EBS/82/239, 12/29/1982). The Dominican Republic completed the purchases of

SDR 123.8 million allocated for 1983 by satisfying the program's performance criteria through September 1983, but did not meet the performance criteria for December 1983. The subsequent negotiations for the second-year program did not result in an agreement.

1. Structure of the economy

a. Institutional setting

The Dominican Republic is an oil importing and primary commodity exporting country, with a per capita GDP of US$1,365 in 1982 (Table 10). Its adjustment programs have been intricately linked with efforts toward the reduction of petroleum subsidies and the taxation of traditional exports indirectly through the exchange rate system. While many of the benefits of the petroleum subsidies have accrued to the urban middle class, the taxation of such traditional exports as sugar has affected the agrarian sector, including the "bateys," the communities of impoverished sugar workers. Features of the program under discussion aimed at redressing the imbalances in the pricing signals which had led to such regressive distortions.

The composition of GDP is fairly diversified, with the primary, secondary, and services sectors accounting for approximately 25 percent, 20 percent, and 55 percent of GDP, respectively (Table 11). Within these broad categories, agriculture, manufacturing, and commerce together contribute about 45 percent of GDP. Sugar and coffee are the two dominant agricultural export products and also provide important bases for food processing in the manufacturing sector. In 1982, these two products accounted for 40 percent of the value of merchandise exports, which, together with the exports of services, accounted for a bit less than 20 percent of GDP. No reliable and systematic employment data are available, but a survey conducted in 1983 indicated a level of unemployment of 21 percent; underemployment is believed to be widespread in the economy.

b. Characteristics of population, poverty and its location

The population was about six million in 1982, and the annual population growth rate is 2.9 percent in spite of having fallen over the last two decades. As a consequence, the population is quite young, with more than 40 percent aged less than 15 years, and 70 percent aged less than 30 years. The relative youth of the population has implied an unemployment rate of more than 20 percent for over 25 years.

Coupled with a high population growth, there has been a continuous rural to urban migration, with the urban and rural populations growing by slightly over 5 percent and 1 percent per annum, respectively, in recent years. Between 1980 and the present, the urban component of the population has grown from about 50 percent to 55 percent, reflecting the low absorptive capacity of the rural sector and better average living conditions for the urban dweller.

Table 10. Dominican Republic: Area, Population, and Income, 1982

Area	48,400 square kilometers
Population	5.9 million
Population growth	2.9 percent per annum (1977-82)
GDP per capita	US$1,365

Source: EBS/83/155 (7/28/83), p. 24.

Table 11. Dominican Republic: Industrial Origin of GDP, 1981-85

	1981	1982	1983	1984	1985
GDP	100	100	100	100	100
Agriculture and fishing	17	21	21	21	20
Mining and manufacturing	23	19	20	20	19
Construction	6	6	7	7	6
Commerce, transport, and communication	25	22	21	21	21
Government	9	9	9	9	9
Other	20	22	22	24	24

Sources: EBS/83/155 (7/28/83), p. 24; SM/87/78 (4/2/87), pp. iv-v.

Even though its per capita GDP places the Dominican Republic among the lower/middle income countries, there is ample evidence of poverty in the country. According to an unpublished 1984 household survey by the Central Bank, about 45 percent of the population lived under the absolute poverty level, 1/ a figure which has not changed from an earlier 1976/77 household survey, which had also indicated that the proportions were roughly similar in both urban and rural areas. 2/ The country's poverty has been characterized as structural, implying a composite of lower personal incomes, high illiteracy, malnutrition, a high rate of infant mortality, a prevalence of infectious diseases, and a lack of clean water supplies, sewerage, and other public services.

The location of poverty in the Dominican Republic may be inferred to be concentrated in the rural sector. In three major regions--North (Cibao), South West, and South East--the higher the share of the rural population, the worse are such important social indicators as infant mortality, illiteracy, access to primary education, and availability of household appliances. In the first two regions, almost two thirds of the population live in the rural sectors. There is a common perception that these social indicators are especially low in the bateys. Per capita GDP in the North and the South East are, respectively, about a third and two thirds higher than in the South West, thus following the same pattern of lower income with higher rurality. Thus, while the urban population also has its representative poor, any study of the ramifications of adjustment programs on poverty has to be concerned with sectors in which the rural population is primarily employed, namely, the traditional export sector.

c. Role of government and the public sector

The public sector accounted for about 14 percent of consumption and 20 percent of investment in 1982. Combined public sector final demand was about 14 percent of GDP. The Government intervenes in the market through price control policies, administered by the Office of Price Control, and through the distribution of domestic and imported foods by INESPRE, the national marketing agency. In addition, the Government sets the prices and tariffs of goods and services, such as electricity, sugar, edible oil, and oil derivatives, produced by public enterprises. The private sector products subject to price control by the Government are milk, medicines, bread, edible oil, and transportation.

The Congress sets minimum wages applicable to both the public and the private sectors. Although wages are negotiated through collective bargaining, wage bargaining is influenced by the changes in the minimum wages.

1/ As defined in terms of basic needs by the World Bank.
2/ Information on the characteristics of population and poverty are primarily from Grossi (1987).

Until its unification in 1985, the exchange system for many years had comprised a dual exchange market where a fixed official exchange rate and a parallel market rate coexisted. The Government controlled the effective exchange rate by changing the composition of transactions allowed in the official and the parallel markets.

2. The 1983-85 program and outcome

a. Background: economic developments prior to the adoption of the program

The program was formulated against the background of sharply deteriorated external terms of trade and a prolonged expansionary fiscal policy that had resulted in major domestic and external economic imbalances. Earlier policy decisions had adjusted neither the official exchange rate at which energy products were imported nor their domestic prices in accordance with their movements in the international markets. As a result, cheaper supply sources were not forthcoming nor was demand curtailed, culminating in oil imports representing more than a third of imports in 1981, rising from about a fifth of imports in the mid-1970s.

In 1982, real GDP growth was down to 1.6 percent, from 4.6 percent per annum during 1980/81 (Table 12). The external terms of trade deteriorated by 27.4 percent, in the wake of the world recession. In spite of a sharp compression of imports, the current account deficit remained undiminished at 5.4 percent of GDP, and the overall balance of payments deficit doubled to 4.2 percent of GDP. External payments arrears continued to build up, gross foreign assets were down to US$100 million (one month of imports), and the net international reserves of the Central Bank reached a negative US$590 million. Central government expenditure continued to increase, despite a sharp reduction in revenue, and the overall deficit increased from 2.4 percent of GDP during 1980/81 to 3.9 percent in 1982.

The public finances were in poor shape because the authorities continued to pursue a system of subsidized prices biased toward urban consumption such as for electricity, petroleum, sugar, and cement. Domestic resources for expenditures were inadequate, because a liberal tax policy was pursued that made the country increasingly dependent on foreign financing and that could last only up to the emergence of the debt crisis and the concomitant drying up of commercial bank lending.

The Government increasingly recognized that an economic adjustment was inevitable. Indeed, the widening of economic imbalances led the Government to adopt a series of measures prior to the program that included an attempt to moderate monetary expansion; the transfer of import payments for capital goods and automobile parts to the parallel market; and increases in a number of consumer prices (for gasoline, sugar, and electricity) (Table 13). In addition, the Government intensified import restrictions by establishing quotas on the

Table 12. Dominican Republic: The 1983 Program

	1980	1981	Program 1982	Program 1983	Revised Program 1982	Actual 1982	Actual 1983
			(Annual percentage change)				
Real GDP	5.7	3.5	1.6	2.0	1.6	1.7	3.9
GDP deflator	13.8	9.7	4.5	9.0	4.5	8.0	3.4
Consumer price index	16.8	7.5	7.5	9.0	7.5	7.6	7.0
Trade volume	-19.1	5.0	-10.2	7.8	-12.0		
Export	21.7	-12.0	-18.8	-8.8	-14.5	-13.3	4.9
Import	24.7	8.3	-27.4	-5.5	-27.4	-16.8	3.1
Effective exchange rate depreciation							
Nominal	--	0.7	-1.3	...	-1.3	12.8	-1.5
Real	1.1	-1.3	1.0	...	1.0	1.7	-7.6
Net domestic credit	20.7	29.1	43.7	19.9	36.0	28.1	...
Public sector	7.8	26.2	31.9	12.4	26.4	26.1	18.2
Private sector	11.8	-1.9	5.8	7.5	6.4	6.4	9.5
Broad money	2.1	11.1	11.0	11.4	6.2	15.9	7.9
			(In percent of GDP)				
Central government savings	2.5	2.0	-1.4	0.8	-0.4	-0.5	0.5
Revenue 1/	13.5	12.3	8.6	9.1	9.8	9.5	10.8
Current expenditure	10.9	10.2	9.8	8.2	10.0	9.8	10.2
Total expenditure 2/	18.5	16.2	13.9	12.5	13.4	13.7	15.2
Public sector deficit	-6.0	-5.9	-7.0	-3.9	-5.6	-7.0	-5.0
Domestic financing	1.5	4.5	5.8	2.2	4.4	2.2	0.9
Foreign financing	4.5	1.4	1.2	1.7	1.2	4.8	4.1
Current account deficit	-10.1	-5.4	-5.4	-3.0	-5.5	-6.4	-6.1

Sources: EBS/82/239 (12/29/82), p. 27; EBS/83/155 (7/28/83), p. 10; and SM/87/78 (4/2/87), p. 4.

1/ Includes capital revenue.
2/ Central government current expenditure plus public sector capital expenditure.

Table 13. Dominican Republic: Domestic Price Developments, 1981-84

(Annual percentage change)

	1981	1982	1983	1984
Retail prices of energy products				
Gasoline	7.5	--	-10.5	28.3
Diesel	18.6	--	--	95.7
Kerosene	12.8	--	--	106.2
LP gas	16.7	--	--	19.0
Fuel oil	38.3	--	--	207.7
Electricity				
Residential	--	16.1	-2.0	3.0
Commercial	--	20.9	1.9	-3.0
Industrial	--	21.8	1.3	2.0
Public sector	--	19.1	--	1.9
Consumer price index	--	7.6	7.0	24.4

Source: SM/87/78 (4/2/87).

availability of foreign exchange for imports of raw materials, staple foods, and medicine, as well as by prohibiting imports of automobiles and other products deemed nonessential. But, as explained below, the depth and breadth of adjustment necessary was not perceived by the authorities till after the breakdown of the program.

b. Major features of the program

The program aimed at a reduction of the external imbalance and increases in both investment and domestic savings. During the course of the program, from 1982 to 1985, the external current account deficit was to be reduced from 5.4 percent to 2.6 percent of GDP. Fixed capital formation and domestic savings were to be raised from 20.8 percent to 22 percent of GDP, and from 15.4 percent to 24.6 percent of GDP, respectively.

The program identified sets of policies to be pursued under the arrangement in a number of areas. On the supply side, the program aimed at increasing public investment in infrastructure in the construction, energy, and agricultural sectors, and at promoting market-oriented private investment in areas such as agriculture, export-oriented manufacturing, and tourism, where the Dominican Republic would have a comparative advantage, as well as in low-cost housing construction as a means of generating employment in the short run. Such policies to promote investment in these areas would be supplemented with an expansion of credit to the agricultural sector in general and to small-scale agriculture in particular. On the demand side, the program assigned fiscal policy a prominent role through a major tax reform, including the introduction of a value-added tax, improvements in tax administration, changes in the expenditure structure and expenditure control, and improvements in the operational efficiency of the state enterprises. In the area of external policy, the emphasis was on the adjustment of the effective exchange rate of the peso and reform of the exchange system. The program aimed to facilitate the unification of the official and the parallel exchange rates by further expanding the scope of the parallel foreign exchange market.

For 1983, the first year of the arrangement, the program set a target of a slight increase in real GDP growth from 1.6 percent in 1982 to 2 percent, with a significant acceleration of inflation, possibly reflecting the lagged effects of the large credit expansion in 1982. With a slower deterioration in the external terms of trade, but a substantial recovery of export volume, the program projected a deceleration of the compression of import volume from 18.8 percent in 1982 to 8.8 percent. The external current account deficit was expected to be reduced from 5.4 percent of GDP in 1982 to 3 percent. To support these targets, the program aimed at reducing the nonfinancial public sector deficit from 7 percent of GDP in 1982 to 3.9 percent, on the basis of major revenue efforts by the Central Government and cuts in current expenditures of both the Central Government and the rest of the public sector. The growth of net domestic credit was programmed to decelerate from 43.7 percent in 1982 to 19.9 percent, as a result of a drastic cut in the expansion of credit to the public sector; the expansion of credit to the private sector was programmed to accelerate somewhat. In addition, the program included a number of other measures concerning external payments and import restrictions and limits on the disbursements of external debt.

c. <u>Outcome of the program</u>

Since the program was interrupted after the purchases for the first year of the program, discussion is focused on economic developments in 1983.

In 1983, real GDP grew by 3.9 percent, significantly in excess of the 2 percent targeted in the program. The more-than-expected growth resulted from recoveries of outputs in the mining, construction, and housing sectors, which were depressed in 1982. However, the external imbalance worsened substantially. The current account deficit increased from 5.5 percent of GDP in 1982 to 6.1 percent in 1983, considerably in excess of the originally targeted level of 3 percent, and in contrast to a substantially more favorable outlook assessed at the time of the mid-year review in July 1983. This unexpected deterioration of the external balance resulted largely from a rapid increase in imports.

The policy stance was more expansionary than programmed. The public sector deficit exceeded the original target. The proposed value-added tax, which was to be introduced as a prior action, was not introduced until late November 1983. Also, about the middle of the year certain public investment programs were quickly implemented to alleviate the unemployment problem. In addition, although the expansion of domestic credit decelerated in 1983, increases in credit to both the public and the private sectors exceeded the originally programmed ceilings.

Key domestic prices remained relatively stable in 1983. The consumer price index (CPI) increased by 7 percent; this relative stability in the CPI was fairly widespread over major broad categories of goods (food, clothing, and housing) included in the basket. The retail prices of energy products were not raised in 1982 and 1983; the retail price of gasoline was reduced by 10.5 percent in 1983. The retail price of electricity was kept virtually the same in 1983 after increases ranging from 16 percent to 22 percent in 1982.

3. Assessment of impact on income distribution

a. Overview

The program aimed at a modest recovery of real growth and a significant adjustment in the external imbalance. To achieve these goals, the program projected increases in domestic investment and savings within the context of a reduced fiscal deficit, a deceleration in the expansion of domestic credit, and a real effective depreciation through greater reliance on a more realistic parallel exchange rate than on the official rate.

The program included a number of specific measures to reduce the public sector imbalance and to correct domestic price signals reflecting true costs, thereby improving supply and reducing the drain on the budget. Measures also aimed at attaining a competitive real effective exchange rate by expanding the transactions to which the parallel exchange rate would be applied, so that the primary export sector would benefit directly and the predominantly poor workers in that sector indirectly.

b. Revenue measures and their impact

As mentioned above, the three-year EFF arrangement became inoperative at the end of the first year. Tracing the revenue measures helps to understand the slow yet clear departure of actual events from what was envisaged at the beginning of the program (Table 14). In the request for the EFF (EBS/82/239), it was reported that the Congress had already approved certain changes in the tax system: (a) a 10 percent ad valorem surtax on all imports other than those of petroleum and other "essential" products; (b) a capital gains tax on the sale of property; (c) some modifications to the income tax, including higher progressivity; (d) an increase in automobile license fees; and (e) other unspecified minor tax changes. It was also reported that the Government had submitted a value-added tax (VAT) proposal to Congress that was expected to become law in April 1983 and was described as the major vehicle for broadening the revenue base and reducing dependence on foreign trade taxes. It would be levied at 6 percent on imports and on sales of domestic businesses--manufacturers, wholesalers, and retailers--with large turnover. (All these measures were expected to yield more than RD$160 million, i.e., about 1.8 percent of GDP on an annual basis.)

In the July 1983 review of the program (EBS/83/155), however, it became clear that the mainstay of the tax measures, the VAT, was not going to be introduced until January 1984. In its place, a 50 percent increase in cigarette excises had already been enacted, and an increase in excises on alcoholic beverages was being proposed. Further,

Table 14. Dominican Republic: Central Government Revenue, 1982-85

(In percent of GDP)

	1982	1983	1984	1985
Total revenue	9.5	10.8	11.3	15.4
Tax revenue	8.3	9.1	10.2	14.4
Taxes on income and profits	2.3	2.3	2.5	2.4
Of which:				
Personal	0.8	0.8	0.8	0.6
Corporate	1.4	1.4	1.4	1.6
Taxes on property	0.1	0.1	0.1	0.1
Taxes on goods and services	3.2	3.5	4.4	4.6
Value-added tax	...	0.1	0.8	1.1
Excises	3.2	3.4	3.6	3.5
Taxes on trade	2.3	2.8	2.8	7.0
Import duties	2.2	2.7	2.6	3.0
Export duties	0.1	0.1	0.2	4.0
Other taxes	0.4	0.4	0.4	0.3
Nontax revenue	1.2	1.7	1.1	1.0

Source: SM/87/78, Tables 14 and 28.

reimposition of a sugar export tax--which had been replaced in 1981 by an excess profits tax--was being considered. Thus the emphasis was on immediate revenue generation rather than on improvement of the tax structure. Also, since the first four months of the year demonstrated strong tax collections owing to improved tax administration, the authorities seemed to give less importance to fundamental tax reform measures.

The delay in introducing the VAT had severe revenue consequences. In addition, more commodities were exonerated from the VAT base than originally contemplated 1/ and, for the first year, it was decided that the tax would be applied only up to the importer-manufacturer level. At this point, the authorities proposed several minor tax policy and administrative measures for a possible second year of the program but were unwilling to modify expenditures in the budget proposals. This, together with disagreements with Fund staff over the multiple exchange system, led to the eventual breakdown of the program.

To sum up, tax measures actually taken by the authorities in 1983 were either discretionary or temporary: (a) increases in cigarette excises; (b) a 10 percent import duty surcharge on imports with the exception of petroleum products and essentials; and (c) improved administration. A much truncated VAT was introduced in late November. Structural measures recommended by the Fund were not implemented. Among these were: (a) the introduction of a capital gains tax upon the transfer of property (which, in the request for funds in 1982, had been reported as being already in place); (b) a limit on reinvestment deductions permitted on income tax declarations; (c) valuation of imports for import duty purposes at a rate equal to or near the free market exchange rate (the rate at which many of the imports concerned were entering) rather than at the artificially fixed par with the U.S. dollar; and (d) an increase in the specific excises on alcoholic beverages.

Before commenting on the impact of the tax measures on the poor, therefore, it is worthwhile keeping in mind not only the measures taken but also those recommended by the Fund. First, the measures recommended by Fund staff and rejected by the authorities would not have hurt the poor. The property tax would clearly fall on the upper-income groups. The Dominican Republic had an urban and rural cadastral survey and the introduction of a property tax systematically and over a long period was likely to generate steady and expanding revenue. However, even the suggestion of initially introducing the tax in the capital of Santo Domingo was rejected. It was well known that deductions permitted on the income tax returns for preferred sectors such as tourism, industrial development, and agricultural business had passed their usefulness,

1/ These included all manufactured items covered by excises (gas, cigarettes, liquor, and beer), all processed food, and intermediate goods (such as paper for cigarettes and bottles for liquor) going into the exonerated final goods.

causing tax avoidance and damaging efficiency. Yet even a 50 percent limitation on this tax provision was rejected. The recommendation for increases in the excises on alcoholic beverages was to reflect, to some degree, the increases in market prices. These products included high-quality beverages such as liquors consumed by upper-income groups; but the proposal was rejected in its entirety. The recommendation to value imports at or near the free market rate for calculation of duty was also to reflect correct prices. Inasmuch as the recommendation would have increased the base across the board, its consequences would not have hurt the poor disproportionately.

Second, the tax measures actually taken during the program were quite neutral. Improvements in administration would, if anything, hit tax evaders and the upper-income groups adversely. The 10 percent import surcharge left out essential imports and would, therefore, not affect the poor adversely. The increase in cigarette excises would affect all smokers, but the exact nature of its incidence would depend on the pattern of consumption. On the whole, therefore, it clearly cannot be concluded that the tax measures taken were detrimental to the poor, and the other measures discussed but not implemented by the authorities would probably have affected the poor even less.

c. Expenditure measures and their impact

The program target was for the overall deficit of the nonfinancial public sector to decline by 3.1 percent of GDP, from the 7.0 percent estimated (at the time for 1982) to 3.9 percent. This was to be broken down as follows: central government current account, 2.2 percent of GDP; current account of the rest of the public sector, 1.5 percent; and an increase in capital expenditure of the public sector, 0.5 percent. Current expenditure was to account for 1.7 percentage points of the improvement in the central government current account position. Nominal current expenditure was to be reduced by RD$66 million, with expenditure on wages and salaries being reduced by RD$35 million and current transfers to the rest of the public sector by about the same amount; other current expenditures showed small increases. On the wages front, the letter of intent and the text of the staff report indicate that civil service salaries above a certain level (RD$500 per month) were being reduced (salaries above RD$500 per month were being reduced according to a progressive scale); the Recent Economic Developments (RED) indicated that no provision had been made for an end-of-year bonus, implying that no bonus would be paid unless financial circumstances allowed. No firm indication of which organizations would bear the cuts in current transfers was given. While the documents did mention attempts to improve the efficiency of public enterprises, the enterprises in fact accounted for a relatively small share of current transfers to the public sector in 1982--about RD$8 million, or less than 10 percent of the transfers. The bulk of the transfers were accounted for by the university, the Agrarian Institute, and the local governments which accounted for RD$65 million or about two thirds.

Concerning the current account of the rest of the public sector, the program attributed the improvement of 1.7 percent of GDP to expenditure cuts, with only 0.1 percentage points coming from revenue. The program referred to improved efficiency and wage restraint in the enterprises and to efforts to reduce arrears in receivables, particularly from the Government; these measures were clearly in addition to those identified as contributing to the reduction in the deficit of 1.7 percent of GDP.

Ex post data on expenditures (Table 15) indicate that actual expenditures deviated significantly from program plans. Current expenditures were over 20 percent more than the program target and increased by 0.4 percent of GDP in contrast to the substantial decline of 1.7 percentage points targeted. Wage and salary expenditures increased by 5 percent, in contrast to the 8 percent decline programmed and current transfers to the rest of the public sector increased by 14 percent, in contrast to the 36 percent decline planned. The current operations of the rest of the public sector did not improve as programmed and capital expenditure exceeded program targets, largely reflecting a housing program introduced in mid-year.

It is difficult to conclude that there were adverse implications for poverty groups as a result of the expenditure policies. Current expenditure was to be cut (in nominal terms) in two areas. Regarding government wages and salaries, the cuts came into effect at a level equivalent to four times the minimum wage and were structured progressively; accordingly, it is unlikely that there were adverse implications for the poorer government workers. Regarding the cut in current transfers by the central government, there is no information on where the burden was intended to fall and what measures, if any, were being taken by the recipients in response. Similarly, it is difficult to attribute adverse consequences for the poor to the various measures to improve the operations of the rest of the public sector.

d. The role of subsidies and their implications

The program did not continue during the second year, and the role of subsidies in the economy appears to have been an important factor in its breakdown. Subsidies were provided through the exchange system as well as through the central government and the public enterprises. Therefore, some discussion of the background and ramifications of the subsidies is useful in understanding the lack of success of the program.

Petroleum products--some US$400 million in imports or about 4 percent of GDP--enjoyed implicit subsidies through access to the official exchange rate and, for a brief period in 1984, to a preferred exchange rate. It could be argued that low-income groups would not be able to afford the higher world prices of subsidized products. Even though the cost of public transportation--particularly the communal taxis--was a sensitive issue, owners of private cars and air conditioned homes as well as other urban (middle- and upper-class) households

Table 15. Dominican Republic: Central Government Expenditure, 1982-85

(In percent of GDP)

	1982	1983	1984	1985
Total expenditure	12.1	13.3	12.0	16.3
Current expenditure	9.6	10.2	9.4	13.2
Wages and salaries	5.4	5.2	4.7	4.2
Goods and services	1.7	1.9	1.8	2.0
Transfers	2.1	2.3	2.5	6.1
To rest of public sector	1.2	1.3	1.6	5.3
To private sector	0.9	0.9	0.9	0.8
Abroad	...	...	...	...
Interest payments	0.6	0.7	0.4	0.9
Other	...	...	...	...
Capital expenditure	2.4	3.1	2.6	3.1
Capital formation	1.4	1.5	1.0	1.2
Capital transfers to rest of public sector	0.9	1.3	1.4	1.8
Other	...	0.3	0.2	0.1

Source: SM/87/78, Tables 16 and 29.

consumed most of the imported petroleum, gasoline, electricity, and energy-intensive products and, therefore, captured most of the subsidy. Similarly, medicine subsidies benefited the urban population more if medical attention is used as an index of consumption. 1/

Food subsidies might have been progressive for food consumers if targeted to the lower-income groups, but most of INESPRE's subsidy costs were for rice, sold at more than 10 percent below cost and consumed more on a per capita basis by the rich than by the poor. 2/ In addition, the food subsidies were linked to price repression of goods produced by poor farmers that, by themselves, had adverse consequences and needed to be removed. The financing mechanism for INESPRE's subsidy program also exacerbated the negative impact on the poor since it was financed mainly through the profits of CEA, the public enterprise for sugar. The potential investment forgone because of the subsidies not only left the economy vulnerable to future external shocks but also implied less investment for the traditional export sector with concomitant sacrifices in the employment of the poor agrarian labor force.

Subsidization through the exchange regime or through inflationary finance was therefore undesirable from the viewpoint of improving the status of the poor. It also extended and aggravated the balance of payments problem. The authorities may have been able to finance the subsidy on basic goods, provided substantial progress was made in the removal of subsidies from petroleum and petroleum products such as electricity. However, they chose to keep the subsidy on petroleum products and decided to finance it partly by generating revenue from increased prices for food and medicine. On the whole, while price reform was the bone of contention throughout the discussions, it was intertwined with a search for other avenues of financing the subsidy on basic goods.

1/ The 1981 Census of National Population and Housing, Office of National Statistics, reveals that the percentage of urban and rural households using electrical appliances such as refrigerators, ovens, irons, radios, and television sets was about 50 percent and 10 percent, respectively. Again, in the three regions in the country mentioned above, medical attention on a per capita basis increased as rurality decreased.

The World Bank has suggested that, for every RD$100 million that went into nonfood subsidies in this period, as much as RD$85 million might have gone to families in the upper 20 percent of Dominican households.

2/ The World Bank, for example, has argued that the wealthiest 40 percent of the population received two thirds of the overall rice subsidy provided by INESPRE. Later, in 1984, INESPRE introduced a subsidy mechanism categorized by grades of rice in order to target the subsidies toward the more vulnerable groups but, as could be expected, surveillance was found to be very difficult.

Thus, when INESPRE announced price rises for basic goods, the subsidization of petroleum continued even as its imports were transferred to an intermediate exchange rate. About US$200 million of imports of goods and services, US$50 million of medicine imports and US$10 million of INESPRE's food imports were transferred to the free exchange market. A rate of US$1 = RD$2 was used by the authorities for calculating the announced price increases in various food items. To protect low-income consumer groups, low grades of chicken, eggs, rice, milk, and spaghetti were not affected, while their higher grades as well as butter, soap, soy oil, wheat cereal, and tomato paste were affected in varying degrees. The price of flour was raised, but that of bread was not, so that no bread was available in the market. This may have led to the disturbances that erupted following the announcement of price changes.

To the end, the authorities interpreted their problem as manageable without serious exchange or fiscal reform, and perhaps with foreign aid. When it became clear that such an option was not available, the authorities chose the package of food price increases with only a gradual elimination of petroleum subsidies. Eventually, petroleum product prices had to be raised by 60 percent in August 1984, which permitted a substantial increase in revenue and involved sizable overadjustment. 1/

4. Concluding remarks

To summarize, the authorities had been providing subsidies to consumers of food, medicine, petroleum, and petroleum products through a multiple exchange rate system as well as through INESPRE. They seemed unable to stop providing subsidies for petroleum through the exchange system. They did try, however, to correct the subsidies for food and medicine through the exchange system as well as through INESPRE and announced higher prices for these items. However, given the extent of the balance of payments problem caused by petroleum (relative to food and medicine) imports, the Fund would have preferred the removal of petroleum subsidies. The authorities faced strong urban opposition to their policy. The program broke down because of a lack of financial discipline in the first year and, probably, an insufficient adjustment in the exchange rate. Also, agreement could not be reached on a package of measures for the second year that was consistent with the objectives of the EFF.

1/ It is also noteworthy that the Fund recommendation to raise the exchange rate used for the valuation of customs duties, to reflect better the rising cost of imports made through the free foreign exchange market, was also implemented at this time. As a result of these measures, total revenue rose by some 30 percent in 1984.

IV. Ghana: The 1983-85 Programs: The Implications for Poverty

In the case of Ghana, two back-to-back stand-by arrangements were selected for analysis. In April 1983, the authorities undertook a three-year economic recovery program (ERP) by means of a stand-by arrangement in the amount of SDR 238.5 million (150 percent of quota) (EBS/83/140). The second part of the ERP was also eventually supported by a second stand-by arrangement in the amount of SDR 180 million (88 percent of quota) (EBS/84/172) for the remainder of 1984 and 1985. Ghana made all purchases under both programs upon meeting the relevant performance criteria and successfully completing two reviews. The present analysis, therefore, pertains to both stand-by arrangements that supported the authorities' ERP.

1. The economy, the poor, and the institutional setting

a. The economy

Ghana is primarily an agricultural country. Agriculture employs nearly 70 percent of the working population and accounts for over 40 percent of the country's GDP. Only 11 percent of the land area is cultivated, half of which is used to grow cocoa, the country's principal commercial crop, which generally provides over 60 percent of export earnings. The timber and mining industries, although estimated to be working at only 25 percent of capacity, are next in importance after agriculture, with gold, bauxite, diamonds, and hardwoods as major sources of foreign exchange (Table 16). The country is well endowed with a broad spectrum of natural resources, including offshore crude oil.

The services sector, consisting mainly of trade and related activities, accounts for about 36 percent of GDP. The manufacturing sector, representing about 16 percent of GDP, is diverse and well developed compared with most African countries. The country had a relatively advanced economic and social infrastructure in the early 1970s, but several years of deteriorating economic conditions caused a serious erosion in its productive capacity.

b. Socioeconomic characteristics of the poor

Statistical information on the socioeconomic characteristics of the population is not systematically collected, but the prolonged recession of recent years has sparked certain attempts at identifying the most vulnerable groups in Ghanaian society. According to UNICEF, 1/ in the early 1980s between 65-75 percent of the rural population and 45-50 percent of the urban population could be classified as below the absolute poverty line. 2/ Table 17 shows an approximate distribution of

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1/ UNICEF (1985).

2/ These numbers are based on an extrapolation of the World Bank definition of the absolute poverty line in 1978, which was identified as US$307 per capita in urban areas and US$150 per capita in rural areas when per capita GDP was US$390.

Table 16. Ghana: Sectoral Composition of GDP, 1985

(In percent)

Agriculture, forestry, and fishing	41.1
Industrial production	15.5
Transport, storage, and communications	7.2
Distribution and other services	36.2
GDP	100.0

Source: International Monetary Fund, SM/87/92.

Table 17. Ghana: Distribution of the Poor by Sector, Early 1980s

(In percent)

Urban	37
Low-income formal	7
Informal	30
Rural	63
All regions except north	43
Northern farmers	20
Total	100

Source: UNICEF (1985).

the poor by sector, and according to this table, 7 percent of the poor are located in the urban low-income formal sector, and 30 percent in the informal sector. No distinction is made between small agricultural holders and landless laborers, but although over 40 percent of the rural poor are spread across the country one particular region--the North--accounts for an additional 20 percent of the total population in poverty.

Regional disparities have not altered significantly over the years. The northern, upper east, and upper west regions stand out as the poorest, both in their urban and rural areas. The particularly severe conditions in the northern part of the country reflect a near collapse of the few previously available social services during the years of the recession.

Nonetheless, the most vulnerable group during periods of recession remain the urban poor. According to one indicator (the percentage of children with significant malnutrition), 82 percent of all health centers in Accra were in the highest priority category, compared with 73 percent in the upper region, 50 percent in the northern, and 27 percent in the rest of Ghana. 1/ The nature of poverty in urban slums reflects, apart from low incomes, overcrowding, malnutrition, inaccessibility to basic services, and gross environmental pollution. Therefore, in a comprehensive analysis of the impact of a stabilization program on the poor (which is not attempted here), it would be important to consider the channels through which policy measures might affect such welfare indicators.

c. The institutional setting

In 1985 total population was 12.6 million and was growing at a rate of 3.3 percent. The per capita income was SDR 540 (Table 18). There is considerable state participation in the major sectors of the economy. Virtually all of Ghana's major exports are produced and/or marketed by state-owned enterprises (SOEs), which also operate key economic infrastructure. In recent years Ghana has sought to develop its energy resources: offshore petroleum was discovered in 1970 and natural gas in 1980. The Ghana National Petroleum Corporation was established in 1983 to explore areas not covered by agreements with foreign companies.

The Government provides hospitals and medical care at nominal rates, and there is a government pension scheme. The major objectives of the military regime that assumed power in December 1981 are a

1/ Categorization of health centers by priority for strengthening, based on the percentage of children with significant malnutrition. Data are compiled by Catholic Relief Services.

Table 18. Ghana: Area, Population, and Income, 1985

Area	238,537 square kilometers
Population (estimate)	12.6 million
Population growth	3.3 percent
GDP per capita (estimate)	SDR 540

Source: International Monetary Fund, SM/87/92.

reduction in the illiteracy rate (which in 1970 was 70 percent), the improvement of child welfare, and the expansion of social legislation. Ghana is a member of the Economic Community of West African States. Overseas aid comes mainly from the European Community, the United Nations, the People's Republic of China, Canada, and the United States.

2. The 1983-85 programs and outcome

a. Background: economic developments prior to adoption of the program

The Ghanaian stand-by arrangements were negotiated under special circumstances. Despite Ghana's abundant natural resources--fertile land, valuable minerals, abundant timber, and substantial hydroelectric power--which in the 1960s supported the country's enviable position as the world's largest cocoa producer along with a relatively large and diversified manufacturing sector, the economy experienced a steady, devastating downward spiral for a decade from the early 1970s. In 1982, real per capita income stood at its lowest since 1970, having declined by 30 percent, real export earnings had fallen by 52 percent owing primarily to cocoa exports, import volumes had fallen by a third, domestic savings had declined from 12 percent of GDP to 3 percent and investment from 14 percent of GDP to 4 percent, and average inflation per annum was 44 percent.

The economic decline was affected by such exogenous factors as two severe droughts and a deterioration in the terms of trade reflecting intermittent oil price increases. In the early 1980s, the situation was especially exacerbated by the most severe drought since independence, the 1981 increase in oil prices, as well as the influx of an additional 10 percent into the population of emigrants returning from Nigeria.

However, domestic policies were also misaligned enough to have resulted in such a significant economic decline. The exchange rate remained virtually unchanged and overvalued through the decade, leading to export declines, protracted exchange crises, restrictive import regimes, and adverse implications for infrastructural and capital imports. To complete the vicious cycle, this made the harvesting, storage, transport, and export of cocoa increasingly difficult, and the diversified manufacturing base narrower. Another effect of the overvalued exchange rate was the diversion of trade from normal channels and the decline of the foreign sector relative to total economic activity. However, as a result of the decline in economic activity, the external accounts of the country were kept within manageable limits throughout the 1970s. The current account balance of the balance of payments was negligible as a percent of GDP for most years between 1978 and 1982. Similarly, Ghana's outstanding external debt remained low by the standards of many developing countries and in fact declined from

8 percent of GDP in 1978 to under 3 percent in 1982. Finally, the debt service payments, while rising steadily over the period, did not exceed 11 percent of merchandise exports (EBS/83/140).

Accelerating domestic inflation reflected expansionary credit and fiscal policies. At the same time, the revenue base contracted with international trade, since exports and imports comprised the primary revenue sources. Interestingly, the deteriorating economic situation was not marked by a growing government deficit; indeed, the deficit as a percent of GDP declined from 7.4 percent in 1977/78 to 4.6 percent in 1982. Rather, the fiscal problems were reflected in a decline in the size of government as the revenue base eroded dramatically. Revenue as a percent of GDP fell from over 10 percent in 1978/79 to 6 percent in 1982 (Table 19). Consequently, the expenditure to GDP ratio fell in the same period from close to 18 percent to 10.2 percent, with current expenditure falling from 14 percent to a little over 9 percent, and capital expenditure from over 3 percent to less than 1 percent (Table 20). By 1982, real public sector wages had fallen to 16 percent of their 1975 level. Declining real wages in both the public sector (as the size of government shrank) and the private sector (as its size contracted) led skilled workers to emigrate, draining the economy of manpower resources. Another ramification of the compression of government was that expenditure on social services suffered and human welfare indicators deteriorated markedly. Thus, not only economic infrastructure but also social infrastructure was extensively damaged by the end of 1982 when the authorities requested a stand-by arrangement with the Fund.

b. Major features of the programs and outcome

(1) The programs

In April 1983, the Provisional National Defense Council (PNDC) launched a three-year ERP developed in close consultation with the Fund and the World Bank. In May 1983, a one-year stand-by arrangement was negotiated and in August it was approved by the Executive Board for an amount of SDR 238.5 million (150 percent of quota). At its end, in August 1984, the Board again approved a 16-month stand-by arrangement for SDR 180 million (88 percent of quota) in support of the second half of the ERP.

The ERP involved fundamental changes in economic policy geared toward sustainable growth and a viable balance of payments position in the medium term by: (a) correcting relative prices to encourage production and exports; (b) liberalizing price and import controls; (c) rebuilding economic and social infrastructure; (d) restoring fiscal and monetary discipline; and (e) encouraging private investment.

To improve the allocation of resources and the external position, the ERP emphasized a flexible exchange system. The central feature of the fiscal program was the re-establishment of the revenue base, which,

Table 19. Ghana: Government Revenue, 1981-85

(In percent of GDP)

	1981/82 1/	1982	1983	1984	1985
Total revenue and grants	6.0	6.0	5.5	8.3	10.8
Tax revenue	5.4	5.1	4.6	6.6	8.7
Income and profits	1.7	1.8	1.0	1.5	2.0
Corporate	--	0.9	0.5	0.9	1.2
Personal	--	0.9	0.5	0.6	0.8
Goods and services	2.6	2.5	0.9	2.1	2.5
General sales	--	0.3	0.8	0.2	0.6
Excise	--	2.2	0.1	1.9	1.9
International trade	1.1	0.9	2.7	3.0	4.2
Imports	--	0.8	1.1	1.2	1.8
Exports	--	--	1.6	1.8	2.4
Other	--	0.1	--	--	--
Nontax revenue	0.5	0.9	0.9	1.4	1.7
Grants	0.1	0.1	--	0.3	0.4

Source: International Monetary Fund, SM/87/92 and SM/85/252.

1/ Fiscal year. From 1982 onward the fiscal year coincides with the calendar year.

Table 20. Ghana: Economic Classification of Government Expenditure, 1981-85

(In percent of GDP)

	1981/82 1/	1982	1983	1984	1985
Total expenditure	13.2	10.2	8.0	9.8	12.3
Current expenditure	11.3	9.3	7.4	8.6	10.4
Wages and salaries	3.9	2.5	2.0	1.9	3.9
Other purchases of goods and services	2.7	2.0	1.9	3.8	3.5
Interest payments	1.8	2.5	1.2	1.3	1.4
Subsidies and transfers	2.9	2.3	2.2	1.6	1.6
Capital expenditure	1.9	0.9	0.6	1.2	1.9
Fixed capital formation	1.6	0.8	0.5	1.1	...
Transfers	0.3	0.1	0.1	0.1	...
Net lending	0.5	0.4	0.2	0.3	0.6
Total expenditure and net lending	13.7	10.6	8.2	10.1	12.9

Source: International Monetary Fund, SM/87/92.

1/ Fiscal year. From 1982 onward the fiscal year coincides with the calendar year.

in the first year of the program, was to be achieved through restructuring relative prices (including a large depreciation) and reviving the base of international trade.

(2) Outcome of the programs

The first year of the program, 1983, did not witness the revival of economic activity, since real GDP fell by nearly 5 percent, reflecting the severe impact of the 1982/83 drought and lags in disbursements of concessional assistance. As a result, the overall supply was lower (owing to both lower domestic production and lower imports), and prices rose much more than envisaged. Both revenue and expenditure experienced shortfalls from the estimates, yet the deficit-to-GDP ratio was lower than programmed owing to reduced public sector activity (Table 21).

The program picked up from 1984, however, with increases in agricultural, mining, and manufacturing output. Real GDP increased by nearly 9 percent in 1984 and 5 percent in 1985. At the program's end, the supply situation eased as food, consumer items, and spare parts reappeared in the market place. This was the result of the removal of practically all restrictions on imports as well as the decontrol of most administered prices. In cases where administered prices were still in effect, such as in the case of petroleum, the impact of the currency depreciation was fully passed through. The cocoa producer price has more than doubled in real terms since 1983. Exports of cocoa rose from a low of 159,000 metric tons in 1983/84 to an estimated 198,000 metric tons in 1985. Demand management and an expanded revenue base led to a fall in the deficit-to-GDP ratio from 4.6 percent in 1982 to 2.5 percent in 1985. Tighter credit policy by means of raised interest rates with a view to achieving positive real rates led to a fall in inflation from 123 percent in 1983 to 10 percent in 1985. The overall balance of payments deficit was reduced substantially from US$243 million in 1983 to US$117 million in 1986. External arrears were brought down, as a result, from US$440 million in 1983 to US$175 million at end-December 1985. The stand-by arrangements are therefore considered to have been successful in meeting their economic objectives.

3. Implications for poverty groups

a. Overall macroeconomic and other nonfiscal policy measures and implications

(1) General considerations

For an agricultural country like Ghana, it is clear that the distributional impact of the adjustment program has had a differential impact between the rural sector and urban dwellers. In assessing, therefore, the distributional implications of the ERP it is important to isolate the instruments that primarily affected the rural sector from those that affected urban workers. Yet it is important to keep in mind

Table 21. Ghana: The 1983-85 Programs

	1981	1982	1983		1984		1985	
	Actual	Actual	Program	Actual	Program	Actual	Program	Actual
			(Annual percentage change)					
Real GDP	-3.8	-6.9	1.7	-4.7	5.4	8.7	5.3	5.1
GDP deflator	80.4	27.9	--	123.3		35.3	25.6	31.2
Consumer price index	116.5	22.1	50.0	123.1	35.0	39.7	20.0	10.3
Trade volume								
Export	-10.0	8.0	-6.0	-27.9	22.3	2.0	28.2	21.1
Import	-4.0	-35.0	-67.5	-9.6	1.9	26.9	32.9	10.9
Terms of trade	-30.0	-19.9	1.0	6.8	31.0	30.2	-10.1	-5.9
Effective exchange rate depreciation								
Nominal	6.3	5.2	...	-58.3	...	-75.4	...	-27.0
Real	4.4	30.4	...	-32.8	...	-61.4	-20.0	-27.3
Net domestic credit								
Public sector	63.2	3.8	25.1	23.3	8.5	9.7	8.8	12.5 1/
Private sector	42.6	16.1	...	81.9	...	78.8	...	70.4 1/
Cocoa financing	89.2	88.2	...	43.0	...	568.7	...	269.4
Broad money	51.9	23.7	...	38.1	...	72.0	31.7	59.5
			(In percent of GDP)					
Budget deficit								
Before grants	...	-4.6	-3.1	-2.7	-2.2	-2.1	-3.1	-2.5
After grants	-7.7	-4.6	-3.1	-2.7	-2.2	-1.8	-2.6	-2.0
Revenue and grants	6.0	6.1	...	5.6	8.3	8.4	11.5	10.8
Expenditure	13.7	10.6	...	8.2	10.5	10.2	14.6	12.8
Domestic bank financing	...	0.4	...	1.4	...	1.1	...	0.8
Current account deficit								
Excluding grants	...	-0.6	...	-0.5	...	-2.8	...	-3.9
Including grants	-1.5	-0.3	-10.0	-0.3	-4.2	-1.0	-5.9	-2.3
Memorandum item:								
GDP (in billions of cedis)	74.3	86.5		184.0		270.6		373.0

Sources: International Monetary Fund, EBS/87/68, SM/87/92 (for 1983, 1984, and 1985 data); SM/87/92, EBS/87/92 (for 1982 data), EBS/84/112 (for 1984 program figures), EBS/86/224 (for 1985 program figures), and EBS/83/140 (for 1983 program figures); and SM/85/252, SM/87/92, and EBS/85/211 (for 1981 data).

1/ Broad coverage of the banking system, including secondary banks.

that Ghana's two stand-by arrangements produced considerable growth, from which all segments of the population have benefited since 1984. The real question, therefore, is the distribution of benefits from the adjustment effort within the urban and the rural sectors. Such a question, i.e., an intrasectoral comparison, is much more difficult to answer than a comparison between the two sectors.

(2) Monetary and credit policies

Overall monetary and credit developments during the 1983-85 period showed a break with past trends in important respects. Unlike the earlier periods, when the Government's financing needs tended to crowd out credit demands by the private sector, the Government's recourse to bank financing was greatly reduced under the Fund-supported ERP. Thus, in 1984, domestic credit expansion to the public sector increased by under 10 percent, compared with 80 percent for the private sector; similarly, in 1985, domestic claims on the Government rose by 13 percent, compared with 70 percent on the private sector (Table 21). The availability of sufficient credit for the private sector was instrumental in the recovery process, especially in terms of financing the imports of raw materials and spare parts after the sharp devaluation of the cedi in April and October of 1983.

At the same time, a substantial portion of the net domestic asset expansion in 1984 and 1985 was absorbed for financing the activities of the Cocoa Marketing Board. Although part of the large increase (about 570 percent in 1984 and nearly 300 percent in 1985) could be explained by higher-than-projected cocoa purchases, another important factor was the deterioration of the Board's liquidity position as a result of large payments of cocoa duties to the Government. On balance, therefore, the financing needs of the public sector may have been higher than the definition of government, in a strict sense, implies. Nevertheless, the rate of credit expansion to the private sector, coupled with a large exchange rate adjustment, improved the profitability prospects of the export- and import-competing sectors, and there was some redirection of credit toward export and import trade, as well as toward the manufacturing sector, away from nontraded goods activities.

With the possible exception of a direct impact on the distribution and accumulation of assets, the effect of which would be minimal on the Ghanaian poor, monetary policy typically affects income distribution through the price and supply responses to demand management policies. In that respect, monetary policies in Ghana under the ERP clearly benefited the lower-income groups through the substantial economic recovery experienced under the adjustment programs.

The rise in the nominal incomes of the rural poor must have been originally mitigated by the sharp increase in the inflation rate (123 percent in 1983), although in later years inflation declined considerably (40 percent in 1984 and 10 percent in 1983). Characteristically, the rural consumer price index has risen more than its urban counterpart, reflecting an oligopolistic environment, transportation costs, and general excess demand conditions (Table 22). Assuming, however, that a large part of household consumption in rural areas is not marketed, it is safe to conclude that monetary expansion benefited the rural and the urban sectors equally, and that the real incomes of the rural population were not disproportionately eroded during the first period of the ERP.

(3) Pricing and labor market policies

The centerpiece of the ERP was the substantial devaluation of the cedi and the subsequent realignment of producer prices, especially of cocoa. Given the structure of agricultural production in Ghana, namely, the heavy concentration of small-scale producers, the doubling of the cocoa producer prices undoubtedly benefited the poorer producers of that crop. The minimum wage, which by 1983 had declined in real terms to only 13 percent of its 1975 level, was doubled at the start of the program in 1983 and was almost tripled at the beginning of 1985, thus contributing an important progressive element in the ERP (Table 23). Similarly, public sector wages were raised substantially to compensate for the past serious erosion, and the differential between earnings of the highest and lowest levels in the civil service was widened. At the same time, however, prices were completely deregulated and manufacturers, retailers, and other traders were allowed to set their own prices freely without reference to the Prices and Incomes Board. In the absence of exact quantitative information, therefore, it is very difficult to assess the distributional impact of those measures, since the nominal incomes of both wage earners and the self-employed were raised, but their real position remains uncertain. However, price controls remained on 23 items, mainly basic food, clothing, and agricultural implements, in order to protect the lowest income groups. It may therefore be concluded that the wage and price measures of the ERP favored the urban poor, but their relative impact on the higher end of the income scale is not clear.

(4) Exchange rate and other external policies

The sharp devaluation of the cedi in 1983 and the subsequent discreet adjustments were the linchpin of the ERP. After a period of a grossly overvalued exchange rate, the cedi was devalued by 89 percent in terms of U.S. dollars in April 1983. A multiple exchange rate system was introduced as a transitional measure, but was abolished later in the year.

The rural poor benefited most clearly from the exchange rate policy under the ERP. The most important poverty groups are landless agricultural workers and smallholders in rural areas. These groups are engaged in the production of both tradable and nontradable commodities. The increase in producer prices made possible by the exchange rate action assisted directly the poor smallholders of export crops, particularly cocoa, and indirectly the landless laborers, through the expansion of rural employment.

Table 22. Ghana: Selected Consumer Price Indices, 1981-85

	Combined Index	Food	Beverages and Tobacco	Clothing and Footwear	Rent Fuel, and Power	Furniture, Furnishings, and Household Equipment and Operation	Medical Care and Health	Trans-port and Communi-cations	Recreation, Entertain-ment, Education, and Cultural Services	Miscella-neous Goods and Services
					(National consumer price indices)					
1981	868.7	828.5	1,178.8	926.7	654.4	1,207.0	727.1	789.1	744.2	890.2
1982	1,062.4	1,126.4	1,059.3	1,049.0	691.1	1,256.4	995.5	796.7	1,019.5	1,167.0
1983	2,357.4	2,754.6	2,302.8	2,085.5	1,721.9	2,429.1	1,991.6	1,608.4	1,406.6	2,255.1
1984	3,304.2	3,058.5	3,907.2	3,604.3	3,142.7	4,765.2	3,143.8	3,081.4	2,660.6	3,919.7
1985	3,647.2	2,717.7	4,901.5	4,643.7	3,372.8	5,404.0	4,100.2	4,741.5	4,435.3	4,997.1
					(Urban consumer price indices)					
1981	800.4	755.2	1,194.3	873.7	480.0	1,209.2	683.5	831.8	797.2	799.5
1982	997.6	1,059.3	957.7	950.0	563.0	1,288.4	937.6	897.0	1,063.9	1,039.6
1983	2,102.6	2,645.9	1,992.3	1,874.7	1,022.0	2,108.1	1,483.9	1,470.1	1,453.9	1,927.8
1984	2,959.7	2,932.4	3,916.2	2,062.1	1,735.5	4,389.1	2,339.8	3,139.2	2,689.8	3,613.5
1985	3,329.2	2,496.1	5,132.6	4,129.3	2,313.3	4,979.9	3,528.7	5,100.9	4,341.9	4,864.0
					(Rural consumer price indices)					
1981	938.5	903.3	1,166.3	970.4	1,048.6	1,205.6	749.1	714.8	655.5	969.3
1982	1,149.7	1,212.8	1,141.7	1,118.6	1,006.7	1,288.0	1,109.1	623.3	945.4	1,301.7
1983	2,457.1	2,637.8	2,383.7	2,150.9	3,321.2	2,701.8	2,024.3	1,769.6	1,237.2	2,387.3
1984	3,652.4	3,178.4	3,899.8	4,016.7	6,618.9	5,128.2	3,548.1	2,957.8	2,599.7	4,015.9
1985	3,973.6	2,939.4	4,531.7	5,034.9	5,992.1	5,809.6	4,389.4	4,051.4	4,591.5	5,000.9

Source: International Monetary Fund, SM/87/92.

Table 23. Ghana: Trends in Nominal and Real Minimum Wage, 1981-85

	Minimum Wage Cedis per day	Consumer Price Index 1975 = 100	Index of Real Minimum Wage 1975 = 100
1981	12.00	2,934.3	20.5
1982	12.00	3,588.6	16.7
1983	20.94	7,997.9	13.1
1984	32.92	11,162.7	14.7
1985	70.00	12,322.8	28.4

Source: International Monetary Fund, SM/87/92.

Although the beneficial effects of the exchange rate devaluation on the rural poor are incontrovertible, their quantitative significance is hard to determine. The official statistics do not reflect the existence of informal transactions and may, therefore, overestimate the importance of a devaluation on the incomes of agricultural workers. Specifically, the official statistics capture the sales of cocoa to the Cocoa Marketing Board, but not the possible smuggling of the crop to neighboring countries, which, in the presence of an overvalued currency, is a likely occurrence. Effectively, therefore, the incomes of the cocoa producers during the pre-adjustment period may have been underestimated and, consequently, it is difficult to quantify the beneficial distributional implications of the cedi devaluation for the rural sector.

The urban poor were faced with higher official prices for tradable goods following the devaluation and, to that extent, were hurt by the fall in the official exchange rate. However, the earlier reasoning about the existence of informal markets applies mutatis mutandis to the case of the urban poor as well. Specifically, official prices had become almost irrelevant during the pre-adjustment period, because transactions were principally carried out in black markets against prices that reflected the scarcity premiums of foreign exchange. It is an open question, therefore, to which extent the urban poor were adversely affected by the devaluation on the uses side of their incomes.

Over the medium term, all lower-income groups benefited from the devaluation, as it reduced the gap between the official and the parallel market exchange rate and thus limited the opportunity for politically powerful groups to appropriate scarcity premiums on tradable goods.

Since the exchange rate policy was the heart of the ERP, an indirect effect benefiting both rural and urban poverty groups was the Government's ability to expand the provision of social services, as the devaluation of the cedi revived the seriously eroded tax base for international trade taxes, which have traditionally been the primary revenue source for the budget.

b. Fiscal policy measures and their implications

(1) Revenue measures

On the revenue side, two specific measures with clear regressive distributional implications were increases in the beer and cigarette excises. After a short transition period, retail gasoline prices fully reflected import costs and exchange rate movements, thus enhancing the regressive nature of those fiscal measures. To the extent, however, that crude petroleum is used as an intermediate input in the production of other goods, the increase in petroleum taxes may have involved a progressive element.

A specific revenue measure with a desirable redistributive effect was the 1984 raising of the minimum exemption level and the lowering of the marginal tax rates of the personal income tax to correct for fiscal drag in earlier years. This measure corrected for the inequity between salaried workers and the self-employed, inasmuch as the latter had been able to evade the tax, whereas the former faced increasingly higher real tax burdens with rapid inflation. The sizable upward adjustments of the airport tax and the casino tax were also clearly progressive, as the introduction of a net wealth tax would have been mainly ineffective.

(2) Expenditure measures

On the expenditure side, the major policy instrument was the substantial upward adjustment of civil servants' salaries discussed earlier. The salary increases, however, were accompanied by the retrenchment of civil service and state enterprise employees with uncertain implications for overall income distribution.

Apart from the wage and employment policy of the public sector, other aspects of expenditure policy were influenced by the overall adjustment effort, in particular by the reconstruction of the tax base. Government spending, in other words, was constrained by the appropriate deficit target. As a result, in 1983 both current and capital expenditures declined as a percentage of GDP, before they recovered in the following two years. Within this framework, a shift in resource allocation toward primary health care and primary and secondary education occurred, which clearly benefited lower-income groups (Table 24). Beyond 1984, therefore, the social objectives of the adjustment effort began to be addressed.

4. Summary and conclusions

The ERP in Ghana between 1983 and 1985 was a successful adjustment effort, which also addressed income distribution, primarily through its supply-side policies. If the focus is on the relative position between the rural and urban sectors, the ERP benefited agricultural producers, notably cocoa producers, through a substantial rise in their nominal incomes and with the help of measures aimed at mitigating the adverse effects of price decontrols. Since the income distribution within the rural sector is narrow, little can be said about intrasectoral differences.

On the other hand, the ERP benefited the urban dwellers less than the farmers, although changes in the relative positions of income groups within the urban sector are much more difficult to measure. Overall it could be argued that the impact of incomes policy and tax measures is unclear and, in the absence of quantitative information, probably neutral. At the same time, expenditure measures appear to have benefited lower-income groups through the redirection of spending toward social programs. In sum, the poor urban dwellers appear to have been better off with the ERP than without it, with the change in relative income positions occurring in the upper parts of the distribution scale.

Table 24. Ghana: Functional Classification of Expenditure, 1981-85

(In percent of GDP)

	1981	1982	1983	1984	1985
General public services	2.8	1.6	1.9	2.2	2.5
Defense	0.5	0.5	0.4	0.6	0.9
Education	2.9	1.8	1.6	2.0	2.2
Health	0.9	0.6	0.4	0.8	1.2
Social security	0.7	0.7	0.3	0.4	0.6
Housing	0.2	--	0.1	0.2	0.2
Other community services	0.3	0.2	0.1	0.2	0.2
Economic services	2.7	1.9	1.7	1.9	2.9
Interest on public debt	2.0	2.5	1.2	1.3	1.4
Transfers to other levels of government	0.5	0.2	0.3	0.3	...
Total expenditure	13.5	10.0	8.0	9.9	12.1

Source: International Monetary Fund, SM/87/92.

V. Kenya: The 1983-84 Program: The Implications for Poverty

In March 1983, the Executive Board approved an 18-month stand-by arrangement with Kenya (EBS/83/41). This program was negotiated during late November and early December 1982, and the adjustment effort under the program started soon thereafter. The stand-by arrangement was for an amount of SDR 175.95 million (170 percent of Kenya's quota at that time). There were two reviews of the program (EBS/83/219, 10/6/83; and EBS/84/79, 4/5/84), both of which were successfully concluded. The program's performance criteria were met, and all drawings scheduled under the program were carried out.

1. The economy, the poor, and the institutional setting

a. The economy

Kenya is a low-income country, which in 1983 had a population of 18.7 million, growing at a rate of about 4 percent per annum. Per capita GDP in 1983 was about SDR 290. Agriculture is the dominant productive sector, accounting for roughly one third of total value added and about 70 percent of employment (Tables 25 and 26). 1/ It is heavily focused on two crops: coffee and tea; between 1981 and 1985, they accounted for 55 percent of the value of marketed agricultural production, almost entirely for the export market. Maize is the principal subsistence crop. Marketed production of maize, however, averaged only 7 percent of total agricultural marketed production and accounted for 25-30 percent of total maize production.

b. Socioeconomic characteristics of the poor

Poverty in Kenya is mostly a rural phenomenon. Using an income level of K Sh 2,000 (US$123) per year as a cutoff level for rural poverty 2/ and adjusting it for differences in food costs and mean household size reveals that 98 percent of the poor (as opposed to 90 percent of the population) lived in rural areas in 1974 (Table 27). 3/

Although other rural groups, such as pastoralists and landless laborers, contained a higher proportion of poor than smallholders, over 70 percent of the rural poor were smallholders. The large number of poor smallholders reflects the large share of smallholders in the total population.

1/ The agricultural sector was comprehensively covered in a World Bank sector report (Report No. 4629-KE, January 7, 1986).

2/ This income level conforms roughly to the level used by Crawford and Thorbecke (1978).

3/ The latest integrated rural survey was undertaken in 1974. After 1974, migration to urban areas caused the share of the population located in urban areas to rise to 20 percent by 1986.

Table 25. Kenya: Area, Population, and Income, 1983

Area	582,600 square kilometers
Population	18.7 million
Population growth	3.9 percent per annum
GDP per capita	SDR 290

Source: SM/86/284 (11/25/86), p. v.

Table 26. Kenya: Industrial Origin of GDP, 1983

(In percent)

Agriculture	29
Manufacturing	11
Government	13
Other	47

Source: SM/86/284 (11/25/86), p. v.

Table 27. Kenya: Poverty in Kenya, 1974

(Number of people in thousands and percent)

	Total Number	Number Below Poverty Line	Percent Below Poverty Line	Percent of Total Poor	Percent of Total Population
Urban	1,400	60	4.3	1.4	9.8
Nairobi	700	20	2.9	0.5	4.9
Other	700	40	4.7	0.9	4.9
Rural	12,895	4,150	32.2	98.6	90.2
Pure pastoralists	725	615	84.8	14.6	5.1
Pastoralists who farm	75	25	33.3	0.6	0.5
Migrant farmers	200	110	55.0	2.6	1.4
Landless with poor occupations	420	210	50.0	5.0	2.9
Landless with good occupations	245	--	--	--	1.7
Smallholders	10,340	2,990	28.9	71.0	72.3
Large farm squatters	600	200	33.3	4.8	4.2
Large farmers	290	--	--	--	2.0
Total	14,295	4,210	29.5	100.0	100.0

Source: World Bank (1982).

Since independence, the structure of production has changed its focus from large-scale production to smallholder production. Smallholders account for about 75 percent of total agricultural output, 55 percent of marketed output, two thirds of the land area devoted to arable agriculture, and over 70 percent of total employment. Most smallholders are not pure subsistence farmers; only an estimated 25 percent are engaged in pure subsistence production. Most settled areas of the country have extensive rural road networks linking farm households to markets and, occasionally, to employment opportunities. Smallholders purchase, on average, about half of the food they consume, with the other half coming from their own production. 1/

The role of smallholders is fairly large in the production of a number of export crops. While ownership concentration in the export- and import-substituting sectors is generally characterized as high, smallholders produce about 60 percent of the marketed production of coffee, 45 percent of tea, 45 percent of sugarcane, and almost all of the marketed production of rice, pulses, cotton, and pyrethrum.

Smallholders' incomes are correlated with both regions and agro-ecological zones. For example, the average household income in the coffee zones is about 75 percent higher than in cotton zones. Income levels are generally higher in zones east of the Rift Valley, while the Western and Nyanza provinces contain the highest proportion of poor households (about 50 percent and 38 percent, respectively). Smallholder poverty, however, is a complex phenomenon and is not merely a function of landholding size or ecological conditions. The extent of smallholder poverty is closely (and inversely) related to the use of purchased inputs and to the level of innovation, as measured by the adoption of cash crops, hybrid maize, and improved livestock. 2/ Smallholder incomes depend quite heavily on nonfarm sources, such as remittances of family members, 3/ and earnings from urban employment or from work on rural enterprises. For the average smallholder, such earnings were equivalent to about 75 percent of the farm operating surplus (Table 28). An analysis of differences in innovation and use of purchased inputs reveals that these differences are related to availability of financing from both loans and nonfarm income. The availability of loans appears to be closely related to the level of nonfarm income.

Urban poverty is still relatively limited, although the share of the urban poor in the total population appears to have risen since 1974, when the urban poor accounted for less than 1 percent of the total population. Most of the urban poor are unemployed or are in the urban informal sector. However, not all the unemployed are poor, because many

1/ Geer and Thorbecke (1986).

2/ World Bank (1982).

3/ Surveys indicate that about one fourth of the urban wage bill is remitted to rural areas (World Bank (1982)).

Table 28. Kenya: Characteristics of the Smallholder Poor

(In Kenya shillings per year)

	Income Class		
	0-999	1,000-1,999	Smallholder Average
Farm sales	191	586	1,192
Subsistence consumption	458	751	1,297
Wages paid	40	46	160
Purchased inputs	50	96	241
Own-produced inputs	13	47	84
Farm operating surplus	129	649	2,081
Nonfarm enterprise surplus	87	170	354
Other nonfarm income	335	666	1,217
Value of land	951	1,084	1,820
Value of building	850	887	1,796
Value of livestock	1,060	1,505	2,462
Total assets	3,150	3,954	6,905
Total consumption	1,611	2,166	3,450
No education (in percent)	83	87	72

Source: World Bank (1982).

unemployed are young dependents rather than heads of households. Similarly, the informal sector is not a homogeneous low-income sector; it includes both rich entrepreneurs and poor self-employed.

c. Institutional setting

The public sector plays a significant role in the economic and social development of Kenya. The Government is active in all sectors of economic life but does not dominate any. It has formulated comprehensive development plans and mobilized considerable domestic and external resources to carry them out and has contributed greatly to the growth of the country's social economic services and infrastructure.

In 1982, more than 200 parastatals were operating in Kenya. Their functions ranged from purely advisory to primarily regulatory and to direct involvement in production, marketing, and financial activities. In the period since 1982, the Government has been engaged in an effort to rationalize and improve the efficiency of the parastatal sector, but progress has been relatively slow.

One of the most important ways in which the Government affects the economy is through its pricing and marketing policies in the agricultural sector. The level of government intervention in pricing and marketing is relatively high. These price and market control systems evolved from policies set up during the colonial period to benefit large-scale farmers. Organization and control of marketing differ according to crop, but in general, restrictive controls apply more for domestically consumed food and industrial crops (chiefly maize, wheat, meat, milk, sugar, and cotton) than for export crops. All major crops have marketing boards or organizations, although the controls and functions exercised by these institutions differ. Large- and medium-scale producers sell chiefly through the marketing boards, while smallholders rely more heavily on local traders and cooperatives for many commodities such as maize, milk, cotton, sugarcane, and foodcrops. The Government sets official producer and consumer prices for a range of commodities, including maize, wheat, sugar, cotton, milk, and meat. Coffee and tea producer prices are not controlled but are based on world prices; consumer prices, however, are subsidized.

2. The 1983-84 program and outcome

a. Background: economic developments prior to adoption of the program

The program was one in a series beginning in 1979 that attempted to deal with the large financial imbalances that followed the coffee boom in the late 1970s. The fiscal situation in Kenya worsened dramatically in the late 1970s, with the overall deficit (before grants) of the Central Government, reflecting rapid growth of expenditure, reaching 10.3 percent of GDP in 1980/81, compared with 5.3 percent in

1977/78. 1/ In 1981/82, the deficit was reduced by 2.5 percentage points to 7.8 percent of GDP, entirely as a result of expenditure retrenchment. The expansionary policy stance over the period aggravated domestic inflation and the external imbalance. The increase in consumer prices accelerated from 9 percent in 1978 to 14 percent per annum during 1979/80, before jumping to 20.3 percent in 1981. The external current account deficit (before grants) averaged about 12 percent of GDP over the period 1978 to 1981. Spurred on by the expansionary policy stance, real growth had averaged about 5 percent a year between 1977 and 1981; however, with a population growth rate of close to 4 percent, per capita output grew at a rate of only 1 percent per annum.

The Government attempted to deal with the situation through a one year program in 1979 and a two-year program beginning in 1980; however, neither program was successful, as some of the performance criteria were not observed, and all the scheduled purchases were not made. A new program, approved by the Executive Board in January 1982, also failed to run its full course. Although some progress in addressing the financial problems was made (in particular, a reduction of the fiscal deficit from 10.3 percent of GDP in 1980/81 to 7.8 percent in 1981/82), a substantial shortfall in foreign aid receipts resulted in the breaking of the ceilings on credit to the Government, and it was not possible to bring the program back on track in the aftermath of the coup attempt in August. A significant reduction in the external current account deficit from 11.4 percent of GDP to 8 percent, achieved in spite of the effects of the world recession on export volume and the terms of trade, reflected to a large extent a more restrictive import policy and slow growth. In 1982, the increase in consumer prices moderated to 14.3 percent, compared with 20.3 percent in 1981, but the growth outlook deteriorated. The growth of real GDP in 1982, originally estimated at 4.5 percent, turned out to be 1.8 percent by the time of the revised program, not only because of demand-restraining measures taken by the authorities, but also because of the effects on business confidence of the coup attempt and the weak external markets.

b. Major features of the program and outcome

(1) Program

The objective of the 1983/84 program was to continue the balance of payments adjustment while providing an environment for a recovery of growth to a more acceptable rate. The program estimate of GDP growth in 1983 was 3 percent, compared with the 4.5 percent

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1/ The ratio of revenue to GDP increased by 1 percentage point of GDP over this period. The growth in expenditure was due to a rapid increase in current expenditure, from 20.4 percent of GDP in 1977/78 to 24.7 percent of GDP in 1980/81, as government employment increased by about 27 percent.

estimated for 1982 at that time; 1/ real GDP in 1984 was expected to grow by 4 percent. Inflation, as measured by the consumer price index (CPI), was to be reduced to 13 percent in 1983 and to 10 percent in 1984, compared with the 1982 level of 14.3 percent. The external current account deficit was targeted to decline from the 8 percent of GDP estimated for 1982 at the time of the program to 7.1 percent (Table 29). 2/

The main focus of policies was the fiscal sector. The central government deficit was to be reduced to 6.7 percent of GDP in 1982/83 from 7.8 percent of GDP in 1981/82, with a further reduction planned for 1983/84. 3/ While revenue measures were taken in December 1982 and again at the beginning of the 1983/84 fiscal year, it was anticipated that these would compensate only in part for the structural inelasticity of the revenue system and the decline in the contribution of import duties owing to the foreign exchange difficulties being experienced. Accordingly, all of the financial adjustment of the central government was to be borne by expenditure.

Credit to government was to be allowed to grow by 20.5 percent and 17.6 percent in 1982/83 and 1983/84, respectively, after expanding at a rate of 65.5 percent in 1981/82. Credit to the private sector was to expand at rates of 15.6 percent and 12.9 percent, after an expansion of 16 percent in 1981/82. As a result, overall domestic credit growth was to be reduced to 15.7 percent in 1982/83 and 14 percent in 1983/84, after expanding by 33.0 percent in 1981/82. To support the restraint of credit to the private sector, the authorities indicated in the letter of intent that the deposit and lending rates would be increased.

On the external side, the exchange rate was depreciated by 15 percent at the beginning of the program and was to be reviewed regularly by the authorities during the program to prevent any undesirable real appreciation. The authorities also indicated in the letter of intent their intention to liberalize the import regime during 1983.

1/ The Board paper presenting the request for the stand-by arrangement (EBS/83/41) estimated GDP growth at 4.5 percent for 1982, while the first review paper (EBS/83/219) put it at 2.7 percent; actual growth was 1.8 percent.

2/ The target for the external current account deficit for 1983 was subsequently reduced to 5.1 percent of GDP.

3/ Before grants. The target for the deficit after grants for 1982/83 was 4.7 percent. At the time of the first review of the program the deficit target for 1983/84 was set at 3.8 percent of GDP, with provision for an increase to 4.1 percent of GDP if sufficient additional foreign aid became available.

Table 29. Kenya: The 1983-84 Program

	Original Program				Revised Program					Actual			
	1981	1982	1983	1984	1981	1982	1983		1984	1981	1982	1983	1984
		Est.	Prog.	Prog.			Prog.	Est.	Prog.				
						(Annual percentage change)							
Real GDP	4.1	4.5	3.0	4.0	4.1	1.8	3.0	3.7	4.0	2.5	1.8	2.6	1.7
GDP deflator	9.7	14.4	12.2	10.0	11.0	10.6	12.2	15.8	10.6	12.2	10.7	9.3	9.2
Trade volume													
Export	0.0	-1.2	3.0	2.9	-5.1	-3.3	-0.1	2.6	0.5	-5.5	-2.9	-4.0	-1.0
Import	-21.5	-13.5	-4.0	5.1	-21.8	-17.8	-8.5	-10.6	10.0	-21.9	15.3	-21,0	17.7
Terms of trade	-13.5	1.4	-1.0	2.1	-13.5	-5.9	-0.7	2.5	7.5	-13.9	-4.8	-6.0	17.0
Effective exchange rate depreciation -													
Nominal	-14.5	3.0	...	...	-15.4	-11.7	...	0.0	...	-18.4	-13.4	-0.9	-1.7
Real	-6.7	...	...	...	2.1	-7.7	...	5.2	...	-10.8	-6.6	6.3	4.7
Net domestic credits 1/	24.2	33.0	15.7	14.0	20.0	26.9	14.8	6.4	14.2	19.1	26.9	6.4	8.9
Government (net)	83.4	65.5	20.5	17.6	74.6	55.1	20.3	-0.8	17.6	74.6	55.1	-0.8	3.2
Private sector	9.5	16.0	15.6	12.9	7.7	16.7	14.9	11.3	12.9	6.8	10.7	9.9	11.4
Broad money 1/	7.1	9.1	13.3	9.8	7.1	8.8	13.3	3.8	12.8	7.1	9.1	11.0	11.4
Budget deficit 1/ 2/													
Before grant	10.3	7.8	6.7	5.2	10.3	8.0	6.9	4.9	5.2	10.3	7.8	5.2	4.4
After grant	9.5	6.5	4.7	3.6	9.5	6.6	4.9	3.1	3.8	9.5	6.5	3.6	3.7
Revenue 1/ 2/	25.3	23.6	23.1	20.0	25.3	24.4	23.8	22.2	21.6	25.2	24.3	22.9	22.8
Expenditure 1/ 2/	35.8	31.6	29.8	25.4	34.8	33.1	30.8	27.4	26.8	34.8	32.1	28.0	27.2
Domestic bank financing	2.8	2.6	1.3	2.5	2.8	2.6	1.4	-0.2	1.4	2.8	2.6	0.1	1.2
Current account deficit													
Excluding grants	11.4	8.0	7.1	5.1	12.3	8.6	5.1	4.6	5.0	11.9	8.9	4.4	5.8
Including grants	10.2	7.1	5.9	3.6	11.1	7.4	3.4	2.7	3.4	10.7	7.6	2.3	3.5

Sources: Data on the original program are from EBS/83/41 (2/22/83) and EBS/83/219 (10/6/83) (for the program for 1984); data on the revised program are from EBS/84/79 (4/5/84); and data on actual developments are from SM/86/274 (11/10/86), p. 4.

1/ For fiscal years.
2/ The difference between expenditure and revenue is not equal to the deficit because of floating checks.

(2) Outcome

The program targets were in general met, and in some cases, overachieved. The external current account deficit declined from 8.9 percent of GDP in 1982, to 4.4 percent in 1983, and to 5.8 percent in 1984.

Credit targets were met. In 1982/83, the growth of credit was significantly below program targets, as adjustment of the government budgetary position was greater than planned (5.2 percent of GDP, compared with the revised program target of 6.9 percent); private sector demand for credit was weak, owing to a weaker-than-anticipated economy. The rates of growth of consumer prices were 10.1 percent and 10.8 percent in 1983 and 1984, respectively, after a 14.3 percent increase in 1982.

Developments in the real sector were less favorable than originally expected by the program. In 1983, real GDP growth was 2.6 percent, somewhat less than the 3 percent targeted, but up nevertheless from the 1.8 percent rate registered in 1982. In 1984, owing in large part to the effect of a drought, real output growth was only 1.7 percent. Despite reduced agricultural sector demand, output in the nonagricultural sector grew by about 3 percent. Aggregate employment growth recovered to 4.5 percent and 2.4 percent in 1983 and 1984, respectively, after increasing at an annual rate of 2 percent during 1981-82 (Table 30).

3. Implications for poverty groups

a. Overall macroeconomic and other nonfiscal policy measures and their implications

(1) Overview

Many of the poor in Kenya have limited contact with the market economy. As a result, the impact of policies on them is significantly reduced. This institutional background of the Kenyan economy should be kept in mind in assessing the distributional implications of the policy instruments adopted in connection with the program.

Judging the overall impact of the program on the poor is problematic, since it involves assessing the overall macroequilibrium effects of the program's policies in comparison with an appropriate counterfactual. The outcome in the real economy in 1983 and 1984 compares favorably with 1981 and 1982, after taking account of the effects of the drought on the 1984 outcome. Although the outcomes in 1981 and 1982 may have been affected by stabilization efforts and, in particular, by fiscal retrenchment in 1981/82, the average growth in GDP during 1983/84 was about the same as the average of 1981/82. The average earnings in the private sector declined somewhat in real terms in 1983, but recovered in 1984; the increase exceeded that for public

Table 30. Kenya: Employment and Earnings, 1981-85

	1981	1982	1983	1984	1985
	(Annual percentage change)				
Employment	1.8	2.1	4.5	2.4	4.9
Private sector	1.1	0	4.6	2.2	3.7
Of which: agriculture	0.6	-3.5	5.9	2.4	2.4
Public sector	2.7	4.4	4.4	2.6	6.1
Average monthly earnings	16.6	6.8	6.6	9.5	8.3
Private sector	12.6	6.5	7.4	11.5	9.3
Of which: agriculture	10.9	4.5	7.7	11.9	10.4
Public sector	20.4	6.7	5.9	7.7	7.2
Cost of living index	12	11	9	9	8

Source: SM/86/284 (11/25/86), pp. 26 and 108.

employees. The annual average increase in employment during 1983-84, at 3.4 percent, exceeded the average of 2 percent during 1981-82. The program was not specific on domestic commodity prices; however, reflecting in part the increase in world market prices of commodities, the increase in the average prices of 12 key commodities, including those substantially produced by smallholders, exceeded the increase in the CPI (Tables 31 and 32).

(3) Monetary and credit policy

The credit restraint had its primary impact on the availability of credit to government; private sector credit was programmed to rise in real terms at about the same rate as in 1982. Accordingly, the credit policies outlined in the program would not be expected to have an adverse impact on income distribution, except as a result of the constraints they placed on fiscal policy. It is also noteworthy that credit availability was not constrained by the credit ceilings during the first half of 1983, as slow growth affected private sector demand for credit.

(4) Exchange rate and other external sector policies

The adoption of the program coincided with a substantial devaluation, and the maintenance of a flexible exchange rate regime was an important policy objective. The conventional wisdom is that in countries where the poor are concentrated in rural areas, devaluation tends to have a favorable impact on the relative position of the poor in the distribution of income, insofar as exportables in these countries are produced in the rural areas. On this basis, the devaluation and the accompanying policy of maintaining the real effective exchange rate would be considered to have benefited the poor. Some of the adverse effects of the devaluation on urban real incomes may have offset some of the benefits to the rural poor because the urban workers may have reduced their transfers to rural family members. Whereas the prominence of plantations in the production of some export crops tended to moderate the extent of the direct benefits to the rural poor, a significant share of export production in Kenya originates in the smallholder sector. Some benefit from increased employment in rural areas would also be expected but, given the surplus labor conditions, little increase in wage levels.

Adverse distributional implications would also not be expected from the other external policy element of the program--the liberalization of the import regime. The major beneficiaries of these restrictions tend to be those with access to licenses, and greater freedom of import of producer goods can benefit production and employment.

Table 31. Kenya: Producer Price Developments, 1981-85

	1981	1982	1983	1984	1985
		(Annual percentage changes)			
Average of 12 commodities	...	13.2	15.6	18.7	7.6
Coffee	...	23.2	25.5	10.2	3.3
Tea	...	9.4	12.5	137.4	-35.1
Consumer price index	20.3	14.3	10.1	10.8	10.5

Source: Calculated from SM/86/284 (11/25/86), p. 107, p. 35.

Table 32. Kenya: Consumer Price Index Developments, 1981-85

	1981	1982	1983	1984	1985
	(Annual percentage changes)				
Total	20.3	14.3	10.1	10.8	10.5
Food	18.5	9.6	9.1	15.2	12.5
Nonfood	21.1	16.9	10.6	8.4	9.2
Low-income	19.3	13.3	10.0	10.9	10.4
Food	18.6	10.0	8.6	15.7	13.4
Nonfood	19.7	15.4	10.9	8.2	8.5
Middle-income	24.9	18.2	10.1	11.0	11.5
Food	18.5	8.3	10.5	13.9	9.0
Nonfood	28.4	23.7	9.9	9.6	12.6
High-income	18.9	17.5	10.3	7.5	8.6
Food	15.7	8.2	13.9	12.1	9.7
Nonfood	19.9	20.4	9.3	6.0	8.2

Source: SM/86/284 (11/25/86), p. 35.

b. Fiscal policy measures and their implications

Fiscal adjustment was a major element of the program and was supported by a tariff increase, accompanied by a liberalization of imports, and a substantial cut in capital expenditure. In terms of functional classification, the expenditure adjustment was directed largely at expenditures in the areas of public administration and defense.

(1) Revenue measures

Tax policy measures were taken in two steps during the program period. In the first step, with effect from December 1982, the following measures were taken to yield additional revenue equivalent to about 1 percent of GDP, on an annual basis, during December 1982-June 1983: (a) all import duties were increased by 10 percent; (b) rates of sales tax on petroleum products and beer were raised; and (c) excise taxes on cigarettes were raised. In the second step, with effect from the beginning of the 1983/84 fiscal year, the following measures were taken to yield about 0.5 percent of GDP during the year: (a) the general rate of sales tax was increased from 15 percent to 17 percent; (b) import duties above 30 percent were lowered by an average of 14.7 percent of the existing rate (to grant relief to manufacturers who exported their products, because every item on which duty was reduced faced a corresponding increase in sales taxes when sold domestically); (c) the air passenger tax was increased by 25 percent; (d) banking registration fees were increased; and (e) administrative measures in areas of income tax, sales tax, and customs were undertaken to ensure prompt receipt of revenue.

The nature of most of these measures would not suggest that their combined effect was to affect the poor adversely. The increase in sales tax on petroleum products could be said to have been progressive, while those on beer and cigarettes probably took a larger share of the income of the poorer sections of the community. 1/ Increases in bank registration and air passenger taxes are likely to have had a progressive effect, since they affect upper-income groups more adversely. Administrative measures to improve tax collections were also of a progressive nature, since they were focused on professionals and merchants who tend to be among the better-off.

Areas where it is more difficult to make a judgment are the increases in the general sales tax and import duties. The December 1982 increase in import duties was an across-the-board percentage increase of rates and, therefore, would not be expected to alter the existing distribution of the burden of this tax, which, given the high rates of

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1/ However, the increase in taxes on beer and petroleum were adjustments to specific rates and, hence, to a large extent merely preserved the real rate of taxation on the product.

duty for luxury goods, was unlikely to have been significantly regressive. The mid-1983 increase in the basic rate of sales tax might of itself seem regressive, but there was a simultaneous reduction of import duty on the less heavily taxed imports. Furthermore, the program measures were expected to offset the structural inelasticity of the Kenyan revenue system and not to lead to any increase in indirect revenues relative to GDP. Hence, the conventional wisdom that indirect taxes tend to be regressive and that the revenue measures in the program therefore had an adverse distributional impact should be applied carefully.

Some regressive elements may have existed, since exporters of manufactured goods who were granted some relief through the reduction of certain import duties and their replacement by sales taxes can be expected to belong to upper-income groups. However, this would depend on whether the burden of taxes on exports fell entirely on the exporter or whether the consumer also bore some of the burden.

During the program period, the revenue/GDP ratio declined from 24.3 percent in 1981/82 to 22.8 percent in 1983/84. The decline reflected the tax measures discussed above and the compression of imports (Table 33).

(2) <u>Expenditure measures</u>

The letter of intent indicated the amount of total expenditure cuts to be made in 1982/83 and the amounts of the cuts for some expenditure items. However, it soon became apparent that revenue would fall substantially short of budget projections. The authorities reacted with expenditure measures across the board, with current expenditures limited to essential outlays, and development expenditures to those with a minimum 70 percent externally funded, or with 90 percent of the work already completed. For the expenditure program for the fiscal year 1983/84, the program documents provide little information on how restraint was allocated across various items of expenditure. Hence, to evaluate the distributional consequences of the expenditure adjustments adopted by the Kenyan authorities, it is necessary to examine the ex post expenditure data to see which programs absorbed the major shares of adjustment, bearing in mind that the scale of the cutbacks adopted and their distribution across programs were the authorities' decisions rather than integral parts of the adjustment program's design. This is particularly valid since the authorities overachieved their deficit and expenditure targets.

Before making this examination, however, the expenditure cuts announced in the letter of intent and identified in the original program paper (EBS/83/41) should be considered. Expenditure cuts relative to the original budget for 1982/83 amounted to 1 percent of GDP, and about 70 percent of these cuts were to be made in the development budget. Not all the items to be cut were identified individually in the letter of intent. Those mentioned were road construction (20.5 percent of the

Table 33. Kenya: Central Government Revenue, 1980-85

	1980/81	1981/82	1982/83	1983/84	1984/85
	(In percent of GDP)				
Total revenue	25.3	24.3	22.9	22.8	22.6
Tax revenue	21.8	21.4	19.7	20.1	19.7
Income and profits	7.0	6.2	6.4	6.2	6.4
Goods and services	9.1	8.8	8.1	9.0	9.7
Sale taxes	6.3	6.1	5.4	6.3	6.1
Excise taxes	2.1	2.0	2.0	2.0	2.8
Other	0.6	0.7	0.7	0.7	0.8
International trade	5.6	6.3	5.0	4.7	4.3
Imports	5.1	6.1	4.8	4.5	3.7
Exports	0.5	0.2	0.2	0.2	0.6
Other	0.2	0.1	0.2	0.2	-0.7
Nontax revenue	3.5	2.9	3.2	2.7	2.9

Sources: SM/84/79 (4/16/84), p. 90; and SM/86/284 (11/25/86), p. 115.

total cut), construction of a national sports complex (5.8 percent), loans to Kenya Airways (4.3 percent), and loans to the National Agricultural Chemicals and Fertilizer Company (3.6 percent). It would be difficult to identify in most of these cuts a marked effect on the poorer groups in society. In the case of road expenditure, it is possible that the major beneficiaries of the increased employment opportunities were unskilled rural laborers. The cuts (about 30 percent of total cut) identified for recurrent expenditure included cuts for the Ministries of Higher Education (3 percent), Basic Education (1.3 percent), and Health (1.9 percent). The emphasis on the Ministry of Higher Education in these cuts does not seem to have had an undesirable distributional impact in the short run.

Concerning the changes in real expenditure by broad category, 1/ interest expenditure was the only category of expenditure to show a real increase during the two years; all other categories declined significantly (Tables 34 and 35). The declines were largest in the areas of general administration and defense, each declining by about 26 percent; expenditure on economic services declined by 24 percent. Relative to these sectors, the social sectors, and particularly education, fared well, with total expenditure on social services declining by only 15 percent. The real decline in expenditure was particularly concentrated in capital expenditure, which fell by 35 percent--a decline in capital expenditure is less likely to affect the poor adversely in the short run. Current expenditure (excluding interest) declined by 11 percent; however, its impact on government services may have been less, since it also reflected a decline in real public sector wages and salaries. Government employment actually increased by 8 percent between 1982 and 1984.

The real decline in expenditure was primarily accounted for by a few broad categories: general administration and defense (29 percent of the real decline in noninterest expenditure), agriculture (19 percent), education (14 percent), roads (13 percent), and health (7 percent).

The distributional implications of a cut in defense expenditure are not obvious, but in the short run it is unlikely to have had any impact on poverty, since the principal affected expenditures are likely to have been on military equipment, which have a very large foreign exchange component. Expenditure on general administration is similarly not generally supposed to have well identified adverse distributional implications. Furthermore, as with other categories of expenditure, the real decline was particularly focused on capital expenditure and on net lending.

Spending on agriculture, forestry, and fisheries declined by about one third in real terms. Most of this decline was concentrated in development spending, which registered a 50 percent fall in real terms;

1/ The CPI is used to deflate all expenditure series.

Table 34. Kenya: Central Government Expenditure--Economic Classification, 1980-85

	1980/81	1981/82	1982/83	1983/84	1984/85
			(In percent of GDP)		
Total expenditure and net lending	34.7	32.1	28.0	27.2	28.6
Current expenditure	24.8	23.9	23.1	21.9	22.8
Goods and services	16.2	17.6	16.7	15.8	15.4
Wages and salaries	6.1	10.0	9.8	9.7	9.8
Other	10.2	7.6	6.9	6.1	5.6
Interest	2.4	3.6	3.9	4.1	4.4
Subsidies and transfers	6.1	2.5	2.4	2.0	2.3
Other levels of government	...	0.4	0.4	0.2	0.3
Educational institutions	...	0.8	0.8	0.5	0.6
Households/nonprofit institutions	...	0.5	0.6	0.5	0.6
Public enterprises	...	0.3	0.2	0.3	0.3
Export compensation	...	0.4	0.2	0.3	0.3
Other	...	0.1	0.2	0.2	0.2
Capital expenditure and net lending	9.0	8.2	4.9	5.3	5.8
Fixed investment	5.9	5.3	3.7	4.1	4.6
Net lending	2.2	2.1	0.7	0.6	0.5
Equity	0.2	0.2	0.2	--	0.1
Capital transfer	0.8	0.6	0.3	0.5	0.6
Unallocated	0.8	0.1	0.1	--	--

Sources: SM/84/79 (4/16/86), p. 92; and SM/86/284 (11/25/86), p. 118.

Table 35. Kenya: Central Government Expenditure--Functional Classification, 1980-85

	1980/81	1981/82	1982/83	1983/84	1984/85
			(In percent of GDP)		
Total expenditure and net lending	34.7	32.1	28.0	27.2	28.6
General administration	5.6	5.3	3.9	4.0	4.1
Defense	4.6	3.1	2.9	2.4	2.2
Social services	9.9	9.5	8.8	8.3	8.8
Education	6.2	6.1	5.7	5.5	5.8
Health	2.4	2.2	1.9	1.8	1.8
Housing, community, and social welfare	1.3	1.2	1.2	1.0	1.2
Economic services	10.4	9.6	7.5	7.5	8.6
Agriculture, forestry, and fishing	3.8	3.2	2.9	2.3	3.1
Roads	2.0	2.4	1.8	1.7	1.1
Other	4.6	4.0	2.8	3.5	4.4
Interest	2.4	3.6	3.9	4.1	4.4
Unallocated	1.7	1.0	1.0	0.9	0.5

Sources: SM/84/79 (4/16/84), pp. 39-40; and SM/86/284 (11/25/86), p. 118.

recurrent spending on agriculture declined by about 7 percent. The decline reflected in large part reduced support for the sugar processing factories and the activities of the National Irrigation Board.

Spending on education fell by about 13 percent in real terms; again the decline was particularly focused on development expenditure, with recurrent expenditure on education falling by 9 percent. While current expenditure actually fell in terms of the CPI, the number of teachers employed grew by 11 percent over the two years (there was no general wage award over the period). Thus, the short-term impact of these cuts on income distribution does not appear to have been large.

Expenditure on health declined by about 20 percent in real terms, with similar percentage declines for both recurrent and development expenditures. However, the decline in development expenditure was particularly large for expenditures on curative facilities in Nairobi and at the provincial level. The share of development expenditure on health for rural health facilities and, to a lesser extent, for district hospitals increased. The decline in current expenditure should be interpreted in the light of the absence of a general wage award.

Spending on roads declined by about 32 percent in real terms. The impact of this decline on poverty is not clear. Since unskilled labor is presumably intensively used in road construction, it can potentially provide employment for the relatively disadvantaged groups; whether this in fact was the case is difficult to determine. The distribution of road expenditure changed somewhat over the period, with the share for major roads declining and that for secondary roads and rural access roads increasing significantly. Real spending on these other roads declined by only 15 percent in real terms over the period.

The large role played by reduced capital expenditure and net lending, which is less likely to have a short-term adverse impact on government services and the poorer groups (except perhaps via employment effects), the heavy burden of cuts on defense and administrative expenditures, and the much lighter burden on social expenditures suggest that the expenditure cuts were not excessively borne by the poorer sections of society. Nevertheless, social expenditures were cut in real terms and these real cuts may have resulted in some reduction of services and benefits to the poor groups in the short run. It is worth bearing in mind, however, that the targets for the reduction of the fiscal deficit and the net expansion of credit to government were exceeded by large margins in 1982/83, and to this extent, the expenditure adjustments were not part of the program.

4. Summary, overview, and conclusions

The 1983-84 program was formulated against a background of many years of poor macroeconomic performance that was characterized by serious imbalances in the fiscal and external accounts and strong inflationary pressures. Despite the expansionary thrust of policies pursued prior to the program, real per capita income had been growing at only 1 percent a year. The program aimed to reduce the macroeconomic imbalances while creating an environment for enhanced growth performance. The program was successfully concluded, and macroeconomic imbalances, as measured by the fiscal deficit, the external current account deficit, and the inflation rate, were substantially reduced. The growth of real output fell somewhat short of program expectations. However, the lower growth is largely accounted for by the impact of the uncertainties following the coup attempt in August 1982 and the drought in 1984.

The restrictive macroeconomic policies pursued undoubtedly affected the growth of GDP in relation to what might have resulted from a continuation of the policies of the late 1970s. However, those policies were not sustainable, and as in the case of the other countries being studied, it is difficult to make a judgment as to whether the outcome under an alternative effective and sustainable set of policies would have been preferable. The analysis indicates that the policies pursued do not seem to have put an unfair weight on the poor. On balance, the exchange rate policies benefited the agricultural sector, where the overwhelming majority of the poor live. The credit program did not result in any reduction in the growth of credit available to the private sector, which, given the moderation in inflation under the program, implied a growth in the real credit available; the credit available to the public sector was cut sharply. However, it does not appear that the fiscal policies pursued had significant adverse distributional impacts.

On the revenue side of the government budget, the tax policies pursued were aimed mainly at raising additional revenue for fiscal adjustment; they had both progressive and regressive elements, but do not appear on the whole to have had a regressive net impact. On the expenditure side, large cuts were made in the capital budget and in the areas of public administration and defense. Although social programs did not bear an unfair share of the expenditure cuts, they were reduced in real terms. However, these expenditure cuts may have had little direct adverse effect on the services provided to the poor, because the real wages paid to civil servants absorbed most of these expenditure reductions.

VI. Morocco: The 1983-84 Program: The Implications for Poverty

The program under study was supported by an 18-month stand-by arrangement (July 1983-December 1984) in the amount of SDR 300 million (133 percent of quota). The arrangement was approved by the Board on September 16, 1983 (EBS/83/178, 8/19/1983). Morocco utilized the entire amount of the arrangement by successfully concluding reviews conducted on four occasions (EBS/84/71, 2/8/1984; EBS/84/129, 6/6/1984; EBS/84/256, 12/7/1984; EBS/85/157, 6/21/1985).

1. The economy, the poor, and the institutional setting

a. The economy

Morocco is a primary commodity exporting country with a fairly large population (20.8 million in 1983) growing rapidly (2.5 percent in 1983). Its per capita GDP was estimated at about SDR 600 in 1983. The primary sector (including the energy sector) contributed 25 percent to GDP in 1983, whereas the manufacturing and the services sectors contributed 17 percent and 58 percent, respectively; of the latter, the Government accounted for 13 percentage points (Tables 36 and 37). Major domestic products are wheat, barley, maize, citrus, vegetables, petroleum, and phosphate products. Citrus, vegetables, and phosphate products are largely export-oriented.

The agricultural sector is the dominant employer, accounting for about 45 percent of the active labor force; the remainder is largely accounted for by the Government and by industry (20 percent each). About 10 percent of the labor force is engaged in public work relief programs, employed abroad, or unemployed.

Exports of goods and services (about 22 percent of GDP in 1983) are largely accounted for by phosphate products and food (including citrus fruits and vegetables). Imports of goods and services accounted for 32 percent of GDP in 1983; the share of food and energy products in total imports was 45 percent in 1983.

b. Socioeconomic characteristics of the poor

Morocco is a fairly urbanized country, with the share of the urban population estimated at about 43 percent. Social indicators are comparable with reference country groups in some respects (e.g., life expectancy and infant mortality rates), but not as favorable in some other respects (e.g., number of physicians). 1/

Poverty groups are largely in rural agricultural and livestock areas, although the urban poor, particularly unemployed workers, are not insignificant. A survey indicated that 45 percent of the rural population relied on incomes below the poverty level in 1973, whereas 28 percent of the urban population relied on incomes below the poverty

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1/ A World Bank study has indicated that Morocco's nutrition indicators are comparable with those of the reference country groups, but its health indicators fall short of those of the reference groups. See World Bank (1981) pp. 229-30. An example of the low health indicators may be found in the population per physician for Morocco, which, at 19:1,000, is substantially larger than 4.6:1,000 for a reference country group. See World Bank and International Finance Corporation (1986), p. 162.

Table 36. Morocco: Area, Population, and Income, 1983

Area (1975 borders)	459,000 square kilometers
Population	20.8 million
Population growth	2.5 percent
GDP per capita	SDR 598

Source: SM/85/193 (7/3/85), p. vi.

Table 37. Morocco: Industrial Origin of GDP, 1980-84

(In percent)

	1980	1981	1982	1983	1984
GDP	100	100	100	100	100
Agriculture, livestock, and fishing	18	15	18	17	17
Energy and water	3	4	4	4	4
Mining	5	6	4	4	5
Manufacturing	17	17	16	17	17
Commerce, transport, and other services	37	39	38	38	39
Government	12	13	13	13	13
Other	8	7	7	7	5

Sources: Calculated from SM/85/193 (7/3/85), Table II, p. 92; and SM/86/199 (8/13/86), p. 2.

level. 1/ These statistics imply that the rural poverty groups accounted for 26 percent of the total population, whereas the urban poor accounted for 12 percent. In rural areas, where social conditions in general are not as favorable as in urban areas, major poverty groups are farm workers, tenant farmers, and smallholders, particularly those in rainfed areas. About 75 percent of Morocco's farmers hold farms of five hectares or less, owning together only approximately 25 percent of the agricultural land. 2/

c. Institutional setting

The public sector influences the economy substantially. In 1983, central government revenue was equivalent to 22.7 percent of GDP, and expenditure, 31.2 percent. The public enterprise sector includes about 600 enterprises, owned fully or partly by the Government, which contributed some 20 percent to the aggregate value added of the economy.

The Government maintains an extensive system of regulations that affect the pricing in both product and factor markets. In product markets, the Government maintains price controls and subsidy systems for goods and services that are essential for consumption and strategically important. In addition, the Government also maintains a system of fixed or support prices for agricultural products. In factor markets, the Government regulates interest rates and maintains minimum wages.

2. The 1983-84 program and outcome

a. Background: economic developments prior to adoption of the program

Following the large increase in world phosphate prices in 1974/75, Morocco maintained a sharply expansionary fiscal policy stance which continued even after phosphate prices fell substantially. The expansionary policy stance, together with the deterioration in the external terms of trade, resulted in large fiscal and external imbalances. Morocco attempted to address these problems through a series of adjustment programs supported by the Fund. In 1978, the Government adopted a stand-by program aimed at cutting government investment expenditure; the program had some initial success, but failed to redress the structural imbalances. In 1980, the Government adopted an EFF program that combined elements of both demand management and structural adjustment; the program, however, was canceled, because the original medium-term assumptions and targets were no longer realistic in the wake of the 1981/82 world recession.

1/ World Bank and International Finance Corporation (1986), pp. 162-63. The estimation of poverty groups is based on the absolute poverty per capita income level of US$389 for the urban population and US$238 for the rural population.

2/ World Bank (1981), pp. 158-76.

In 1982, the Government adopted a one-year stand-by arrangement that included a substantial reduction in the overall budget deficit, a real effective depreciation, increases in interest rates, restraint on credit expansion, trade liberalization, and a number of structural measures in education, taxation, and public enterprise operations. Although all the performance criteria of the program were met, the performance of the economy deviated from the course projected, with the fiscal and external imbalances either not diminished or enlarged, because of a number of factors. The external demand for, and the prices of, Morocco's export products became much weaker than anticipated; the planned fiscal consolidation on the expenditure side was not achieved; and, with longer-term implications, the structural measures were not implemented.

As a consequence, the Central Government's fiscal deficit in 1982 remained high at 12.5 percent of GDP, compared with the targeted 8.2 percent; the external current account deficit increased to an estimated 12.9 percent of GDP from 12.6 percent in 1981, compared with the targeted level of 9.9 percent.

The 1983-84 program was designed and adopted against the background of a sharp worsening of internal and external imbalances. In addition to the imbalances in the external current account and the fiscal account, the symptoms of imbalances were found in many other areas, in particular, in low domestic savings and a large external debt burden.

b. Major features of the program and outcome

(1) Program

The program was predicated on a fairly pessimistic outlook for the external terms of trade but an optimistic outlook for a recovery in the volume of exports. The external terms of trade, after deteriorating by more than 10 percent in 1981/82, were projected to decline further, by 5.1 percent in 1983, and to be virtually stagnant in 1984. On the other hand, the volume of exports was projected to increase by 9.2 percent in 1983 and by 8.2 percent in 1984.

Against this background, the target for real GDP growth was set at about 3 percent per annum, lower than the level achieved in 1982, but somewhat higher than the average for 1981-82. The overall fiscal deficit was to be reduced from 12.5 percent of GDP in 1982 to 8.7 percent in 1983 and 5.9 percent in 1984 (Table 38). Credit policy, reflecting the credit expansion that had already taken place during the first half of 1983, allowed an acceleration of the expansion in net domestic credit from 13.8 percent in 1982 to 20 percent in 1983, but envisaged a reduction in the rate of expansion to 10.7 percent in 1984. The burden of this reduction was allocated largely to the government sector. The external current account deficit was to be reduced from 12.9 percent of GDP in 1982 to 8.9 percent in 1983 and to 6.6 percent in 1984.

Table 38. Morocco: The 1983-84 Program

	1980	Original Program 1981	Original Program 1982	Original Program 1983 (Prog.)	Original Program 1984 (Prog.)	Revised Program 1982	Revised Program 1983 (Est.)	Revised Program 1984 (Prog.)	Actual 1981	Actual 1982	Actual 1983	Actual 1984
					(Annual percentage change)							
Real GDP	3.7	-1.3	5.6	3.1	2.5	5.6	0.6	3.0	-1.3	[illegible].8	2.2	2.4
Unemployment rate												
GDP deflator	9.0	10.8	9.2	10.1	11.2	9.2	6.5	11.7	10.8	9.2	2.7	9.1
Consumer price index	9.4	12.5	10.6	10.1	11.0	10.6	6.3	11.0	12.5	10.5	6.2	11.0
Trade volume												
Export	0.5	2.1	0.2	9.2	8.2	0.2	14.9	6.6	3.8	0.5	10.1	4.6
Import	-5.1	4.8	6.0	-9.1	-4.5	6.0	-9.6	1.1	4.5	5.7	-4.7	7.4
Terms of trade	-1.1	-6.2	-5.5	-5.1	1.4	-5.2	-5.7	2.2	-6.3	-4.4	-1.4	-2.8
Effective exchange rate 1/ depreciation -												
Nominal	-6.2	-6.9	4.2	...	...	-4.3	-6.0	...	-10.1	-4.2	-6.0	-12.0
Real	-8.8	-5.4	-3.4	...	...	-4.4	-6.6	...	-10.0	-3.3	-6.6	-7.0
Net domestic credits	16.1	19.6	13.8	20.0	10.7	13.8	20.0	9.9	19.6	13.8	10.7	9.5
Government (net)	17.7	21.2	9.2	23.9	7.1	9.2	26.4	6.6	21.2	9.2	25.9	5.3
Private sector	13.8	17.5	20.6	14.8	15.1	20.6	11.3	14.9	17.5	20.6	11.5	16.0
Broad money	10.8	16.4	12.5	16.6	9.6	12.5	17.4	11.7	16.4	12.5	17.4	10.3
						(In percent of GDP)						
Budget deficit (After debt relief)												
Before grant	10.7	14.5	12.5	8.7	5.9	12.5	8.4	6.6	14.6	12.3	8.5	6.8
After grant	10.2	12.4	12.2	6.8	...	12.2	7.4	6.5	12.5	12.0	7.4	6.6
Budget deficit: cash (After debt relief)	...	...	...	...	...	10.0	10.9	7.0	14.6	10.0	10.9	7.1
Revenue	21.6	23.3	23.0	21.9	...	23.0	22.1	22.5	23.2	22.8	22.3	22.2
Expenditure	34.0	37.2	37.0	30.5	...	37.1	31.0	29.1	37.1	36.6	31.2	28.8
Net extrabudgetary operations	1.7	-0.6	1.4	-0.1	...	1.5	0.5	--	-0.6	1.5	0.4	-0.2
Domestic bank financing	3.9	4.8	2.5	4.5	...	2.5	7.1	2.0	5.0	2.2	6.7	1.5
Current account deficit (After debt relief)												
Excluding grants	8.0	12.6	12.9	8.9	6.6	13.2	6.7	6.1	12.5	13.3	6.7	8.1
Including grants	7.4	10.5	8.7	7.8	6.2	11.9	5.6	6.0	10.5	11.9	5.6	8.0

Sources: EBS/83/178 (8/19/83), p. 5; EBS/84/129 (6/6/84), p. 4; EBS/85/157 (6/21/85), p. 6.

1/ Based on Morocco's currency basket.

The program incorporated a number of policy measures to support the adjustment process. The restraint on credit expansion, to be supported by fiscal adjustment, was to be complemented by a greater reliance on interest rates and the money market for efficient allocation of credit, rather than on direct control of credit. In addition, the prices of consumer goods and fertilizers were to be increased substantially, and public utility rates were to be increased gradually, together with a liberalization of controlled prices in general.

On the external side, the program emphasized maintenance of a flexible exchange rate, gradual removal of trade restrictions, and elimination of the advance import deposit system.

The 1983-84 program was the latest in a series of Fund-supported programs for Morocco. It was preceded by the 1982 program, negotiated during the early months of 1982 and approved by the Board in April 1982. The 1983-84 program was negotiated in July 1983 and approved by the Board in September 1983. Therefore, it is likely that economic developments in 1982 and 1983 were affected by the 1982 and the 1983-84 programs, respectively. In addition, the 1984 budget and fiscal outturn were affected by the 1983-84 program.

(2) Outcome

The external terms of trade continued to deteriorate during the program period, but the deterioration of 1.4 percent in 1983 was smaller than the 5.1 percent originally projected in the program, whereas the deterioration of 2.8 percent in 1984 was worse than the small increase of 1.4 percent projected. The volume of exports increased by 10 percent in 1983 and 4.6 percent in 1984, the latter somewhat lower than projected. A continued drought severely restrained the recovery of agricultural production, limiting the level of cereal production in 1983/84 at about 5 percent higher than 1982/83, but 23 percent below the level of 1981/82.

The program was adapted to the changing external circumstances; thus, the target for growth in 1984 was raised from the original level of 2.5 percent envisaged in mid-1983 to 3 percent in the latest revised program; the target for the fiscal deficit in 1984 was raised from 5.9 percent of GDP to 6.6 percent.

During the program period, Morocco achieved significant adjustment in both fiscal and external accounts; the fiscal deficit was reduced from 13.5 percent of GDP during 1981/82 to 7 percent in 1984, more or less as planned, and the external current account deficit was reduced from about 13 percent of GDP to 8 percent, although the latter deficit in 1984 was about 2 percent of GDP higher than the revised target. 1/ The external adjustment was achieved, on the basis of a substantial real effective devaluation during the program period, against the background of a deterioration in the external terms of trade. The recovery of foreign demand and a substantial real effective devaluation contributed to a 15 percent growth in export volume over 1983/84.

The fiscal adjustment made it possible for the net domestic credit expansion to decelerate substantially from 19.6 percent in 1981 to 9.5 percent in 1984, thus restraining annual CPI inflation at 11 percent in 1984, in spite of substantial nominal and real exchange rate depreciations during 1981-84. The credit restraint was supported by a sharp reduction of credit expansion to the government sector, whereas the credit expansion to the private sector remained relatively unaffected in comparison with 1981. Real GDP growth averaged slightly above 2 percent per annum during 1983/84, somewhat below the original program target of 2.8 percent per annum.

During the program period, the inflation rate remained somewhat below the levels of the preprogram years, but relative producer and factor prices changed substantially (Table 39). During 1983/84 (October/November), agricultural producer prices generally were raised faster than the overall price level, with the price of maize increasing by 30 percent, compared with increases of 9.1, 11, and 6.2 percent in the GDP deflator, the CPI, and the cost of living index, respectively, in 1984. The prices of food and clothing in the cost of living index increased by some 5 percent. Sharp increases, ranging from 13 percent to 28 percent, were effected for retail prices of petroleum products in conformity with the program objectives, with the highest increase registered for kerosene. National minimum wages for both agricultural and industrial workers increased by 20 percent, substantially exceeding the cost of living index.

Pricing policy measures were an important part of the program. In assessing the distributional impact of the pricing measures in the 1983/84 program, however, it is necessary to take into account the

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1/ In 1983 and 1984, a significant part of the reduction of the fiscal deficit reflected a reduction of foreign interest payments from debt relief. The Government also accumulated sizable arrears during 1982-84. The fiscal data in this study reflect the old presentation used for the reviews of the programs. Subsequent to the reviews, a number of changes have been made in the presentation of fiscal data. On the basis of this new presentation, the fiscal deficit on a commitment basis as a percentage point of GDP in 1984 was about 3 points higher than indicated by the old presentation, thus the extent of the fiscal adjustment during the program was smaller than indicated by this study. The reduction of the fiscal deficit on a cash basis, however, was broadly similar in both the old and the new presentations. See EBS/85/157 (6/21/1985).

Table 39. Morocco: Domestic Price Developments, 1980-85

	1980/81	1981/82	1982/83	1983/84	1984/85
Agricultural producer prices 1/					
Wheat	...	3.7	--	7.1	20.0
Barley	...	4.2	--	10.0	36.4
Maize	...	4.2	--	30.0	23.1
Sugar beets	...	14.8	--	12.9	8.6
Sugar cane	...	10.5	--	14.3	16.7
Retail prices of					
Petroleum products 2/					
Regular gasoline	23.1	5.9	4.4	24.0	...
Premium gasoline	21.9	5.6	4.3	23.5	...
Kerosene	13.5	7.1	8.0	28.0	...
Gas-oil	29.7	6.2	7.1	26.4	...
Fuel-oil	51.7	7.6	6.0	24.6	...
Butane and propane	5.4	--	6.8	12.7	...
Cost of living index 3/					
Food	8.1	14.9	13.0	4.8	13.0
Clothing	4.7	6.8	5.6	5.2	9.0
Housing	12.2	8.5	6.4	7.8	10.2
Health	6.4	8.3	11.0	10.2	10.0
Transportation	14.8	11.9	7.1	8.9	14.0
Overall	9.5	12.5	10.5	6.2	12.5
National minimum wages 4/					
SMIG	7.7	20.4	15.3	19.9	9.7
SMAG	--	20.2	14.8	20.0	9.7

Source: SM/85/193 (7/3/85), pp. 9, 22, 25, 30.

1/ Changes for crop years ended in October.
2/ Changes during the years ended in November, except for 1982/83, for which changes during the year ended in August are shown.
3/ Changes for the years ended in April.
4/ Changes during the years ended in various months.

background against which such measures were taken. In 1983, the Government controlled the prices of about 240 goods mainly to protect the purchasing power of consumers. At the same time, the Government subsidized the domestic utilization of six goods (flour, sugar, edible oil, butter, petroleum products, and fertilizer). Although the Government had increased controlled retail prices on several occasions since 1979, evoking serious opposition and even social unrest, the policy to subsidize the domestic utilization of goods, mostly imported, encouraged consumption and imports--thus having serious adverse effects on the fiscal and the external balances. The amount of subsidies in 1983 accounted for 3 percent of private consumption and for 10 percent of government current expenditure.

Against this background, the Government implemented increases in prices ranging from 17 percent to 67 percent, except for granulated sugar and nonluxury flour that accounted for 40 percent of total subsidies. The Government also decided to change the method of subsidizing the granulated sugar from guaranteeing a fixed retail price for the consumer to maintaining a fixed per unit subsidy. The prices of petroleum products were raised by between 4 percent and 8 percent. In addition, the prices of fertilizers, electricity, and water were raised by up to 48 percent.

3. Implications for poverty groups

a. Macroeconomic and other nonfiscal policy measures and implications

The 1983/84 program followed a series of programs that had various degrees of success. It is particularly misleading, therefore, to use the before-after comparison methodology in assessing the distributional implications of the program. The program was designed and executed during a period in which the external terms of trade continued to deteriorate; the cumulative deterioration of the terms of trade during 1981-84 was 15 percent. Therefore, economic developments during the period were the result not only of policy measures adopted in connection with the successive programs but also of external factors.

(1) Monetary and credit policy

The program targeted substantial fiscal adjustment and credit restraint, particularly a slowdown in the increase in credit to the Government. Most of these targets were achieved. The increase in net credit to the Government fell from an average of 15 percent per year during 1981-82 to 5.3 percent in 1984, whereas the increase for the private sector fell only slightly to 16 percent, implying a substantial increase not only in real terms but also in relation to the level of economic activity. The program was not specific in allocating credit among various sectors within the private sector. However, it envisaged a conducive environment for efficient allocation of credit by simplifying the interest rate structure, by raising the level of interest rates, and by enhancing the role of the capital market in the sectoral allocation of credit.

(2) Pricing policy

In assessing the distributional implications of the pricing policy measures of the program, it is relevant to note the special treatment the Government granted to two commodities mainly consumed by low-income households, granulated sugar and nonluxury flour. It is also important to note the adverse impact of the subsidization policy, i.e., encouraging consumption and increasing demand for scarce foreign exchange and domestic financial resources that could be utilized for other critical purposes. Subsidization was not effective in helping the poor in the sense that a large fiscal deficit, through its impact on domestic credit creation, tended to raise the rate of inflation, negatively affecting real wages and hurting both rural and urban workers.

The pricing policy also had generally favorable implications for the agricultural workers, and for the producers of the agricultural crops--both the owners of large farms and the smallholders. It is not clear to what extent this improvement in the relative price of agricultural crops resulted in an increase in agricultural real wages. In view of the significant unemployment in Morocco, the impact on real wages may have been small, and the improvement of the agricultural sector may have benefited the relatively rich farmers or the landowners by increasing their profits or rents, including those of large-scale absentee landowners.

(3) Labor market policy

Increases in minimum wages for both agricultural and industrial workers exceeded the increase in the cost of living index. The increase in minimum wages, which affected wages for the lowest-income scale, also exceeded the increase in the wages for public sector workers. Although the retail prices of energy products increased sharply during 1983/84, the increase in the CPI fell from 12.5 percent in 1981 to 6.2 percent in 1983, with the increase in food and clothing prices about 5 percent, although it accelerated again in 1984.

(4) Exchange rate and other external sector policy

The 1983/84 program relied on a flexible exchange rate system to achieve external adjustment. The real effective exchange rate depreciated by 14 percent during 1983-84, after depreciating by 13 percent during 1981-82. The exchange rate depreciation undoubtedly had differential distributional effects on different income groups, benefiting income groups engaged in export activities, but adversely affecting those income groups with high consumption of imported goods. The latter group in Morocco is the urban population, which, at about 43 percent of the total, is a substantial part of the population.

b. Fiscal policy measures and their implications

Fiscal adjustment was to be supported both by revenue and by expenditure measures, but more by the latter than the former. Expenditure restraint was to be achieved through a substantial scaling down of the system of consumer subsidies and an adjustment of capital expenditure.

(1) Revenue measures

Tax policy measures were similar in both the 1982 and the 1983/84 arrangements. The 1982 measures, slated to yield 1 percent of GDP, included increases in excises on alcohol and luxury goods, an increase in the fringe benefits tax, a rate increase (from 40 percent to 48 percent) on salaries and business profits in excess of a certain amount, as well as a rate increase (from 15 percent to 17 percent) on the sales tax (Table 40). The 1983/84 measures, expected to yield slightly more than 1 percent of GDP, included a further rise (to 19 percent) in the sales tax, a new tax on gasoline, a doubling of the motor vehicle tax, an exit tax, a restructuring of certain registration fees, and an increase in the income tax by means of a lump-sum tax equal to 25 percent of the annual average of receipts from tax on business profits and 1 percent of the annual average turnover during the period 1980-83. 1/

These tax policy measures had a number of distributional implications. The excises on alcohol and luxury goods, as well as the motor vehicle tax, would be expected to fall on upper-income groups. The exit tax would also be expected to be progressive in nature, primarily affecting travelers going abroad and foreign tourists. The increase in the general rate of the sales tax excluded coverage of essentials taxed at lower rates. Similarly, the increase in the income taxes affected enterprises with income levels above a certain range, limiting the possibility of an adverse incidence on businesses with low profits.

The distributional implications of the introduction of the gasoline tax and the restructuring of registration fees were less clear. The former could affect travelers of all income groups adversely, although the likelihood of a progressive incidence in this case was high.

1/ An important element of tax policy in 1984 related to plans for the introduction of a fundamental tax reform in the 1985 budget, setting up a corporate income tax and a global personal income tax, and substituting a value-added tax for the sales tax, which was basically a differential tax on production and services. But these measures were delayed longer than expected and were not introduced in Parliament during the course of the program.

Table 40. Morocco: Central Government Revenue, 1980-84

	1980	1981	1982	1983	1984
			(In percent of GDP)		
Total revenue	23.3	23.2	24.3	22.7	22.2
Tax revenue	19.8	20.0	20.1	20.2	20.0
Income and profits	4.8	4.9	4.3	4.6	4.7
Business profits	2.5	2.3	1.7	1.9	2.3
Wages and salaries	1.6	1.7	1.7	2.0	1.7
Other	0.8	0.9	0.8	0.7	0.8
Goods and services	5.8	5.2	5.5	6.1	5.6
Sales taxes	2.7	2.6	2.9	3.3	2.8
Excises	2.6	2.3	2.2	2.4	2.4
Other	0.5	0.3	0.5	0.4	0.5
International trade	8.4	9.0	9.6	8.6	8.8
Imports	8.0	8.7	9.3	8.4	8.5
Exports	0.3	0.3	0.3	0.2	0.3
Other	0.9	0.8	0.8	0.8	0.9
Nontax revenue	3.5	3.3	4.1	2.5	2.2

Sources: SM/84/173 (7/23/84), p.77; SM/84/150 (6/29/84), p. 30; and SM/85/112 (4/25/85), p.79. In this presentation, revenue includes the net surplus of the extrabudgetary activities of the Government. See Table 38.

(2) Expenditure measures

Expenditure measures were major instruments of fiscal adjustment in the program. The targeted reduction of budgeted expenditure in 1983, about 1.3 percentage points of GDP in current expenditure and 5 percentage points of GDP in capital expenditure, was larger than the targeted increase in revenue and was to be followed by another reduction of 2 percentage points of GDP in 1984, fairly equally divided between current and capital expenditure. For current expenditure, a major adjustment in consumer subsidies, a public sector wage freeze, a limit on the increase in government employees, and a reduction of transfers to public enterprises were envisaged. The further reduction of subsidies on sugar cubes, flour, and edible oil originally planned for 1984, however, was postponed, following social unrest early that year. For capital expenditure, the program documents do not indicate how the targeted adjustment was to be allocated among various projects; however, target capital expenditure was raised by one half of 1 percentage point of GDP in 1984.

Over the life of the program, the net effect of the measures concerning wages and salaries on the share of such expenditures in GDP was negligible (Table 41). While the wage and salary freeze was to reduce such expenditures relative to GDP in 1984, these expenditures had been programmed to rise relative to GDP in 1983, owing to a wage increase granted early in 1983 and the increase in employment in that year. It would be difficult, therefore, to attribute an adverse distributional impact of the program in this area. In the area of expenditure for other goods and services, the program targeted a real reduction. In the absence of information on how these cuts were to be allocated, it is difficult to infer distributional implications.

The net effect of the measures on subsidies was to decrease consumer subsidies slightly as a percentage of GDP. This was entirely due to the reduction of petroleum subsidies, which fell by 0.8 percent of GDP over the period, owing to an increase in domestic prices; subsidies for other consumer products increased significantly as a percentage of GDP, owing to an increase in costs that more than offset the price increases. In discussing food subsidies in Morocco, it is useful to note that a World Bank study indicated that the subsidization program was in general not considered to be cost effective. 1/ Moreover, the study indicated that the resources could be more effectively used for health, rather than for nutrition, since Morocco was making a better showing than other comparable countries in nutrition but a less favorable showing in health. 2/ In 1984, the largest share

1/ World Bank (1981), p. 124.
2/ Op. cit., p. 124 and pp. 229-30.

Table 41. Morocco: Economic Classification of Government Expenditure, 1980-84

	1980	1981	1982	1983	1984
			(In percent of GDP)		
Total expenditure and net lending	34.0	37.7	36.6	31.2	29.0
Current	21.8	24.6	22.7	22.8	22.1
Goods and services	16.1	17.0	16.1	16.6	15.2
Wages	11.3	12.2	11.6	12.1	11.3
Others	4.8	4.8	4.5	4.5	3.9
Interest	2.5	3.8	3.5	3.7	4.2
Domestic	0.8	0.9	0.8	1.1	1.3
Foreign	1.7	2.9	2.6	2.7	2.9
Subsidies	3.3	3.8	3.2	2.4	2.7
Consumer	2.0	2.7	2.2	1.7	2.0
Other	1.2	1.1	1.0	0.7	0.7
Capital	12.2	12.5	13.9	8.4	6.7
Net extrabudgetary expenditure	--	0.6	--	--	0.2

Source: SM/85/193 (7/3/87).

(47 percent) of subsidies was estimated to have transferred to high-income groups; the smallest share (16 percent) was actually transferred to low-income groups. 1/

Ex post data on current expenditure suggest that social expenditure suffered relatively little, whereas the cutbacks in expenditure on goods and services (inclusive of salaries) fell primarily on economic services, defense, and general administration. Rather limited data on the functional classification of capital indicate that the cut was largely accounted for by a cut in defense expenditure (Table 42).

In subsidy expenditure, the subsidy on flour accounted for the largest share. Over the life of the program, the price of high-quality flour was raised by 40 percent, but the price of low-quality flour was not raised. Consequently, the price of high-quality flour increased in real terms, whereas the price of low-quality flour decreased, resulting in a decrease in the percentage subsidy on high-quality flour and an increase in the subsidy on low-quality flour. Because the cost of high-quality flour also increased, however, the percentage subsidy declined only slightly, from 16 percent to 15 percent, whereas the percentage subsidy on low-quality flour increased from 24 percent to 43 percent in 1984, resulting in a substantial net real increase in subsidies.

Petroleum subsidies were reduced during the program period by increasing the prices of petroleum products by between 4 percent and 8 percent. The extent of the increases in these prices was smaller than the increases in the prices of some other products, such as butter, luxury flour, edible oil, and fertilizers. However, the increase in the prices of petroleum products had a regressive element, since the increase in the price of kerosene exceeded the average increase in the prices of petroleum products, whereas the increase in the price of gasoline was below the average increase.

Two other commodities on which large amounts of subsidies were paid are sugar and edible oil. For sugar, the total amount of subsidies declined somewhat both in nominal and real terms; the percentage subsidy on sugar cubes fell sharply (from 16 percent to 3 percent), reflecting a smaller increase in cost than the increase in the consumer price, whereas the percentage subsidy on powdered sugar rose (from 9 percent to 35 percent), reflecting an increase in cost. For edible oil, the percentage subsidy increased (from 19 percent to 35 percent); total subsidy payments also increased substantially.

1/ World Bank (1986b). The high-income groups refer to the income groups in the upper 30 percent expenditure class; the low-income groups refer to the income groups in the lowest 30 percent expenditure class.

Table 42. Morocco: Functional Classification of Current Expenditure, 1980-84

	1980	1981	1982	1983	1984
	(In percent of GDP)				
Total	21.8	24.6	22.7	22.8	22.1
General public service	4.0	4.1	3.9	4.0	3.6
Defense	4.0	4.4	4.4	4.5	4.1
Social services	8.6	9.7	8.7	8.6	8.6
Education	5.3	5.7	5.2	5.6	5.3
Health	0.9	1.0	0.9	1.0	0.9
Community/cultural	0.3	0.3	0.3	0.4	0.4
Consumer subsidies	2.1	2.7	2.3	1.6	2.0
Economic services	1.5	1.5	1.3	1.2	1.2
Agriculture	0.9	1.0	0.9	0.8	0.7
Other	0.6	0.5	0.4	0.4	0.5
Unallocable	3.7	4.9	4.4	4.5	4.6

Source: SM/85/193 (7/3/87).

4. Summary, overview, and conclusions

The 1983/84 program was formulated and executed during a particularly difficult period. Financial imbalances had been unsustainably large; earlier programs had not achieved the targeted adjustment partly because of an unexpected worsening of external developments. Furthermore, the increase in some consumer prices had been met by social unrest. The outlook for external developments was not favorable either. The external terms of trade, after having declined by more than 10 percent during the two preceding years, were expected to decline further.

The program targeted substantial adjustments in both fiscal and external current account balances. Real growth, at 2.8 percent per annum, was projected to be only marginally lower than the average growth during 1980-82, and the actual growth rate was only slightly lower than the target. In addition, a substantial fiscal adjustment contributed to a reduction of credit expansion and a deceleration of domestic inflation.

From a distributional perspective, a critical issue related to the 1983-84 program is the impact of the reduction of subsidization and the consequent sharp increases in the prices of some consumer goods (particularly food and fuel). In discussing this issue, the apparent unsustainability of the heavy subsidization and the long-term adverse consequences (the inefficient use of scarce domestic and foreign resources) of the subsidization policy should be weighed against the immediate adverse distributional implications of the reduction of the subsidies. In increasing prices, the Government provided exceptions for the granulated sugar and nonluxury flour consumed mostly by low-income groups. In addition, it is also noteworthy that the subsidization program was not benefiting the poor exclusively; only 16 percent of the subsidies were actually being transferred to the poorest 30 percent of the population. In this respect, it is difficult to conclude that the immediate effect of the reduction of subsidies was regressive. However, certain price increases were not without regressive elements. For example, the price increase for kerosene exceeded that for some other more luxurious energy products, such as high-quality gasoline.

During the program period, the increase in minimum wages substantially exceeded the increase in the cost of living index. Among the products included in the cost of living index, food and clothes showed lower increases in prices than other products did.

Among the revenue measures, taxes on nonessential goods (e.g., excises on alcohol and luxury goods, motor vehicle tax, and exit tax) would be expected to have been largely progressive. The increase in the general rate of sales tax excluded coverage of essentials. It is less obvious whether the increase in the gasoline tax would be expected to be progressive.

Expenditure measures were major instruments for fiscal adjustment. The program envisaged a public sector wage freeze, a limit on the increase in government employees, major cuts of consumer subsidies, and a reduction of transfers to public enterprises. Public employees in Morocco are by no means a poverty group; therefore, the public sector wage freeze and the limit on the increase in government employees were not regressive policy measures. The planned reduction of consumer subsidies was implemented flexibly; thus, the reduction of subsidies on sugar cubes, flour, and edible oil originally planned for 1984 was postponed, following the social unrest early that year. The subsidy payments on two critical commodities (granulated sugar and nonluxury flour) were maintained at levels to keep prices from increasing. Over the life of the program, consumer subsidies as a percentage of GDP decreased only slightly, with a significant reduction of petroleum subsidies being largely offset by an increase in other consumer subsidies. Although domestic prices for a variety of consumer goods increased substantially, the increase largely reflected an increase in costs rather than a reduction in subsidies. Ex post expenditure data suggest that social expenditure suffered little.

VII. Philippines: The 1983-85 Programs: The Implications for Poverty

Implications for poverty are examined under two stand-by arrangements in support of adjustment programs undertaken by the Philippine authorities in 1983 and 1984. The first became effective on February 25, 1983 (EBS/83/24 and Supplement 1) for a period of one year in the amount of SDR 315 million, or 100 percent of the country's quota at that time. Under that arrangement the Philippines made two purchases totaling SDR 100 million. Subsequently, drawings were interrupted owing to the nonobservance of performance criteria, including the non-completion of the mid-term review. At the same time, serious difficulties developed in the reporting of key financial data and the establishment of a reliable data base.

The second stand-by arrangement was approved on December 14, 1984 for an 18-month period in the amount of SDR 615 million, or 139.6 percent of the Philippines' quota (EBS/84/226 and Supplement 1). That arrangement too was interrupted because developments deviated from the program objectives, and only SDR 403 million was drawn. The analysis in the following sections is based on policies associated with both arrangements.

1. The economy, the poor, and the institutional setting

The Philippines is a low-income country, with a total population of 52.1 million in 1983 and growing at an average rate between 1978 and 1983 of 2.7 percent per year. The per capita GNP in 1984 was US$616 (Table 43). Although in 1984 agriculture accounted for one fourth of GNP, it accounted for over 50 percent of total employment. At the same time, the manufacturing sector, with an equal GNP contribution, employed

Table 43. Philippines: Area, Population, and Income

Area	300,000 square kilometers
Population (1983)	52.1 million
Population growth (1978-83)	2.7 percent
GNP per capita (1984)	US$616

Source: EBS/85/182.

under 10 percent of the labor force. Commerce and other services accounted for over 40 percent of GNP and for about 35 percent of total employment (Table 44).

The principal crops are paddy rice and corn, which in 1985 accounted for about 18 percent and 7 percent, respectively, of value added in agriculture. The two most important export crops are coconuts and sugar. Production of most crops is dominated by smallholders, who own two thirds of all farm land. Medium and large farms are of considerable importance in the sugar industry, however, and account for 80 percent of the total sugarcane area. The sugar and coconut sectors have been exempted from past land reform programs.

Income inequality is particularly pronounced in the Philippines. In 1985 the top 10 percent of families received 35.6 percent of total income, whereas the bottom 10 percent received only 2.3 percent of national income. Such a gap places the Philippines among the high inequality cases in the developing world. Although some marginal improvement in income distribution has been observed in recent years, it has been concentrated in the middle and the upper end of the income scale. On the other hand, the share of families in the poorest deciles has remained unchanged in the last two decades.

In the Philippines, as in most low-income countries, poverty is concentrated in rural areas. The World Bank estimates that in 1983 the total number of poor families was 3.6 million, of which 2.8 million, or 77 percent, were located in rural areas and 0.8 million, or 23 percent, in urban areas. 1/ Poverty incidence, i.e., the proportion of families below the officially designated poverty line, was estimated for 1983 at 45 percent in the rural sector and at 26 percent in the urban sector.

The concentration of poverty in rural areas reflects both the tendency of skilled labor to migrate to urban areas and also the spatial bias of government spending in favor of Metro Manila and other large cities. Nutrition is an area that has been neglected by the Government. A study on a food price subsidy scheme concluded that there is a strong relationship between malnutrition and poverty. 2/ Groups such as the households of landless farm workers and tenant farmers are most likely to be malnourished because of their limited income sources.

At slightly over 10 percent, the Philippines has one of the lowest tax ratios in the world. A recent analysis in a World Bank study indicates that the overall tax system is regressive, mainly owing to the predominance of indirect taxes as the principal revenue source (Table 45). Redistribution through the budget is therefore achieved through the expenditure side, which is, however, structurally bounded by the low tax ratio. Recent extensive tax reforms have paved the way for

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1/ World Bank (1985).
2/ Garcia and Pinstrup-Andersen (1987).

Table 44. Philippines: Sectoral Origin of GNP and Employment, 1984

(In percent)

	GNP		Employment
Agriculture, fishery, and forestry	26.0		50.2
Mining and quarrying	1.8		0.1
Manufacturing	25.5		9.5
Construction	5.8		3.7
Electricity, gas, and water	1.1		--
Transportation, communication, and storage	6.3		4.5
Trade	18.5		12.6
Finance and housing	7.8	)	
Services	9.1	)	19.4
Net factor income from abroad	-1.9	)	
Total	100.0		100.0

Source: SM/85/251, Table 2 and Annex I, Table 5; and World Bank (1987b), Table 1.3.

Table 45. Philippines: National Government Tax Revenues by Source, 1980-85

(As a percent of tax revenues) 1/

	1980	1981	1982	1983	1984	1985
Tax revenues	100.0	100.0	100.0	100.0	100.0	100.0
Direct taxes	29.7	32.4	32.2	31.4	33.1	36.0
Income taxes	21.0	21.7	22.0	21.6	24.2	24.1
Individual	(9.7)	(9.8)	(8.8)	(8.1)	(7.5)	(8.2)
Corporate	(9.9)	(10.2)	(10.4)	(10.8)	(14.1)	(12.6)
Others	(1.4)	(1.6)	(2.8)	(2.8)	(2.5)	(3.3)
Social security contributions	8.0	8.4	8.5	7.7	6.0	5.5
Other	0.8	2.3	1.7	2.0	3.0	6.4
Indirect taxes	70.3	67.6	67.8	68.6	66.9	64.0
Specific taxes	13.7	14.6	15.2	14.6	17.1	20.0
Import duties	22.4	21.0	9.3	27.1	24.4	20.2
Export and premium duties	1.4	0.7	0.6	0.6	2.6	1.5
Other	32.8	31.3	42.6	26.3	22.7	22.4

Source: World Bank (forthcoming).

1/ Details may not add up to totals due to rounding.

a substantial improvement in the elasticity of the tax system, which in turn could provide the revenue base for expanded public spending on infrastructure and social services.

2. The 1983-85 programs and outcome

a. Background: economic developments prior to adoption of the programs

In early 1981 domestic monetary and fiscal policies turned sharply expansionary as a result of a rescue operation to preserve the stability of the financial system following an internal financial crisis. Those policies were not reversed in the second half of the year and resulted in a jump of the National Government 1/ deficit to 4 percent of GNP in 1981 compared with about 1 percent in previous years (Table 46). The deterioration in the fiscal accounts was supported by a 26 percent expansion in net domestic assets in 1981, while the increase in short-term external debt, which was not monitored under the Fund program then in effect, accounted for about half the increase in total external debt during the program period.

The economic situation deteriorated further in 1982, as expansionary financial policies were not matched by the expectation of a world economic recovery, which, it was believed, would boost export earnings and limit the current account deficit. On the contrary, the international recession deepened during that period and Philippine export growth slackened. At the same time, international interest rates remained at historically high levels. Domestically, the National Government budget deficit widened to 4.3 percent of GNP in reflection not only of cyclical influences but also of structural weaknesses in the revenue system, including problems of tax administration. Bank financing of the deficit was a principal factor behind the rapid growth of net domestic assets, which increased by a further 29 percent in 1982 (Table 46).

The Philippine external situation deteriorated progressively in 1982. Exports fell sharply, imports declined only moderately, and interest payments rose substantially. The current account deficit widened to a record level, equivalent to over 8 percent of GNP, whereas the balance of payments deficit stood at US$1.6 billion, also a record level. Following revisions in the data, it is now estimated that at end-1982 gross reserves of the monetary authorities had declined to US$1.8 billion, about US$0.8 billion lower than a year earlier, one third of which were illiquid.

Owing to an insufficient data base, developments under the 1983 stand-by arrangement were hard to follow for a good part of the year.

1/ National Government is the term used by the Philippine authorities for Central Government.

Table 46. Philippines: The 1983 and 1984-85 Programs

	1980	1981	1982	1983		1984		1985	
		Actual		Prog.	Actual	Proj.	Actual	Prog.	Actual
	(Annual percentage change)								
Real GNP	4.4	3.7	2.7	2.0	1.1	-2.0	-6.8	--	-3.8
GNP deflator	16.3	10.4	7.7	11.0	11.7	...	49.1	22.0	17.6
External sector									
Exports (US$)	25.8	-1.1	-12.3	9.9	-0.3	8.5	7.7	10.0	-16.1
Imports (US$)	25.8	2.8	-3.5	3.1	-2.3	-19.3	-18.9	-1.6	-15.8
Terms of trade	-21.3	-12.0	-2.8	3.2	4.4	...	-2.4	...	-6.6
Effective exchange rate									
Nominal	0.3	1.3	0.8	...	-10.0	...	-29.5	...	-7.3
Real	5.0	3.7	3.3	...	-15.3	...	-1.1	...	9.5
Money and credit									
Net domestic assets	31.9	25.8	28.5	20.2	23.9	...	2.5	4.8	13.5
Public sector	33.9	59.9	81.2	8.1	12.7	...	10.5	-5.5	19.3
Private sector	19.1	20.4	13.7	...	12.4	...	-11.3	8.5	-9.7
Broad money	18.2	21.1	16.1	...	18.6	10.0	7.3	12.9	9.7
	(In percent of GNP)								
External current account deficit	-5.4	-5.4	-8.2	-6.2	-8.1	-5.0	-4.0	-4.1	--
Fiscal accounts									
National Government revenue	13.1	11.8	11.4	11.2	12.0	11.3	10.6	10.9	11.6
National Government expenditure	14.4	15.9	15.7	13.6	14.0	13.0	12.4	12.9	13.2
National Government deficit	-1.3	-4.1	-4.3	-2.4	-2.0	-1.7	-1.8	-2.0	-1.6
Public sector deficit	...	-5.3	-4.8	...	-3.6	-3.2	-3.0	-2.7	-2.6

Sources: EBS/86/222, Table 2; Annex V, Table 1; Annex X; EBS/85/182, Annex IV; EBS/85/261, Annex III; EBS/84/117, Table 4, Appendix III; EBS/83/24, Table 2 and Table 5; SM/86/249, Table 12; EBS/84/226, Annex IV.

However, the situation in the external accounts soon became unsustainable, as the economy experienced a record outflow of short-term capital of about US$1 billion. On October 17, 1983 the authorities requested a 90-day standstill from commercial banks on all maturing nontrade-related payments of principal to foreign financial institutions. At the same time, foreign exchange allocation procedures were introduced and a substantial differential between the official and black market exchange rates emerged. As a result of that crisis, the authorities formulated a comprehensive economic policy package, which aimed at reversing the unsustainable trends in the external sector, while allowing for the elimination of the restrictions on current payments and imports, which were the immediate response to the severe foreign exchange crisis.

Nonetheless, the adjustment during 1984 was uneven. There was considerable improvement in the external sector, which, however, did not have a parallel in domestic policies. Because of the constraints in external financing, an expansionary monetary policy initially accommodated rapid increases in domestic prices. By end-September 1984 the 12-month rate of inflation was 63 percent and the average increase in prices for the year as a whole was over 50 percent, compared with 10 percent in 1983 (Table 47). It is difficult to quantify the impact of the adjustment on agriculture, since many activities are not marketed. The urban manufacturing sector and the urban population as a whole were hit particularly hard. Although several changes were made to both public and private compensation packages after mid-1983, the absence of a formal indexation scheme implied that nominal wage increases fell far short of inflation. In 1984, therefore, real wages declined by 20-25 percent. 1/

Against this background, during the consultations held in June 1984, the authorities agreed to certain general guidelines of economic policy, which formed the framework of the 1984-85 stand-by arrangement approved later in the year.

b. Major features of the programs and outcome

(1) The 1983 program and its objectives

The principal elements of the 1983 program were a reduction of the fiscal deficit to 2.4 percent of GNP from 4.3 percent of GNP in 1982; a deceleration in the expansion of net domestic assets from 29 percent in 1982 to 20 percent in 1983; a flexible management of the exchange rate; and containment of minimum wage adjustments in the public sector to gains in productivity.

The basic objectives of the program were a reduction in the current account deficit from 8.2 percent of GNP in 1982 to 6.2 percent in 1983

1/ EBS/84/226.

Table 47. Philippines: Unemployment, Underemployment, Wage Rates, and Inflation, 1980-85

(In percent)

	1980	1981	1982	1983	1984	1985
Unemployment rate 1/	8.1	8.9	9.5	7.9	10.6	11.1
Underemployment rate 1/	34.5	36.3	34.2	35.9	35.7	33.7
Minimum wage rate 2/						
Agriculture	...	14.0	1.3	6.8	41.8	17.7
Private industry	...	14.5	1.4	7.5	41.6	17.8
National Government	...	24.6	3.9	2.9	36.8	17.5
Consumer price index 2/						
Philippines	...	13.1	10.2	10.0	50.3	23.1
Metro Manila	...	12.2	11.0	10.8	49.3	20.7

Sources: SM/85/251; SM/86/249; and Nugui, Bernal, Quimbo, and Tayzon (1987).

1/ As percent of the labor force.
2/ Percentage change from previous year.

and an analogous decline in the overall balance of payments deficit from 3 percent of GNP in 1982 to 1.5 percent of GNP in 1983. At the same time, real GNP growth was expected to decline from 2.7 percent in 1982 to 2 percent in 1983, while inflation 1/ was estimated to rise from 7.7 percent in 1982 to 11 percent in 1983 (Table 46). Other aspects of the program included the continued pursuit of important structural reforms initiated with the World Bank under its structural adjustment loan.

(2) General outcome of the 1983 program

With the exception of the budget deficit, developments under the 1983 stand-by arrangement quickly turned out to be sharply at variance with the program's objectives. During the first half year, the overall balance of payments deficit exceeded the target for the whole year and finally registered US$2 billion, compared with a target of US$0.6 billion. The current account deficit widened to the equivalent of 8.1 percent of GNP, compared with a target of 6.2 percent. Domestic credit expanded strongly, and by the third quarter of 1983 it became clear that the ceiling on net domestic assets for March and June 1983 had been substantially exceeded. There was a large monetary expansion in the last quarter, when reserve money rose by 57 percent and M3 growth accelerated from 12 percent at end-September to 19 percent.

In the National Government budget, adjustment was achieved through a reduction in capital expenditures, and a substantial increase in revenues related to discretionary measures instituted three times during the year. As a result, the overall deficit declined to 1.7 percent of GNP, compared with the program target of 2.4 percent of GNP. At the same time, the public corporations' contribution to aggregate demand rose considerably, mainly through sharp increases in capital projects.

The developments on the monetary side and the large losses of external reserves in the first three quarters of 1983 precipitated the financial crisis of October 1983, which, in turn, paved the way for the 1984 stand-by arrangement (EBS/84/117, SM/84/132).

(3) The 1984 program and its objectives

The 1984 stand-by arrangement became effective on December 14, 1984 in the wake of strong measures in the course of the year. These included a significant tightening of domestic financial conditions in anticipation of the exchange system reform that was implemented in October and a range of tax measures that strengthened revenue performance in the last quarter of 1984.

The main elements of the program were: (a) a comprehensive tax reform; (b) a structural reform of the sugar and coconut sectors; (c)

1/ As measured by the implicit GNP deflator.

rationalization of the public investment program, including the National Government and the major nonfinancial corporations; (d) rehabilitation programs for the Philippine National Bank, the Development Bank of the Philippines, and the Philippine Export Guarantee Corporation; and (e) a closer monitoring of the major nonfinancial public corporations with a view to reducing their operating and overall deficits (EBS/85/109).

(4) General outcome of the 1984 program

The outcome of the 1984 stand-by arrangement was uneven and, during the last months of the program implementation, it was seriously affected by the planned presidential elections of February 1986. Among the achievements of the program were the elimination of payments arrears on schedule, the containment of the external current account and overall deficits with the program targets, and the sharp reversal of the inflationary environment that had been caused by the external crisis of 1983.

However, important weaknesses remained in the implementation of policies during 1985. While progress was made in the identification of areas requiring structural adjustment, particularly in tax reform and in the reform of the sugar and coconut sectors, implementation in those areas and in import liberalization was generally delayed. Monetary policies were generally tighter than programmed, and the resultant high real interest rates, coupled with lingering inflationary and devaluation expectations, caused an unanticipated large drop in real activity (Table 46). The financial environment deteriorated early in 1986, when fiscal policy turned sharply expansionary in anticipation of the presidential election. In that unsettled period currency demand rose sharply, a black market in foreign exchange re-emerged temporarily, and interest rates again rose to very high levels. The third program review was not completed, the arrangement was canceled in June 1986, and the new Government engaged in discussions with the Fund toward a new arrangement (EBS/86/222).

3. Implications for poverty groups

a. Overall macroeconomic policy and other nonfiscal policy measures and implications

(1) General considerations

One of the major stumbling blocks in the assessment of the poverty implications of Fund programs is the difficulty of disentangling Fund-related policies from measures taken by the authorities independently or even from unrelated external shocks. The story of the Philippines in 1983-85 exemplifies this well. Although in 1983 a stand-by arrangement was already in place, developments during the early part of the year were little related to the economic policies under the arrangement. In the event, adjustment was forced by the severe shortage of foreign exchange, which culminated in the October 1983 crisis and resulted in a sharp compression of imports, activity, and employment. Similarly, 1984 was a year without a formal arrangement, but in preparation for a Fund-supported program the authorities introduced various measures in the form of prior actions. The original measures of the 1985/86 stand-by arrangement were supplemented with additional policies during the course of the program. At the same time there were conscious slippages from agreed measures toward the end of the arrangement as the country moved closer to the presidential election of 1986. This background must be clearly kept in mind in the discussion that follows.

(2) Monetary and credit policies

During the early part of 1983, monetary policy was particularly expansionary, mainly owing to a conscious accommodation by the Central Bank of sudden and substantial losses on previously negotiated foreign exchange swaps and forward cover transactions. The eventual tightening of monetary and credit expansion led to a sharp increase in interest rates, with concomitant consequences for investment and real economic activity.

Between September and December 1983, reserve requirements against short-term deposits were raised by 5 percentage points, and in January 1984 reserve requirements on long-term deposits were raised by 1 percentage point. Those were raised again in April 1984, thus bringing the reserve requirement on short-term and long-term liabilities to 24 percent and 6 percent, respectively. In addition, the rates on major rediscount facilities for commercial banks were raised and linked with market rates.

Monetary restraint was significantly tighter than programmed for much of 1985. The tightening of reserve requirements was complemented by substantial sales of central bank and treasury securities that raised their stock by about one third in 1985. As a result, interest rates became substantially positive in real terms, despite the accelerating pace of inflation. It is estimated that, measured against the annualized 6-month change in consumer prices, real deposit and lending rates reached peaks of 15 and 24 percent, respectively, by mid-1985.

The distributional implications of monetary policy during 1983-85 were clearly negative. In the beginning of the period expansionary monetary policy accommodated a high rate of inflation; at the end of the period inflation was decelerating but the unnecessarily tight restraint led to a sharp decline in activity. The emergence of high positive real interest rates in a period of sharp inflationary pressures protected the interest income of large depositors, while at the same time contributing to a substantial output decline in most domestic industries and services. Although the massive decline in trade and inventory financing also affected the income of traders and merchants, the most serious redistributive effects are related to the reduction in output and increase in unemployment in many sectors: real GNP is estimated to have fallen by nearly 7 percent in 1984 and by 4 percent in 1985; the official unemployment rate reached 10.6 percent and 11.1 percent in 1984 and 1985, respectively, compared with an average of 8.5 percent between 1980 and 1985.

The eventual monetary restraint experienced in late 1984 and 1985 affected poverty groups more seriously in urban than in rural areas, because the sectors hardest hit by the financial squeeze were distributive trade, community services, and personal services, in which the incidence of poverty is relatively high. Equally important, the serious financial restraint that was necessary to restore confidence in the banking system limited the capacity of the authorities to provide compensatory aid to the most vulnerable groups, as it did in the early 1970s. 1/

(3) Labor market policies

The recession of 1983-85 resulted in a serious compression of incomes, but several increases in the minimum wage cushioned the impact of the adjustment on the poorer segments of the population, at least for those employed in the formal sector. Minimum wages in the private sector were adjusted in October 1983 and three times in 1984 in response to the rapid increase in prices (Table 47). However, there was no further adjustment in 1985, when inflation rates exceeded 20 percent.

Minimum wages in the public sector were increased by 15.5 percent in November 1983, by 10 percent in May 1984, and by about 6 percent through 1985. On average, therefore, nominal minimum wages in agriculture, industry, and the National Government in 1985 were all about 18 percent higher than their 1984 levels. Since the corresponding rate of inflation was 23 percent, however, minimum wage rates continued to decline in real terms in 1985, a process that for some sectors had begun in 1982. In general, there were no substantial differences in the impact of real income compression among the various sectors of the economy.

There is little quantitative information on poverty thresholds and poverty incidence, but the World Bank has noted a disturbing trend in real wages and poverty thresholds between 1971 and 1983, namely the rapidly narrowing gap between the wage rate and an estimated poverty threshold in recent years. 2/ According to these calculations, the ratio of the average daily wage rate to the poverty threshold earning level (expressed as an index) declined from 204 in 1971 to 103 in 1983. Since real wages declined between 1983 and 1985 by an average of 8 percent, it is possible, indeed likely, that more families were pushed below the poverty line during the period of adjustment.

1/ EBS/85/21 and EBS/86/22.
2/ World Bank (1985), Table 12.

(4) Pricing policies

The pricing policies enacted during 1983-85 reversed a long tradition of price controls and other direct regulations that had tended to favor urban consumers at the expense of agricultural producers. The decontrol of all commodity prices (except rice) in 1984 and of rice in 1985 was an important step toward improving farm incentives and increasing efficiency in the agricultural sector.

Moreover, the role of the National Food Authority, which until 1985 encompassed such diverse activities as wheat importation and flour distribution, was limited to only the price stabilization of rice and corn. As a result, there was a shift in the profit gains from the agency and the consumers back to agricultural producers. At the same time, however, subsidies to farm inputs were phased out in conjunction with a World Bank agricultural credit project.

It should be noted in this context that the 1985 stand-by arrangement included policy commitments for the reform and eventual removal of the sugar and cocoa monopolies, with a view to increasing producer prices, enhancing output incentives, and raising productivity (EBS/84/226, EBS/85/109). Those reforms were never completed and the failure of the authorities to remove the sugar and cocoa monopolies exacerbated and prolonged poverty in the rural areas.

The price decontrol measures, which in many areas were complemented by trade and marketing liberalization policies, were an important step toward reversing a distorted system of price incentives that had existed in the Philippine economy for many years. Arguably, the impact on the consumers was minimal, since many commodities already commanded market prices through the rent-seeking activities of various intermediaries. For example, the Kadiwa stores, which were originally created to make basic commodities available to low-income consumers at fixed prices, had progressively become similar to normal retail outlets. On balance, therefore, the liberalization of pricing policies had beneficial consequences for poverty groups, owing to the positive impact on the sources side for farm producers and to the neutral impact on the uses side for urban dwellers (EBS/85/109 and Supplement 1).

(5) Exchange rate and other external policies

External sector policies between 1983 and 1985 may be broadly divided into two subperiods, with opposite distributional implications: 1983, when the financial crisis came to a peak; and 1984/85, when the situation stabilized and later began to improve under the influence of external developments and domestic economic management.

The measures taken during the latter part of 1983 were the initial reaction to the financial crisis of October of that year and basically amounted to closing the economy. The peso was devalued twice in the course of the year, by 7.8 percent in June and by 27.3 percent in

October, with a net effect of a real 16 percent devaluation between 1982 and 1983. In a series of parallel moves, the authorities also imposed severe import restrictions, foreign exchange allocations, and capital controls. 1/ The exchange system that emerged in the aftermath of the financial crisis thus aimed at establishing a centralized system of foreign exchange collection and allocation to priority uses, so that the economy could operate with minimum trade flows.

The intensification of import controls at the time of two devaluations resulted in a serious reduction of aggregate supply, i.e., the simultaneous emergence of inflation and recession. Manufacturing and trade were hit particularly hard, but agriculture was affected much less, because the two devaluations raised production incentives that had been eroded after years of an overvalued currency and pervasive interventions of state trading monopolies. The restrictive trade measures of 1983 also protected highly inefficient import competing activities.

Overall, therefore, the external policies of 1983 had adverse distributional effects on all segments of the population, but especially on urban workers. On the uses side, the poor across the board were negatively affected by the sharp increase in the price level, as a result of both the devaluations and the commodity shortages precipitated by the import restrictions. On the sources side, the poor were particularly affected in the areas of manufacturing, mining, and trade, where the recessionary effects of the external policies were more pronounced.

The second subperiod of external sector policies during the adjustment progress formally began with the 1984 arrangement, although several important measures had been taken earlier in the form of prior actions. Following about three quarters of real effective appreciation, the peso was devalued by 22 percent in June 1984, and at the same time a tax on foreign exchange purchases and a temporary export surcharge were imposed. Those measures, which gave rise to multiple currency practices, were the last policies directly or indirectly related to the foreign exchange crunch of 1983.

October 1984 marked the beginning of a new direction in the exchange system of the Philippines, with the elimination of many restrictions, the abolition of the foreign exchange and export taxes, and the floating of the exchange rate. The exchange system that evolved during the 1984/85 arrangement paved the way for liberalizing the trade and payments system beyond the reversal of the restrictions that had been imposed in the aftermath of the 1983 crisis. The major objective of the authorities during 1984/85 was to preserve exchange rate flexibility while at the same time ensuring that the overall exchange

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1/ For a complete list of the restrictions in the exchange and trade system between 1983 and 1984 see SM/84/132, pp. 55-61.

rate policy was sufficiently supportive of an export recovery and trade liberalization.

The impact of the external sector policies under the 1984/85 arrangement on poverty groups is hard to establish, if only because the effects of import liberalization on economic recovery and of the establishment of proper export incentives on resource allocation are of a longer term nature and are, therefore, linked with those of other macroeconomic policies that occurred at the same time. Two immediate beneficial effects may, however, be pointed out: first, the convergence of the official and the parallel market exchange rate in late 1984; second, the abolition of channels for the preferential acquisition of foreign exchange. Both of these developments had a favorable impact on low-income groups, first by reducing the premiums in the price of tradable goods and, second, by phasing out the speculative activities that had indirectly induced the poor to engage in activities that were unsustainable in the long run.

b. Fiscal policy measures and their implications

(1) Revenue measures

The 1983-85 period is characterized by a proliferation of discrete tax measures, generally limited in scope, whose main aims were to restrain imports and to generate budget revenue. Not surprisingly, therefore, most tax measures took the form of increases in import duties or additional surcharges on tradable commodities. Among the most important trade tax measures was the successive increase of the ad valorem import surcharge from 3 percent to 5 percent in November 1983, to 8 percent in April 1984, and to 10 percent in June 1984. Additional tariffs and export taxes were also imposed on logs and lumber, bananas, coconut products, pineapples, and shrimp. Excise taxes were also raised on tobacco, alcohol, and petroleum products. 1/

These tax increases, which at the time of their inception were expected to yield additional revenue equivalent to over 2 percent of GNP, did not materialize. The contraction in economic activity, the compression of real incomes, and imperfect tax administration, all contributed to a persistent deterioration in tax collections, the large number of measures notwithstanding. Total tax revenue in 1984 declined by 1.4 percent of GNP, reflecting a commensurate decline in international trade taxes and a constant tax ratio in domestic-based taxes.

In 1985, a substantial increase in revenues from the income tax and from excise duties was partially offset by a decline in collections from trade taxes, particularly import duties, with a net improvement of

1/ A complete set of revenue measures enacted in 1983-85 may be found in SM/85/251, Tables 31 and 35, and SM/86/249, Annex I.

revenue performance of 1.0 percent of GNP. The increase in the income tax was primarily due to upward adjustments in tax rates for dividend and interest income and the removal of several exemptions. Higher revenues from excise taxes resulted mainly from increased rates on a series of excisable products such as petroleum, beer, spirits, and other minor items. The decline in import duties was attributed to a growth of customs exemptions for public enterprises and to the decline in world oil prices in 1985.

In summary, the main features of the revenue package during the 1983-85 adjustment program were: (a) multiple discrete changes in tax rates, primarily on tradable commodities; (b) the removal of exemptions that had seriously eroded the tax base and their reintroduction at a later stage under political pressure; and (c) steps to improve tax administration and taxpayer compliance, but with a disappointing overall collection performance.

The tax system in the Philippines is clearly regressive owing to the prominence of indirect taxes, which account for nearly two thirds of total tax revenue (Table 45). An analysis of tax incidence indicates that the slight progressivity of direct taxes is more than offset by the regressivity of indirect taxes. Table 48 shows the effective tax burden by income class and the share of income received and the taxes paid by each income class in 1985. According to Table 48, the bottom income group pays nearly 27 percent of its income in taxes, whereas the top income group pays only 18 percent. There is, however, some evidence of an inverse U-shaped pattern of incidence, because it is the middle-income groups that pay the highest proportion of taxes, except for the income tax.

Although in quantitative terms the impact of the tax measures was limited, primarily owing to the erosion of the tax base, the potential effect of the revenue package from the uses side was regressive, because its main components were increases in domestic excises and customs duties. The only progressive element was the upward adjustment of the tax on dividend and interest income, which, however, came late in 1985 and did not have serious distributional implications.

From the sources side it can be argued that the revenue instruments affected poverty groups adversely over the medium term, because many new customs duties and surcharges reversed the trade liberalization process initiated in 1981. This development not only unduly extended the life of some inefficient industries, with undesirable employment effects, but also created a bias against the reallocation of productive resources into tradable activities.

(2) Expenditure measures

As is typical in Fund stand-by arrangements, the economic programs supported by the Fund did not specify explicit expenditure measures. Instead, public expenditures were calibrated by the

Table 48. Philippines: Tax Burden, Income, and Tax Collection Shares by Income Class, 1985

(In percent)

Income Classes 1/	Total Tax Burden 2/	Income Share Before Tax 3/	Direct Taxes Share 3/	Indirect Taxes Share 3/
I-III	26.8	10.8	7.0	10.5
IV-VI	32.1	36.5	26.4	36.1
VII-IX	18.2	52.7	66.6	53.4
Total		100.0	100.0	100.0

Source: World Bank (in progress).

1/ Income classes are defined as families within the following annual ranges (in pesos):

I -	Under 6,000
II -	6,000 - 9,999
III -	10,000 - 14,999
IV -	15,000 - 19,999
V -	20,000 - 29,999
VI -	30,000 - 39,999
VII -	40,000 - 59,999
VIII -	60,000 - 99,999
IX -	100,000 and over

2/ In percent of average family income.
3/ In percent of total income or total tax collections.

authorities in a manner consistent with the overall deficit objective. As a general rule, capital and maintenance and operating expenditures were drastically curtailed, whereas other major components of current expenditure either declined somewhat in real terms (wages and salaries) or rose considerably (interest payments). Unlike other countries, the Philippines initially attempted to address program slippages through revenue increases, but it, too, eventually resorted to expenditure cutbacks, because the serious inelasticity of the tax system typically limited the room for maneuver.

During 1983, wages and salaries increased by 6.5 percent, in reflection of a general hiring freeze and only one cost of living adjustment at the end of the year. Subsidies for fertilizers were reduced, but interest payments grew rapidly as a result of increased foreign borrowing and the exchange rate devaluation. Capital expenditures also declined in nominal terms, and at the same time there was a shift away from infrastructure outlays on power and road construction in favor of other projects.

Similar trends were observed in 1984, a year with no formal Fund arrangement. With the exception of net lending and equity contributions to public enterprises, all major expenditure categories were restrained, with a more pronounced effect in infrastructural investment outlays.

In 1985 current expenditure and equity and net lending rose substantially and contributed to a 0.8 percent rise in total expenditure as a proportion of GNP. Large budgetary allocations to public financial and nonfinancial institutions, which absorbed 20 percent of total expenditure in 1985, contributed to that increase. Those were essentially transfers to cover losses from nonperforming assets and from operating deficits arising from inadequate tariff and price structures. In contrast, capital expenditure was cut back sharply in real terms, declining from 1.9 percent of GNP in 1984 to 1.5 percent in 1985, with investment in infrastructure particularly hard hit. Maintenance and operating expenditures also declined as a proportion of GNP, although only marginally (Table 49).

It is always difficult to assess the distributional impact of government spending classified by economic type of expenditure. If quantitative information was available, transfer payments, subsidies, and interest would be conceptually easy to evaluate, as they would be equivalent to negative direct taxes, negative indirect taxes, and direct personal receipts. Maintenance and operating expenditures, capital expenditures, and net lending are conceptually very difficult to allocate, because of insufficient information about the links between budgetary disbursements and the programs or final objectives that they support. Wages and salaries are relevant only to the extent that benefits accruing to individuals are measured in their capacity as factors of production.

Table 49. Philippines: National Government Budgetary Expenditures and Net Lending, 1981-85

	1981	1982	1983	1984	1985
	(In percent of total expenditure and net lending)				
Current expenditure	54.9	58.9	65.1	64.3	69.0
Wages and salaries	22.1	20.2	26.2	25.3	28.6
Other expenditures on goods and services	23.4	23.6	22.5	18.6	16.5
Interest payments	5.0	6.8	9.4	15.6	18.3
Transfers to local governments	3.2	4.5	4.9	4.2	4.4
Subsidies	1.1	3.8	2.1	0.6	1.2
Capital expenditure	26.4	19.1	19.6	14.7	11.0
Infrastructural investment	20.7	14.3	13.1	9.4	6.9
Other capital expenditure	5.6	4.8	6.5	5.3	4.1
Equity and net lending	18.7	22.0	15.3	21.0	20.0
Equity contributions	16.8	17.8	10.8	14.7	18.0
Loans less repayments	1.9	4.2	4.5	6.3	2.0
Total expenditure and net lending	100.0	100.0	100.0	100.0	100.0
	(In percent of GNP)				
Current expenditure	8.7	9.2	9.1	8.0	9.1
Wages and salaries	3.5	3.2	3.7	3.2	3.8
Other expenditures on goods and services	3.7	3.7	3.1	2.3	2.2
Interest payments	0.8	1.0	1.3	1.9	2.4
Transfers to local governments	0.5	0.7	0.7	0.5	0.6
Subsidies	0.2	0.6	0.3	0.1	0.1
Capital expenditure	4.2	3.0	2.7	1.9	1.5
Infrastructural investment	3.3	2.3	1.8	1.2	0.9
Other capital expenditure	0.9	0.7	0.9	0.7	0.5
Equity and net lending	3.0	3.5	2.1	2.6	2.7
Equity contributions	2.7	2.8	1.5	1.8	2.4
Loans less repayments	0.3	0.7	0.6	0.8	0.3
Total expenditure and net lending	15.9	15.7	14.0	12.4	13.2

Source: International Monetary Fund, SM/86/249, Table 21.

By focusing on the poor, rather than on income distribution as a whole, the functional classification of expenditures becomes more relevant than the economic classification for distributional considerations. Wages and salaries, for example, represent incomes of civil servants who belong to the middle class; changes in this category would not affect poverty groups. However, the poor would be affected by the provision of services of government programs, and in that respect the functional structure becomes important. Tables 50 and 51 show developments in the functional breakdown of public spending between 1980 and 1985.

As Table 51 indicates, total expenditures peaked in 1981 and progressively decreased through 1984, before picking up again slightly in 1985. The decline was particularly sharp in 1984, when the foreign exchange crisis broke out and the economy was forced to adjust abruptly. Characteristically, all expenditures as a proportion of GNP were substantially reduced to make room for a sharp increase in interest payments, the share of which in total expenditures climbed from 5 percent in 1981 to nearly 18 percent in 1984 and 1985.

All poverty groups were adversely affected by these developments owing to the cutback in social services, which implies a reduction in their real consumption. The rural poor were additionally affected by the curtailment of economic services, which in many cases had a direct consequence for their productive efficiency. In particular, the reduction of fertilizer subsidies and the sharp cutback in irrigation and road construction investment projects had a negative impact on agricultural productivity and incomes, although the overall result was mitigated by the favorable effect of other policies (see subsections a.(4) and a.(5). Nevertheless, the deterioration in local feeder roads and other rural infrastructure limited the access of the poor to markets and to government services that were potentially available in rural communities.

Social services as a percentage of GNP reached a peak in 1982 and declined for the following two years before stabilizing in 1985 (Table 51). In terms of composition, the shares of health and housing declined substantially between 1982 and 1985 (Table 50). Moreover, changes in the composition of disbursements within those programs affected the poor adversely, particularly in the area of health, where a large amount of resources was reportedly channeled toward highly specialized facilities. The World Bank estimates that the share of preventive care in government health expenditures declined from 26 percent in 1982 to 14 percent in 1985. It averaged 22 percent over the period 1981-85, compared with 69 percent for curative care. 1/ It should be noted, however, that although expenditure cutbacks on health reduced the real consumption of the poor in absolute terms, the distributional implications are unclear, because the observed

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1/ World Bank (forthcoming).

Table 50. Philippines: National Government Expenditures by Function, 1980-85

(In percent of total expenditures)

	1980	1981	1982	1983	1984	1985
Economic services	39.7	39.8	35.4	31.3	23.5	26.7
Agriculture	5.4	5.9	7.0	5.9	5.0	6.2
Industry, trade, labor, and tourism	3.6	5.9	5.1	4.2	3.1	3.5
Utilities and infrastructure	30.7	27.9	23.3	21.2	15.3	17.0
Social services	21.6	21.0	23.7	24.3	21.5	17.2
Education	13.1	12.6	13.6	12.7	13.2	12.6
Health	4.0	3.7	4.6	5.1	4.0	2.9
Social security and welfare	2.0	2.0	2.6	2.8	2.2	0.9
Housing and community development	2.6	2.8	2.9	3.8	2.1	0.9
Defense	13.7	11.7	12.5	13.1	10.8	9.7
General public services	18.7	22.3	20.9	21.2	26.6	28.9
Subtotal	93.7	94.8	92.5	90.0	82.3	82.5
Interest payments	6.3	5.2	7.5	10.0	17.7	17.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: World Bank (forthcoming).

Table 51. Philippines: National Government Expenditures by Function, 1980-85

(In percent of GNP)

	1980	1981	1982	1983	1984	1985
Economic services	5.4	6.1	5.0	4.1	2.6	3.8
Agriculture	0.7	0.9	1.0	0.8	0.6	0.9
Industry, trade, labor, and tourism	0.5	0.9	0.7	0.6	0.4	0.5
Utilities and infrastructure	4.2	4.3	3.3	2.8	1.7	2.4
Social services	2.9	3.2	3.4	3.2	2.4	2.4
Education	1.8	1.9	1.9	1.7	1.5	1.8
Health	0.5	0.6	0.7	0.7	0.4	0.4
Social security and welfare	0.3	0.3	0.4	0.4	0.3	0.1
Housing and community development	0.4	0.4	0.4	0.5	0.2	0.1
Defense	1.9	1.8	1.8	1.7	1.2	1.4
General public services	2.5	3.4	3.0	2.8	3.0	4.1
Subtotal	12.8	14.5	13.1	11.8	9.2	11.6
Interest payments	0.9	0.8	1.1	1.3	2.0	2.5
Total	13.7	15.3	14.2	13.1	11.2	14.1

Source: World Bank (forthcoming).

compositional changes raise questions about progressivity in the original benefit incidence. 1/

The implications of the adjustment program for social expenditures on a per capita basis are even more severe. The continued rapid population growth during the stabilization period induced a rapid fall in the real per capita level of social expenditures after 1982. Per person expenditure fell by more than one third from 1981 to 1985, with the largest drops occurring in housing (minus 75 percent) and health (minus 35 percent) (Table 52). In summary, therefore, the expenditure measures taken between 1983 and 1985 had a clear adverse impact on the welfare of all poor from the uses side and an additional negative impact on the rural poor from the sources side.

c. A digression into an empirical study

A World Bank study 2/ on the effects of macroeconomic performance on income distribution indicates that the theoretical propositions embodied in the present analysis are substantiated empirically. The study does not focus exclusively on Fund-supported adjustment programs, nor does it follow the classification of policies adopted in the present investigation. Consequently, it is not possible to use its results directly for the assessment of the impact of the two stand-by arrangements on poverty. Nonetheless, some of the results are worth noting. In particular, the World Bank study finds that between 1980 and 1986 gains in productivity and increases in the real exchange rate and the real interest rate tended to reduce inequality. On the other hand, higher underemployment, inflation, and government spending tended to favor upper-income groups at the expense of poor individuals.

The empirical results of the World Bank study are in line with the propositions employed in the present analysis, keeping in mind the important distinction between income distribution in general and poverty in particular. The positive contribution of the real interest rate in reducing inequality is a somewhat surprising result, which may be explained by the view that short-run improvements in economic activity benefit high-income groups more than low-income groups.

4. Summary and conclusions

Implications for poverty were examined under two stand-by arrangements in support of adjustment programs undertaken by the Philippine authorities in 1983 and 1984. The stabilization period may be broadly delineated between October 1983, when a severe foreign

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1/ If the original distribution of benefits is regressive, i.e., pro-rich, a cutback in government spending will improve income distribution; at the same time, the poor will also be hurt owing to the reduction of services in absolute terms.

2/ World Bank (forthcoming).

Table 52. Philippines: Real Per Capita Government Expenditures in Social Services, 1980-85

(In pesos)

	1980	1981	1982	1983	1984	1985
Total	117.3	126.4	122.6	116.6	83.0	80.1
Education	70.1	74.1	73.0	63.3	50.3	52.2
Housing and community development	13.9	16.6	15.6	18.9	8.0	4.2
Health	21.2	22.7	24.7	25.3	15.3	14.7
Social security, welfare, and social services	12.1	13.0	9.3	9.1	9.4	9.0

Source: World Bank (forthcoming).

exchange shortage emerged, and the end of 1985, when, in anticipation of the presidential elections in February 1986, several program policies were reversed. During most of 1984 the Philippines did not have a formal arrangement with the Fund, but the authorities took a series of adjustment measures in the form of prior actions for the stand-by negotiations.

The October 1983 foreign exchange crisis effectively closed the Philippine economy and induced a major recession. The immediate response was a series of devaluations, spread over a year, and the introduction of severe import and payments restrictions. But an expansionary monetary policy accommodated a rapid increase in inflation, which averaged 50 percent in 1984. Against this background, the authorities formulated the 1985-86 package with a view to restoring confidence, reversing the external sector restrictions, and improving the growth prospects of the economy. The serious erosion of the tax base, however, constrained the Government's spending policies, and in fact caused a serious curtailment of infrastructure projects. The authorities attempted to mitigate the severe erosion of real incomes by raising wages and salaries several times during 1984, but real wages nonetheless declined by 20 percent in 1984 and by 5 percent in 1985.

Monetary policy was initially accommodating and thus validated the inflationary pressures, which in turn caused a serious decline in real wages. The eventual tightening of credit expansion in excess of that necessary to accommodate the fiscal deficit, while observing the external constraints, affected poverty groups in urban areas on the sources side by raising unemployment in commerce and service activities.

The decontrol of commodity prices reversed a distorted system of price incentives that had beset the Philippine economy for a number of years. At the same time, the impact on consumers was minimal, since many commodities already commanded market prices through premiums extracted by various intermediaries. On balance, the liberalization of pricing policies had a positive impact on the sources side for producers and a neutral impact on the uses side for urban dwellers.

External sector policies may be divided into two subperiods: 1983, when the financial crisis came to a peak; and 1984-85, when the situation stabilized and later began to improve. During the early period, the external policies had adverse distributional effects on all segments of the population, but especially on urban workers. On the uses side, low-income groups were affected by the sharp increase in price levels and the commodity shortages, both precipitated by the interaction between devaluations and import restrictions. On the sources side, the urban poor were particularly affected in the areas of manufacturing, mining, and trade.

Budgetary policies were generally ad hoc and were almost exclusively aimed at sustaining a deficit objective. As a result, both the allocational and the distributional concerns of fiscal policy were largely neglected. Typically, the programs targeted infeasible revenue increases to accommodate ambitious expenditure plans, but implementation slippages turned the priorities around. In general, tax measures were largely ineffective and their impact on the poor, minimal, primarily because they affected the middle- and upper-income groups.

The decline in tax yield triggered substantial expenditure cuts, especially in maintenance and operating expenditures and in capital projects. On the sources side, such adjustments limited the productive capacity of the rural poor and probably transferred resources from the smallholders to large-scale farm industries in monopoly sectors (sugar and coconut), with adverse distributional implications. On the uses side, the reduction in social expenditures limited the benefits accruing to the poor from such important programs as health, education, and housing. It should be noted, however, that although in absolute terms such cutbacks reduced the real consumption of the poor, their distributional implications are unclear because of a questionable progressivity pattern in the original benefit incidence. In other words, if the original distribution of benefits was pro-rich, a curtailment of public programs would improve the relative position of middle- and lower-income groups, while in absolute terms the situation of the poor could still deteriorate.

In conclusion, the adjustment measures reflected in the 1983 and the 1984-85 stabilization programs, as well as those taken during that period outside the stand-by arrangements, had a clear adverse impact on the poor in the short run. During the latter part of the adjustment period, certain structural policies, especially the removal of import restrictions and price liberalization, set the stage for an increase in the productive capacity of the poor and the shift of their resources to more efficient uses over the medium term.

VIII. Sri Lanka: The 1983/84 Program: The Implications for Poverty

The economic program for 1983/84 (July/June) was approved in September 1983 and was to be supported by a one-year stand-by arrangement with the Fund in the amount of SDR 100 million (EBS/83/166, 8/9/1983). Although the program officially entered into force in September, discussions were conducted in July, and policy measures implemented prior to its adoption formed a basis for the program. In particular, the fiscal, credit, and pricing policies which had been pursued by the authorities prior to the program formed an important basis for the program.

Sri Lanka utilized SDR 50 million (SDR 10 million in September 1983, SDR 20 million in November 1983, and SDR 20 million in January 1984). Ethnic disturbances that occurred in the last week of July, shortly after the return of the negotiating mission to headquarters, posed serious obstacles for the authorities in implementing the program measures. A review mission that visited Colombo in November-December 1983 did not reach understandings with the authorities on policies, measures, and performance clauses for the second half of the program, and the arrangement was interrupted (SM/84/150, 6/29/84).

1. The economy, the poor, and the institutional setting

a. The economy

Sri Lanka is a low-income country with a fairly large population (15.4 million as of mid-1983), growing at an annual rate ranging from 1.2 to 1.5 percent. Its per capita GDP was estimated at about SDR 352 in 1983. The services sector contributes about one half to GDP, with the central government as the dominant subsector. The agricultural sector provides roughly one fourth of GDP, one half of employment, and more than one half of exports (Tables 53 and 54). Major agricultural crops are paddy and three tree crops--tea, natural rubber, and coconuts. Paddy, accounting for about one fourth of agricultural value added, is the single largest agricultural crop and is entirely consumed domestically. The tree crops, together accounting for another one fourth, are export oriented.

Exports of goods and services, accounting for about one fourth of GDP in 1983, were concentrated largely on the three tree crops. Imports accounted for 40 percent of GDP; the share of food, energy products, and fertilizers in total imports was about half.

b. Socioeconomic characteristics of the poor

Various overall social indicators, such as life expectancy, the infant mortality rate, and the number of physicians, suggest that living conditions in Sri Lanka are far better than reference country groups in the region. Owing to government policies, distribution of income (both size and sectoral) is relatively equitable in comparison with reference country groups. The gaps between sectors are nevertheless significant. The population in Sri Lanka is predominantly in rural areas, which accounts for about 74 percent of the total, with the urban and the estate sectors accounting for 16 percent and 10 percent, respectively. Living conditions in rural areas in general are not as favorable as in urban areas. For example, the urban population has greater access to safe water and electricity. 1/

Poverty in Sri Lanka is largely a rural phenomenon. In the 1981/82 survey, about one fourth of the population was characterized as a poverty group, and 82 percent of the population in the poverty group was

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1/ The shares of urban population with access to safe water and electricity are 65 percent and 46 percent, respectively; comparable shares for rural areas are 18 percent and 8 percent. See World Bank and International Finance Corporation (1986), pp. 220-21.

Table 53. Sri Lanka: Area, Population, and Income, 1983

Area	65,584 square kilometers
Population	15.4 million (mid-1983)
Population growth	1.5 percent (1985)
GDP per capita	SDR 352 (1983)

Source: SM/86/143 (6/23/1986), p. v.

Table 54. Sri Lanka: Distribution of Income Receivers, 1981-82 Survey

(In percent)

Agriculture and forestry	47.5
Manufacturing	12.7
Wholesale, retail	10.7
Community social and personal services	9.7
Public administration and defense	3.8
Other	15.6

Source: Central Bank of Ceylon (1984).

in the rural sector, followed by the urban poor (14 percent), and the poor in the estate sector (6 percent). 1/ The major poverty groups are predominantly landless farm workers and smallholders in rural areas. The largest poor group consists of casual farm employees; the second largest group consists of self-employed smallholders. 2/ In the rural and estate sectors, the poor form the bulk of the agricultural labor force and are engaged in the production of paddy, for domestic consumption, and the tree crops, for export. 3/ In urban areas, the poor are largely unskilled workers employed in manufacturing, construction, and the service sectors and self-employed carpenters and artisans operating on a small scale.

c. Institutional setting

The public sector is a dominant user of final goods (10 percent of consumption and more than one half of investment goods); moreover, the public sector, particularly the central government, is an important regulator of the prices of both goods and factors of production. The Government sets the floor prices for important products (e.g., paddy and sugar) and ceiling prices for some other products (e.g., fertilizers and energy). The Government also maintains, through wage boards, the minimum wages for the private sector. The exchange arrangement is characterized as a managed floating system.

2. The 1983/84 adjustment program and outcome

a. Background: economic developments prior to adoption of the program

The economy responded sharply to the 1977 reform, which aimed at removing major bottlenecks of growth by improving the infrastructure, liberalizing the price system, removing import controls, and increasing investments. The reform was supported by a one-year stand-by arrangement (1977/78) and subsequently by an extended arrangement (1979-81). Although both of the programs ran their full course, and the total amounts in the arrangements were drawn, Sri Lanka experienced a sharp deterioration of external terms of trade in 1980/81, and the objectives and targets of the EFF program had to be substantially revised.

Economic developments during 1977-81 were mixed. Real GDP growth averaged 6 percent per year, and the unemployment rate was substantially reduced. On the negative side, however, the overall deficit of the central government increased from 7.7 percent of GDP in 1977 to 15.6 percent in 1981; the external current account, partly as a result of consecutive annual deteriorations in the external terms of trade,

1/ Gunaratna (1985a).
2/ Gunaratna (1985b).
3/ Central Bank of Ceylon (1984); Visaria (1981).

changed from a surplus of 2.1 percent of GDP in 1977 to an estimated 13.3 percent in 1981. External debt increased from about 40 percent of GDP at the end of 1977 to 53 percent at the end of 1981.

In 1982, the impact of the deepening world recession on the economy was aggravated by poor weather conditions. However, policy adjustments were delayed by pre-electoral considerations. Fiscal and credit policies became more expansionary, whereas the exchange rate appreciated sharply as a result of its close link with the appreciating U.S. dollar. Real GDP growth fell from 5.8 percent in 1981 to 5.1 percent in 1982; the fiscal deficit increased from 15.6 percent of GDP to an estimated 17.2 percent; and the external current account deficit was estimated to have increased from 13.3 percent of GDP to 15.3 percent. Net international reserves, after declining from SDR 161 million in 1978 to SDR 4 million in 1981, turned to a negative SDR 20 million in 1982. External outstanding debt increased to 57 percent of GDP, and the debt service ratio to 19 percent.

b. Major features of the program and outcome

(1) Program

The program was aimed at an annual growth of about 5 percent in real GDP and a gradual slowing down of domestic inflation from 24 percent a year during 1980-82 to 8 percent in 1983-84. The overall budget deficit of the central government was to be reduced from 17.2 percent of GDP in 1982 to 14.6 percent and 11 percent in 1983 and 1984, respectively, whereas the current account deficit was to be reduced from 15.3 percent of GDP in 1982 to 10.5 percent in 1984 (Table 55). In addition to the fiscal measures summarized in the next subsection, the program included a number of other macroeconomic policy measures: maintenance of a flexible exchange rate regime, moderation in credit expansion and its restructuring in favor of the private sector, maintenance of positive real interest rates, increases in the administered prices of key products (paddy, petroleum products, transport fares, fertilizer, flour, and milk products), full pass-through to domestic prices of the impact of the devaluation, discontinuation of the wage indexation system in the civil service, limited growth of employment in the public sector, and standard understandings pertaining to exchange restrictions.

The program was designed on the basis of a sharp improvement that was expected for the external terms of trade. A notable feature of the program was a substantial slowdown of domestic credit expansion, particularly of credit to the public sector. 1/ It was planned for the increase in net domestic credit to slow down from 42.9 percent a year

1/ In the context of the discussion of credit policy, the public sector refers to the central government; public corporations are included in the private sector.

Table 55. Sri Lanka: The 1983-84 Program

	The Program					Actual			
	1980	1981	1982	1983	1984	1981	1982	1983	1984
		Estimate		Program					
	(Annual percentage change)								
Real GDP	5.8	5.8	5.1	4.6	5.5	5.8	5.1	5.0	5.1
GDP deflator	20.0	20.8	12.1	13.0	8.0	20.5	11.0	16.6	20.3
Consumer price index	37.7	23.7	11.0	13.0	8.0	23.7	11.0	11.3	16.8
Trade volume									
Export	-1.0	9.0	2.8	-5.4	12.3	9.1	6.4	-8.1	19.4
Import	7.5	-6.0	22.3	0.9	4.3	-10.1	14.9	1.3	3.7
Terms of trade	-15.0	-6.0	7.4	16.8	0.8	-6.9	-3.0	18.8	19.2
Effective exchange rate depreciation -									
Nominal	-17.3	-3.5	5.4	...	...	-3.5	5.4	-11.0	3.6
Real	-3.4	10.5	-3.0	...	...	10.0	4.5	4.2	6.4
Net domestic credits	70.8	26.7	31.2	15.9	...	32.7	25.5	17.2	0.9
Public sector	109.7	31.4	26.1	3.8	...	41.6	24.3	4.1	-11.9
Private sector	57.7	34.0	24.0	23.0	...	34.6	25.9	31.8	16.1
Broad money	31.8	23.2	24.6	14.9	...	23.2	23.8	22.5	16.6
	(In percent of GDP)								
Budget deficit									
Before grant	23.1	15.6	17.2	14.6	11.0	15.6	17.6	13.6	8.9
After grant	19.2	12.4	13.8	10.4	...	12.4	14.2	10.8	6.7
Revenue	19.9	17.9	16.6	18.9	...	17.4	16.2	18.9	22.0
Expenditure	43.0	33.5	33.8	33.5	...	33.0	33.8	32.5	30.8
Domestic bank financing	10.6	4.5	3.7	0.3	...	4.5	3.7	0.4	-1.4
Current account deficit									
Before grants	19.8	13.3	15.3	12.2	10.5	13.8	15.4	12.5	4.2
After grants	16.4	10.2	11.8	8.6	...	10.2	12.0	9.2	0.9

Sources: SM/83/166 (8/9/83), p. 49, for data on the program; SM/85/101 (4/9/85), p. 6, and SM/86/139 (6/16/86), p. 4, for actual data.

during 1980-82 to 15.9 percent in 1983 and for the increase in credit to the public sector to slow down from 55.7 percent to 3.8 percent. This policy, which was to result in a substantial expansion of credit to the private sector in real terms (although the real expansion was to be somewhat lower in than 1982) and in a substantial real decline in outstanding credit to the public sector, was to be achieved by a reduction in the government deficit and domestic financing of the deficit.

In fiscal policy, the original central government budget for 1983 was formulated in November 1982. Additional measures, largely on the expenditure side, were introduced during the course of 1983. It is evident that the program affected the fiscal outturn for 1983 and influenced the formulation of the original 1984 budget. The extent to which the program affected the fiscal outturn of 1984 is not clear, and the program's impact on the 1984 fiscal outcome and its possible distributional implications are not discussed.

The original 1983 budget envisaged an overall central government fiscal deficit of 16.4 percent of GDP (which was reduced to 14.6 percent in March 1983). The program retained the deficit target of 14.6 percent, but subsequently reduced the target to 13.6 percent by lowering the expenditure target to 32.5 percent of GDP, compared with 35.3 percent in the original budget, but maintaining the revenue target at 18.9 percent as originally budgeted. The 1984 budget projected continuation of fiscal adjustment by aiming at a further reduction of the deficit to 10.1 percent of GDP, with the burden of adjustment, in comparison with the program for 1983, split equally between revenue and expenditure.

(2) Outcome

External and domestic developments during the program period were mixed. The external terms of trade improved significantly more than expected. However, the July 1983 ethnic disturbances, which occurred immediately after the return of the negotiating mission to headquarters, had a sharply adverse impact on the economy by destroying physical assets and slowing activity in the manufacturing and tourism sectors.

The outcome of the program for 1983 was also mixed. Whereas the growth target was attained, the inflation target was exceeded, as a result of an excessive credit expansion. Such credit expansion adversely affected the external balance by increasing import demand. The central government overall budget deficit was reduced from 17.6 percent of GDP in 1982 to 13.6 percent in 1983, which was also the program target. The external current account deficit declined from 15.4 percent of GDP in 1982 to 12.5 percent in 1983, slightly in excess of the program target.

The growth of aggregate real output in 1983 was slightly lower than during 1980-82. The program aimed at a slight decline of real growth from 5.6 percent per annum during 1980-82 to 4.6 percent in 1983, but actual growth exceeded the target and attained 5 percent. Although the substantial reduction in the overall fiscal deficit contributed to the sharp deceleration in the growth of credit to the public sector, the growth of overall domestic credit exceeded the target, thus causing an acceleration of domestic inflation.

In retrospect, the most significant policy developments in 1983 were the sharp curtailment of credit to the public sector and increases in a number of key administered prices, e.g., the prices of kerosene, gasoline, and diesel. The deceleration in the growth of credit to the Government and the acceleration in the growth of credit to the private sector were evident even from the beginning of 1983; these trends persisted, however, and even intensified in some instances, with the entry into force of the arrangement, although during the program period, the authorities made some effort to restrain the growth of credit to the private sector. The increases in energy prices took place prior to adoption of the program and again when the negotiation for the arrangement was proceeding.

The originally envisaged slowdown in overall credit expansion was not achieved in 1983 because whereas the growth of credit to the Government was sharply reduced as planned, the growth of credit to the private sector exceeded the target. The level of the real effective exchange rate appreciated during 1983, although the nominal rate depreciated (Table 55).

3. Implications for poverty groups

a. Macroeconomic and other nonfiscal policy measures and implications

The impact of the program on income distribution should be assessed taking into account the relatively short duration of the arrangement. 1/ Although the analysis focuses largely on 1983, economic

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1/ For a longer-term analysis of the impact of adjustment policies on the distribution of income in Sri Lanka, see Bhalla and Glewwe (1986) and Sahn (1987). The Bhalla and Glewwe study concludes that Sri Lanka's policies to promote growth-oriented adjustment accelerated growth and raised a number of living standard indicators without worsening expenditure inequality. The Sahn study notes that, during 1977-84, policies promoted investment in physical capital (social infrastructure) at the cost of human capital (nutrition and health expenditure) and that the fiscal deficit increased, aggravating domestic inflation and reducing real wages; however, the study does not attempt to analyze whether the continuation of the pre-1977 policies to alleviate poverty directly through government expenditures would have had more favorable results for the poor.

developments in 1983 were affected to a considerable extent by the events (an improvement in the external terms of trade, a drought, and civil disturbances) that occurred before the program was adopted. Some of the policy measures--particularly the credit policy and the pricing policy--adopted in the program had been pursued by the authorities from the beginning of the year. The impact of the policy measures adopted in connection with the program might have carried over into 1984. Also, in some instances, particular policy measures adopted were not in conformity with recommendations made by the Fund, such as those on technical assistance (see subsection b. below).

(1) Money and credit policy

On credit policy, other than the overall restraint on credit expansion and the reorientation of credit expansion in favor of the private sector (particularly the export sector), the program was aimed at a substantial fiscal adjustment to support the programmed reduction in the expansion of credit to the public sector.

Expansion of credit to the export sector, where the poor are extensively employed, is expected to have had a favorable impact on the poor in Sri Lanka unless it was excessive, aggravated domestic inflation, and adversely influenced the real wages of the poor. In this respect, the program's targets and the policy instruments adopted to achieve those targets had positive distributional implications, although actual credit expansion did exceed the target and thus aggravated domestic inflation.

(2) Pricing policy

The program was aimed at the flexible pricing of energy. Thus, the administered prices of some key energy products were raised between 35 percent and 70 percent in 1983. The largest price increase was registered for kerosene at about 70 percent; the price increases for gasoline and auto diesel were lower, at about 35 percent (Table 56). These price developments were not favorable for the poor. Although the rural poor in Sri Lanka rely mainly on firewood for fuel, the price of firewood closely followed developments in kerosene prices. However, the kerosene stamp program was in place at the time to mitigate the impact of the increase in kerosene prices on the poor; the Government's kerosene subsidy payments increased by 68 percent in 1983, although total subsidy payments stagnated in nominal terms and declined in real terms. 1/

1/ This policy to raise the prices of petroleum products and to compensate for its adverse impact on the poor through the kerosene stamp scheme may be comparable with the policy in 1977 to decontrol food prices gradually and to compensate for its adverse impact on the poor through the food stamp scheme. A number of studies have found that the food stamp scheme was effective for the poor, while minimizing the fiscal burden. See Edirisinghe (1986).

Table 56. Sri Lanka: Domestic Price Developments, 1980-84

	1980	1981	1982	1983	1984
	(Annual percentage change)				
Guaranteed paddy price	...	...	--	8.7	--
Export unit values					
Tea	9.9	5.5	-0.3	50.0	47.0
Rubber	9.5	3.1	-18.3	28.8	14.9
Coconuts	31.0	-20.9	-28.0	61.1	75.9
Energy prices					
Kerosene	41.5	16.5	--	69.2	--
Gasoline	32.7	13.7	--	35.0	--
Auto diesel	10.0	28.6	--	37.1	--
Electricity	3.2	--	77.8	--	0.1
Consumer price index	37.7	23.7	11.0	11.3	16.8

Sources: SM/86/143 (6/23/86), pp. 11, 24; SM/83/186, p. 86 (1980 and 1981 data).

The program was also aimed at a flexible pricing policy in general. Thus, in addition to energy prices, a number of other administered prices were affected. The most important of these was the guaranteed paddy price, which was increased, however, by only 8.7 percent in 1983 in nominal terms implying a decline of about 4 percent in real terms. In view of the small percentage of paddy procured by the Government under the guaranteed price scheme and the low correlation between the guaranteed prices and market prices, any impact of the real decline in the guaranteed paddy price on the incomes of small paddy farmers and workers was apparently indirect and not clearcut.

(3) Labor market policy

The program sought wage restraint. For the civil service, the wage restraint initially took the form of replacing the monthly indexation scheme by a semiannual indexation scheme. The impact of the wage restraint on the income of the rural poor is difficult to assess. Wage restraint was a necessary policy response to deteriorations in real growth, high inflation, and a large external imbalance. Underlying the policy of wage restraint were the objectives of breaking the wage-price spiral and of promoting a favorable environment for investment, growth, and a more competitive external sector.

The movements of minimum wages in 1983 do not give a clearcut indication of any notable impact on the income of the poor. In 1983, the minimum wages on average increased by 7.4 percent in nominal terms, and the government wage by 14.9 percent. These increases imply a 3.6 percent decline in the real minimum wage and a 3.2 percent increase in the real government wage--not a favorable development for the poor in Sri Lanka, in view of the location of the poor in the private sector (Table 57). However, in the private sector, the minimum wage for the agricultural sector increased by 9.7 percent, substantially higher than the 1.3 percent increase for the industry and commercial sector. These developments were not unfavorable for the poor in rural agricultural areas, compared with urban workers. The decline in the minimum wages in real terms reflected the acceleration in inflation, which exceeded the program target by 9 percentage points. Thus, the deterioration in the real income of those whose wages were affected by the minimum wage regulation should be attributed to the circumstances that led to the failure by the authorities to observe the program targets.

(4) Exchange rate and other external sector policy

The program included the maintenance of a flexible exchange rate regime, together with a liberal trading system, as a major policy instrument. Although a significant nominal devaluation was implemented in connection with the program, however, the excessive domestic credit expansion and the consequent domestic inflation resulted in a real appreciation of the domestic currency. During the program period, sharp increases in the world market prices of major export crops (tea, rubber, and coconuts), complemented by the relatively flexible exchange rate

Table 57. Sri Lanka: Wage Developments, 1980-84

	1980	1981	1982	1983	1984
			(Annual percentage change)		
Nominal wages					
Minimum wage	23.2	3.3	15.5	7.4	18.8
Agriculture	24.8	0.2	17.7	9.7	25.9
Industry and commerce	24.7	8.8	6.6	1.3	3.2
Government employee wage	10.2	13.2	28.5	14.9	14.4
Real wages					
Minimum wage	-10.7	-16.5	4.1	-5.5	1.5
Government employees	-20.2	-8.5	15.8	0.9	-2.2

Sources: SM/84/173 (7/23/84), p. 24; SM/86/143 (6/23/86), p. 30.

regime, raised the real domestic prices of these crops substantially, with favorable distributional implications for the smallholders and agricultural workers in the tree crop sector. In this case, the origin of the favorable impact was external.

b. Fiscal policy measures and implications

The fiscal policy measures adopted in 1983 were focused largely on the expenditure side, in particular on cutting capital expenditure. In the discussion of fiscal measures, it is again important to note that some of the measures were not necessarily adopted in connection with the program and some were not in conformity with recommendations made by the Fund.

(1) Revenue measures

A number of measures were introduced in February and April 1983. In February, the authorities raised the business turnover tax (BTT) rates; some rates, however, were reduced in November. Most import duty rates were also raised substantially, together with an expansion in the base of import duty. The revenue yield from these measures was projected to be about 2 percent of GDP. These measures were taken prior to adoption of the program, but were incorporated in the program.

The increase in the BTT rates was a significant measure. The BTT had three components: (a) a single rate for wholesalers and retailers; (b) multiple rates for manufacturers and importers; and (c) multiple rates for selected services.

For the first group, the rate was increased from 2 percent to 4 percent in February, but it was brought down to 1 percent in November. This increase may have added a regressive element to the tax package, since no exemptions were allowed in the structure of the turnover tax for items of widespread use among the poor, such as rice, unprocessed foodstuffs, and powdered milk. However, the rate was reduced to 1 percent during the program period. 1/

For the second category, the rates were increased by about 5 (or less) percentage points in February and again in November, with exceptions for petroleum products, rice, wheat, flour, bread, and sugar, although some of these items faced higher import duties. In this case, the beneficial treatment of petroleum products, including gasoline for automobiles, added a regressive element to the rate increase; however, the beneficial treatment of some essential goods for the poor, such as rice, wheat, flour, bread, and sugar, was a progressive element of the package.

1/ In 1985, a Fund technical assistance mission recommended complete exemption for unprocessed food, milled rice, medicines, and a few items that weighed heavily on the consumption expenditure of low-income groups. See Aguirre, De Wulf, Feltenstein, and Cox (1985).

For the third group, the rates for some items were reduced by half in February (e.g., tourist hotels, contractors, shipping, and airline business); the direct impact of these increases may have been regressive, although the measures were intended to promote improvement in the external balance and in domestic employment by promoting tourism.

With respect to the incidence of import duty changes, a clearcut conclusion is difficult. In February, items hitherto free of duty were subjected to a 5 percent tax; rates up to 12.5 percent were increased by 2.5 percentage points; and rates between 12.5 percent and 100 percent were raised by 10 percentage points, with a ceiling at 99 percent. The rates on diverse items, such as antibiotics and automobiles, were reduced in June, while those on books and periodicals were withdrawn in November. Other rates that were reduced were mostly on intermediate goods, such as laminations of polyethylene and polyester, flat bars of iron and steel, liquified propane, and plastic discs. Rates on certain capital goods, such as machinery for tea production, were increased.

The export duties on all varieties of tea were increased together with the ad valorem excise duty on tea. Although this increase in export duties had adverse implications for the production and exports of tea over the longer term, in 1983/84 the tea sector benefited substantially from the sharp increase in the world market price of tea. 1/

Finally, the excise on leaf tobacco was increased by over 20 percent in three steps from February to November. Excises on various kinds of liquor were changed in November: those of higher quality, manufactured by the State Distilleries Corporation, were increased, while those for locally produced lower-quality varieties were reduced, thus adding a progressive element to the change.

On balance, income and profit taxes stagnated relative to GDP in 1983, whereas indirect taxes, such as the BTT, excise, and import and export duties increased (Table 58). These developments, however, were accompanied by the introduction of exemptions for items critical for the poor, thereby mitigating the adverse distributional consequences.

(2) Expenditure measures

Two thirds of the reduction of the 3 percentage points of GDP planned in the program were allocated for capital expenditure, the remaining one third for current expenditure. One half of the cut in current expenditure was to come from a reduction in interest payments and the other half from a reduction in wages and salaries. With respect to capital expenditure, no new unplanned project was to be started in 1983 or 1984, and a stricter control of expenditure was instituted.

1/ The export duties on tea were subsequently reduced when world tea prices fell.

Table 58. Sri Lanka: Revenue, 1980-84

	1980	1981	1982	1983	1984
			(In percent of GDP)		
Total revenue	19.9	17.4	16.2	18.9	22.0
Tax revenue	18.7	16.1	14.9	16.3	19.4
Income and profits	3.2	2.4	2.9	2.7	3.5
Corporate	2.6	1.7	2.1	2.0	2.4
Personal	0.6	0.7	0.8	0.7	1.1
Goods and services	5.0	5.5	6.2	7.0	7.0
Business turnover tax	2.5	3.3	4.1	5.1	5.3
Excise	2.5	2.2	2.1	1.9	1.7
International trade	10.2	7.7	5.3	6.0	8.5
Imports	4.4	3.2	2.6	3.2	4.3
Exports	5.8	4.5	2.7	2.8	4.2
Other	0.3	0.5	0.5	0.6	0.4
Nontax revenue	1.2	1.3	1.3	2.6	2.6

Sources: SM/84/173 (7/23/84), p.77; SM/86/143 (6/23/86), p. 85.

With respect to current expenditure, the wage indexation scheme for public workers was made more restrictive; hirings were limited only to the filling of existing vacancies and the implementation of the public investment programs; and fertilizer subsidies were to be reduced. The savings in interest payments were to come from a reduction in the deposit rates of the government subsidized National Savings Bank.

In comparison with the original budget, the program targeted a major cut in capital spending. The implications of this cut should be assessed against the background of the rapid buildup of capital expenditure which had occurred since 1977. The authorities had already decided, before the program, that the high level of capital expenditure was not sustainable.

In current expenditure, the restraint in interest subsidies and public wages should not be considered to have been adverse for poverty groups, because the recipients of these expenditures--bondholders and public employees--are better off relative to the rural poor. The reduction in the fertilizer subsidy was a significant measure with important implications for smaller farmers, since over one half of the fertilizer subsidy was being paid to paddy farmers. However, fertilizer costs represent only about 14 percent of the costs of paddy production and the rate of subsidy on the type of fertilizer used for paddy was greater after the June 1983 adjustments than it had been during most of the 1970s.

The adjustment of capital expenditure was apparent even in the movement of actual expenditures (Tables 59 and 60). Expenditure and net lending declined by 1.3 percentage points of GDP in 1983, largely because of a decline in capital expenditure, although net lending increased substantially. While expenditure and net lending declined relative to GDP, they did not decline in real terms, as measured by using changes in the CPI. This reflected in part a real growth in GDP, but also the improved terms of trade in 1983, which led to divergence in the behavior of the CPI and GDP deflator.

In assessing the distributional impact of the decline in capital expenditure, it is noteworthy that the decline was not focused on social expenditure--capital expenditure on social projects actually increased quite sharply, owing to higher expenditure on health projects. The increase in net lending was entirely accounted for by an increase in advance account lending.

One notable area where the adjustment might be said to have had an effect on the poor is that of food stamps, which were being used by poverty groups mainly to purchase rice. In 1983, expenditure on food stamps declined by about 16 percent in real terms when measured against the CPI. However, the price of rice distributed through the Food Commissioner's channels stayed constant between September 1981 and end-1983, and the free market price of rice also showed little change. Since rice has at least as large a share in the food purchases of the

Table 59. Sri Lanka: Economic Classification of Government Expenditure, 1980-84

	1980	1981	1982	1983	1984
			(In percent of GDP)		
Total expenditure and net lending	41.6	33.0	33.8	32.5	30.8
Current	18.5	17.2	18.3	17.8	15.7
Goods and services	7.0	6.2	6.6	6.4	6.0
Wages	5.0	4.2	4.3	3.9	3.5
Others	2.0	2.0	2.3	2.5	2.5
Interest	3.4	4.4	5.1	5.4	4.4
Foreign	0.6	0.8	0.9	1.0	1.1
Domestic	2.8	3.6	4.2	4.4	3.3
Subsidies	8.1	6.5	6.5	6.0	5.3
Public enterprises	2.4	1.7	1.8	1.8	1.4
Other government	0.2	0.2	0.3	0.3	0.3
Food subsidies	2.9	2.1	1.6	1.2	1.0
Pensions	2.5	2.5	2.8	2.6	2.6
Adjustments	--	0.1	0.1	-0.3	-0.5
Capital	17.2	13.3	15.7	13.3	13.0
Fixed investment	7.9	4.6	4.8	4.4	4.2
Transfers	9.4	8.6	10.9	8.9	8.8
Public enterprises	9.0	8.4	10.7	8.6	8.7
Other government	0.2	0.1	0.1	0.1	--
Others	0.1	0.1	0.1	0.2	0.2
Net lending	5.9	2.5	-0.2	1.4	2.1
Advance accounts	4.9	2.0	-0.9	0.9	1.9
Other	1.0	0.5	0.7	0.5	0.2

Sources: Derived from SM/86/143 (6/23/86), p.86.

Table 60. Sri Lanka: Functional Classification of Government Expenditure, 1980-84

	1980	1981	1982	1983	1984
			(In percent of GDP)		
Total expenditure and net lending	41.6	33.0	33.8	32.5	30.8
General administration	...	4.1	4.8	4.1	4.2
Social services	...	9.7	9.1	8.4	7.1
Education	...	2.4	2.5	2.3	2.0
Health	...	1.3	1.2	1.7	1.1
Welfare	...	4.5	4.3	3.7	3.5
Housing	...	1.3	0.9	0.6	0.4
Community	...	0.2	0.2	0.1	0.1
Economic services	...	13.9	14.8	14.2	14.2
Unallocable	...	1.7	1.8	1.8	1.4

Sources: Derived from SM/86/143 (6/23/86), p.90.

poverty groups as the food stamp program provides in income, the adverse impact on the poverty groups of the holding of the value of food stamps in nominal terms seems not to have been substantial. The policy of holding food stamp payments constant in nominal terms was not related to the program but had been in effect for a number of years prior to adoption of the 1983/84 program.

Finally, in 1983, kerosene stamp payments increased substantially. The kerosene stamp scheme functioned as a cushion for the poor in the implementation of the policy to raise energy prices toward international levels.

4. Summary, overview, and conclusions

Sri Lanka is a low-income country with a large poor population concentrated in rural agricultural areas. Production of paddy and three tree crops is a main economic activity in rural areas. The Government extensively influences production, allocation, and distribution by controlling a large number of product and factor prices.

The 1983/84 program followed a sharp deterioration in the external terms of trade and growing domestic and external imbalances. The program aimed at reducing these imbalances through a flexible pricing policy, restraint on wage increases, curtailment of public expenditure, and restraint on the growth of credit to the public sector. The implementation of the program was assisted by a larger-than-expected improvement in the external terms of trade, but was severely constrained by bad weather and civil disturbances. The stand-by arrangement was interrupted in mid-year.

The distributional implications of the program, particularly the implications for poverty groups, may be examined from a number of angles. The substantial fiscal adjustment and consequential restructuring of credit expansion in favor of the private sector (in particular the export sector) may have eased supply of credit in the export sector where many of the poverty groups are extensively employed. A large increase in the price of the key energy product--kerosene--apparently had a negative distributional impact on the poor. However, kerosene is a relatively small item in the total consumption budget of the poor. Moreover, the increase in price was accompanied by a similar increase in the subsidy payments for kerosene, thus offsetting any adverse impact on poverty groups relying on kerosene stamps.

Minimum wages declined in real terms, but the decline was less for agricultural workers than for the rest of the workforce. Moreover, the decline was a consequence of inflation that exceeded the program target, suggesting that the decline should be considered a consequence of the circumstances that led to a failure by the authorities to observe the program targets, rather than a consequence of the program.

The overall revenue performance did not change significantly, but the reliance on indirect taxes increased relative to the reliance on direct taxes; however, the increase in indirect tax rates was accompanied by exemptions for items essential for the poor.

The burden of fiscal adjustment fell largely on the expenditure side, in particular on capital expenditure. This fall in capital expenditure relative to GDP implied reduced employment opportunities in the short run and perhaps lower growth over the longer run. However, social expenditure was not affected by the cuts.

Finally, the real growth rate of the economy did not fall, and the three tree crop sectors experienced a sharp increase in real prices during the program period, with important distributional implications for the poor in rural agricultural areas. In these respects, the economy benefited from the sharp improvement in the external terms of trade.

IX. Thailand: The 1982/83 Stand-By Program: The Implications for Poverty

In support of their policy program for the 1982/83 fiscal year (beginning October), the Thai Government requested and received in October 1982 a stand-by arrangement with the Fund, ending December 31, 1983, for the amount of SDR 271.5 million (100 percent of quota) (EBS/82/192), with a follow-up request for modification of the stand-by arrangement (EBS/83/114) in June 1983. The arrangement was the result of higher-than-anticipated domestic inflation in 1982, together with a slowing of export growth and a shortfall in fiscal revenues that led the authorities to revise their medium-term adjustment strategy in the hope of reversing these adverse economic trends.

1. Structure of the economy

a. Institutional setting

Thailand is a primary commodity exporting country, with a population of about 50 million during the period of the program, growing at about 2 percent per annum, and a per capita GDP of US$769 in 1984 (Table 61). The economy has a fairly large manufacturing base. In 1983, agriculture accounted for 24 percent of GDP and manufacturing for 21 percent (Table 62). The agricultural sector, which accounts for about one fourth of GDP and more than half of merchandise exports, is dominated by smallholders. Major crops are rice, maize, sugar, and natural rubber--all export oriented (Table 62). 1/

1/ Farmers' incomes critically depend on the levels of their outputs, which are affected by variations in weather conditions, and the prices of the outputs, which are determined largely by international prices.

Table 61. Thailand: Area, Population, and Income, 1984

Area	514,000 square kilometers
Population	50.4 million
Population growth	1.9 percent
GDP per capita	US$769

Source: SM/86/109 (5/23/86), p. v.

Table 62. Thailand: Industrial Origin of GDP, 1981-85

(In percent)

	1981	1982	1983	1984	1985
Agriculture	25.0	24.2	23.7	23.2	23.2
Mining and quarrying	1.5	1.4	1.3	1.4	1.4
Manufacturing	20.7	20.8	21.1	21.2	20.9
Construction	5.0	4.7	4.6	4.7	4.6
Electricity and water	2.0	2.1	2.1	2.3	2.4
Transport and communications	6.5	6.7	6.8	6.8	7.0
Trade	16.4	16.3	16.1	15.8	15.7
Banking, insurance, and real estate	6.2	6.6	7.1	7.5	7.6
Ownership of dwellings	1.5	1.5	1.5	1.5	1.5
Public administration and defense	4.2	4.3	4.2	4.1	4.1
Other services	11.0	11.4	11.5	11.5	11.6
Total	100.0	100.0	100.0	100.0	100.0

Source: SM/86/109 (5/23/86), p. 78.

Exports of goods and services accounted for about one fourth of GDP in 1983; more than half of total value of merchandise exports is accounted for by seven major exports (rice, rubber, maize, tin, tapioca, sugar, and shrimp).

b. Characteristics of population, poverty, and its location

The poor are located primarily in the agricultural sector. While the sectoral distribution of employment has changed significantly in the last two decades, with the share of manufacturing in total employment tripling since 1960 to 10 percent, over two thirds of employment is still in agriculture. Particularly important are the relatively poor engaged in paddy cultivation, which is the lifeline of rural households in most parts of the country. For the country as a whole, 16 percent of the urban population and 27 percent of the rural population lived below the poverty line in 1981. 1/ This reflected, however, a remarkable decline in poverty in the two decades since 1962, when 57 percent lived below the poverty line. Also, the drop in rural poverty was higher--from 61 percent to 27 percent--compared with urban poverty--from 38 percent to 16 percent.

The greater poverty of the rural areas reflected disparities between the urban and rural populations in the central and south regions, since no urban-rural disparity existed in the north and northeast. Among the four regions, 16 percent of the central, 21 percent of the south, 23 percent of the north, and 36 percent of the northeast regions lived below the poverty line, while only 4 percent lived below the poverty line in Bangkok. Thus, while two regions did not exhibit any urban-rural disparity in the incidence of poverty, for the country as a whole the same disparity continued to exist as in many developing countries. Given that much of the rural poor are employed in crop--and especially paddy--production, the effects on this sector are, therefore, especially important in considering the poverty implications of any adjustment program.

c. Role of government and the public sector

The Government accounts for about one fifth of consumption and, together with public enterprises, for about one third of investments. The Government controls deposit and lending rates for financial institutions. The baht was pegged to the U.S. dollar through November 1984. The Government regulates a number of product prices. It supports paddy prices through paddy mortgage and loan schemes. At the time of the program, more direct price support schemes also existed for rice, which were suspended in 1983/84. However, price guarantee schemes are relied on in a wide variety of crops such as jute, kenaf, and coffee, and the production, quality, and sales--domestic and exports--of sugar

1/ See Krongkaew (1985). The poverty line is as defined by the World Bank (1980).

are regulated through a Sugar Act. 1/ Finally, the Government maintains a minimum wage law under which a Tripartite Committee comprising representatives of employees, unions, and the Government recommends annual changes in minimum wages.

2. The 1982/83 adjustment program and outcome

a. Background: economic developments prior to adoption of the program

Thailand experienced two decades of strong economic performance until the late 1970s when adverse external developments, as well as an ambitious Fourth Development Plan (1977-81), weakened its balance of payments and increased inflation, though an average output growth rate of 6-7 percent was maintained. From 1981, however, the world recession caused the Thai economy to suffer a sharp deterioration in its external terms of trade. At the time of the original program, the terms of trade were estimated to have deteriorated by about 22 percent during the two years 1981 and 1982, an estimate that was increased to more than 26 percent at the time of the revised program. The growth of real GDP had also decelerated to 4 percent in 1982 (Table 63).

There was a substantial reduction in the current account deficit in 1982, largely owing to a strong growth in export volume, together with lower imports reflecting reduced domestic demand caused by tight financial policies and the effect of a drought on agricultural incomes. The real effective exchange rate appreciated by 8 percent in 1982, which occurred because of the link between the baht and the U.S. dollar. In contrast, domestic imbalances widened. The rate of expansion in credit to the Government accelerated sharply, from about 18 percent in 1981 to over 30 percent in 1982. The overall fiscal deficit almost doubled, from 3.1 percent of GDP in 1981 to 5.3 percent in 1982 at the time of the original request for a stand-by arrangement, rising further to 5.9 percent at the time of the request for review.

b. Major features of the program

The 12-month program aimed at reducing domestic imbalances and restraining the increase in the external current account deficit. The overall fiscal deficit was to be reduced from 5.3 percent of GDP in 1982 to 3.5 percent in 1983 for the original program, and from 5.9 percent to 4.5 percent for the revised program.

Looking at some of the nonfiscal aspects of the revised program, inflation was targeted at 3.9 percent. While the increase in credit to the Government was envisaged as decelerating from 30.5 percent in 1982

1/ At the time of the November 1984 devaluation, the Government again temporarily controlled a number of prices to minimize the impact of the devaluation on domestic prices.

Table 63. Thailand: The 1982-83 Program

	The Original Program				The Revised Program			Actual		
	1980	1981	1982 Est.	1983 Program	1981	1982	1983 Program	1981	1982	1983
					(Annual percentage change)					
Real GDP	5.8	7.0	4.9	6.0	6.6	4.1	6.0	6.3	4.1	6.0
GDP deflator	16.4	9.5	5.0	6.0	9.4	3.7	3.9	8.0	3.4	3.2
Trade volume										
Export	...	...	...	...	14.8	16.4	-3.5	12.0	11.6	-9.6
Import	...	...	...	...	0.3	-13.7	11.0	0.0	-11.3	27.0
Terms of trade	-4.8	-10.3	-11.5	4.3	-14.5	-15.8	4.6	-12.6	-11.1	7.1
Effective exchange rate depreciation -										
Nominal	...	...	...	...	-2.4	12.6	...	-6.0	6.6	1.8
Real	...	...	...	...	-1.1	8.0	...	-1.7	6.2	3.0
Net domestic credit	18.4	18.0	21.2	18.2	18.0	21.4	22.9	16.7	22.6	25.6
Government (net)	35.3	17.8	14.2	31.8	17.8	30.5	24.9	23.8	34.7	8.7
Private sector	12.2	18.0	16.5	17.1	18.0	17.4	21.9	14.4	18.4	32.4
Broad money	22.4	15.6	18.9	16.7	15.6	24.0	24.8	16.1	24.4	24.0
					(In percent of GDP)					
Budget deficit 1/										
Before grant	4.5	3.1	5.3	3.5	3.6	6.2	4.9	3.7	6.1	4.4
After grant	...	...	...	...	3.1	5.9	4.5	3.2	5.8	4.1
Revenue 1/	13.7	14.5	13.5	14.9	14.0	13.2	14.4	14.3	13.8	14.7
Expenditure 1/	18.2	17.6	18.8	18.4	17.6	19.4	19.3	18.0	19.9	19.1
Domestic bank financing 1/	...	...	...	...	...	...	...	2.1	3.5	1.5
Current account deficit	6.2	6.9	4.0	4.7	6.9	2.7	3.9	7.1	2.7	7.2

Sources: EBS/82/192 (10/20/82), p. 8.; SM/84/16 (1/12/84), pp. 4-5; EBS/85/128 (5/15/85), p. 12.

1/ Fiscal year.

to 24.9 percent in 1983, credit to the private sector was programmed to rise from 17.4 percent to 21.9 percent. On the external side, on the basis of a slight improvement (4.6 percent) in the projected terms of trade and a similar increase in the volume of exports, the program projected a significant increase in the volume of imports (11 percent) above the depressed level of 1982. Though the current account deficit was expected to increase to 3.9 percent in 1983, this was still below the pre-1982 levels.

The program relied on a number of policy instruments other than credit and fiscal policy measures. In addition to the standard provisions on the maintenance of a liberal trade system and a flexible exchange rate, the program set targets for minimum wages during the program period; the minimum wage for Bangkok and eight provinces was to be raised by about 5 percent at the beginning of the program in October 1982; the minimum wage for the provinces and public sector wages were to remain constant. In 1983, they were raised again, resulting in an 8 percent increase for all regions (Table 64).

c. Outcome of the program

The developments in external circumstances were favorable during the program period. Weather was better than anticipated; the improvement in the external terms of trade, at 7.1 percent, was larger than the anticipated 4.6 percent.

The inflation target was achieved, as was the credit ceiling to Government, though not to the private sector. There was an appreciation of the baht both in nominal and in real effective terms. This and a large increase in domestic demand contributed to a 27 percent increase in the volume of imports, while export volume declined by 9.6 percent. The improvement in the terms of trade did not, however, enable Thailand to attain the target for the current account deficit in 1983.

Any negative impact of demand management policy adopted in connection with the program was not severe enough to dampen the growth in real output, which was achieved at the target rate of 6 percent. The overall fiscal deficit target was also achieved: 4.1 percent of GDP compared with the 4.5 percent targeted.

3. Assessment of impact on income distribution

a. Overview

The ramifications on the poor of those major economic changes emanating from specific policies attributable to the program, as well as from exogenous factors affecting the domestic economy, are described below. Among policy measures, major energy prices were allowed to fall in 1983, although the decline in world energy prices was not allowed to pass through fully (Table 65). The decline was larger for fuel oil than for premium gasoline and for high-speed diesel oil. These developments

Table 64. Thailand: Wage Developments, 1981-85

(Percentage change)

	1981	1982	1983	1984	1985
Nominal wages					
Minimum wages					
Bangkok	13.0	4.9	3.1	--	6.1
Central South	11.0	--	8.0	--	5.0
North Northwest	18.0	--	8.0	--	6.0
Consumer price index	12.3	2.6	3.8	-0.8	3.5
Real wages					
Minimum wages					
Bangkok	0.6	2.2	-0.7	0.8	2.5
Central South	-1.2	-2.5	4.0	0.8	1.4
North Northwest	5.1	-2.5	4.0	0.8	2.4

Source: SM/86/109 (5/23/86), p. 90.

Table 65. Thailand: Energy Prices, 1982-85

(Percentage change)

	1982	1983	1984	1985
Average import price of oil	3.1	-12.5	-3.3	9.6
Electricity	4.7	-1.9	--	--
Premium gasoline	11.8	-6.3	-7.1	--
High-speed diesel	--	-5.4	-4.1	--
Fuel oil	--	-8.5	--	--

Source: Calculated from SM/86/109 (5/23/86), p. 88.

should not be considered unfavorable for the poorer segments of society. However, the relative decline in electricity prices was the lowest, and this would have affected consumers across the board. On the wage front, the 1983 increase in the minimum wages in areas other than Bangkok was considerably higher than the increase in the CPI, implying an improvement in real incomes of the low-income groups in the organized sector (Table 66). 1/

Among exogenous factors and policies which might not be directly related to the program, the appreciation of the nominal and real effective exchange rates during the program period indicate an adverse impact on the large agricultural population engaged in the production of export crops. In the case of paddy, which continues to be the most important agricultural crop, 2/ the 5 percent decline in paddy prices affected primarily the marginal farmers who are the poorer cultivators. On the other hand, the urban poor were positively affected, since retail prices of paddy fell (Table 67).

Structural changes in paddy production--increases in yield per hectare and area under cultivation--and favorable weather conditions toward the end of the 1983 cropping season helped increase paddy production, however, by 12 percent, following a decline of 3 percent in 1982. This helped achieve a 5 percent growth of incomes of paddy farmers--over 1 percent in real terms--thereby offsetting the adverse ramifications of lower domestic prices and the appreciated exchange rate, as well as the removal of the direct price support scheme for paddy.

On the whole, the growth in agricultural earnings in 1983 was extremely uneven, ranging between minus 41 percent for sugar growers and 38 percent for rubber growers (Table 66). The growth in earnings was on average lower for agricultural farmers than for nonagricultural income receivers.

b. Revenue measures and their impact

The revenue measures that were undertaken were expected to yield 0.9 percent of GDP in the original program and 1.2 percent in the revised program. They comprised: (1) an acceleration in the timing of corporate income tax payment to a current-year basis for all corporations and of the personal income tax for self-employed professionals; (2) increases in import duty rates, principally of items

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1/ It would be difficult to conclude much about the direction of movement of unorganized sector wages. However, Table 66 shows that farm incomes from principal agricultural products did rise in 1983 and 1984.

2/ It accounts for 60 percent of total cultivated area and one third of agricultural value added. Almost one third of total rice production is exported, representing nearly 40 percent of estimated world rice exports.

Table 66. Thailand: Income Growth by Major Income Group, 1981-85

(Annual percentage change)

	1981	1982	1983	1984	1985
Agricultural sector					
Farm income from principal agricultural products	16.5	-3.3	3.5	3.4	-4.4
Of which:					
Paddy	23.3	-13.7	5.3	5.7	-4.9
Maize	23.7	-27.2	23.3	22.0	-2.8
Sugarcane	120.0	26.0	-41.0	7.8	1.7
Rubber	-19.7	-2.3	38.3	0.1	8.5
Nonagricultural sector					
Regular income earners	5.6	16.2	5.6	5.6	5.6

Source: SM/86/109 (11/23/86), p. 75.

Table 67. Thailand: Average Paddy and Rice Prices, 1981-85

(Percentage change)

	1981	1982	1983	1984	1985
Retail price (5 percent)	26.2	-1.4	-4.8	-0.4	-3.0
Paddy price (grade 1)	14.9	-16.3	-4.9	0.3	-7.8
Export price	21.2	-31.0	-2.8	-4.2	-0.1

Source: Calculated from SM/86/109 (5/23/86), p. 80.

currently taxed at less than 5 percent, and imposition of a special surcharge of 10 percent of the existing duty rate for imports subject to a duty of 60 percent or less; (3) restructuring of excise rates on special blend liquor and imported liquors from a specific to an ad valorem basis; (4) increases in excise rates on selected petroleum products; and (5) intensified administrative improvements for better collection of business and income taxes. Also, during the course of the program, a reduction in the export duty on rice by 5 percent of the value of exports was carried out.

The original program failed to generate the projected revenue, primarily owing to lower inflation and the decrease in petroleum product prices noted above. 1/ Nevertheless, the revised program met the revenue target as a share of GDP (Table 68). However, the focus of the policy measure regarding petroleum excises was to raise revenues through higher tax rates on petroleum, a measure which would not affect the poor disproportionately. The revenue impact from liquors was negligible; in any event, the varieties affected were mainly items consumed by the richer groups.

The improvements in the income tax collection procedures and administration could also be said not to hurt the poor since they sought to improve the compliance of the self-employed and the professionals. These changes followed more progressive discretionary changes in the previous fiscal year, when personal allowances were increased, a tax on income from sales of immovable property was introduced, and the final withholding tax on interest income was raised by 25 percent. Thus, the changes in the personal income tax were clearly not adverse in their effects on the poor.

Given the structure of rice production in Thailand, lowering of the export duty on rice would have brought the poor, marginal farmers into production, as mentioned above. 2/ Over and above the efficiency considerations that were the primary motivation for reducing the export duty, its reduction also added a progressive element to the tax measures during the program. This cushioned some of the adverse effects of the price decreases discussed earlier.

A World Bank study on the effects of the reduction of the export duty on rice 3/ has shown that the reduction led to a higher foreign demand through a lower f.o.b. price. This development was possible owing to the price liberalization program carried out in the previous two years. Since rice supply is lagged one year, rice production was

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1/ See EBS/83/114, p. 4.

2/ O'Mara and Le-Si (1985) show that the supply response elasticity of dropping the policy of rice export taxation is about 0.3. Some of the strongest responses came from the small farms, when the price incentives (through tax reductions, for example) were sufficiently high.

3/ Amranand and Grais (1984).

Table 68. Thailand: Central Government Revenue, 1980-84

(In percent of GDP)

	1980/81	1981/82	1982/83	1983/84
Total revenue	14.3	13.7	14.8	15.0
Tax revenue	12.8	12.4	13.3	13.7
Taxes on income and profits	2.8	2.8	2.9	3.2
Personal	1.1	1.3	1.5	1.7
Corporate	1.7	1.5	1.4	1.5
Taxes on consumption	5.6	5.8	6.0	6.3
Business tax	2.7	2.6	2.7	3.0
Excise taxes	2.9	3.2	3.3	3.3
Taxes on trade	3.5	2.8	3.2	3.4
Import duties	2.8	2.3	2.8	3.1
Export taxes and duties	0.7	0.5	0.4	0.3
Other taxes	0.9	1.0	1.2	0.8
Nontax revenue	1.5	1.3	1.5	1.3

Source: SM/86/109 (5/23/86), p. 96.

diverted abroad from the domestic market, and incomes of paddy farmers tended to rise. The study concludes that the policy had a positive effect in favor of crop farmers. Further, the Bank study provides a simulation to show that as the elasticity of world demand for rice increases--and it is believed that it is indeed very high--the crop farmers benefit more. 1/

Another World Bank study 2/ has argued that the taxation of the primary occupation of the vast majority of low-income Thais via the export tax had been a major regressive feature of the tax system. Fund programs have consistently promoted the removal of the various forms of export taxation of rice and the program under consideration was no exception.

The import duty changes enacted during the program were quite broad, being primarily in the form of a surcharge rather than differentiated rate increases affecting the tariff structure itself. The effect of the surcharge, for example, was to affect the importers proportionately across the board. On balance, therefore, the tax measures of the program could certainly not have led to major questions regarding any adverse effects on the poor. Indeed, if anything, the revenue measures adopted in the program would primarily affect the rich.

c. Expenditure measures and their impact

The original program projected expenditures falling from 18.8 percent of GDP in 1982 to 18.4 percent in 1983, with most of this decline coming from capital expenditure. This would result from limiting the increase in total expenditure 3/ to the lowest rate of increase in many years; one third of the budgeted rise in expenditure was accounted for by a rise in interest payments. However, the revised program estimate for expenditure reduction was lower, at 0.1 percent of GDP (from 19.4 percent to 19.3 percent).

Looking at actual developments, current expenditure increased slightly, from 15.0 percent to 15.2 percent of GDP (Table 69). Excluding interest payments, there was a slight decline relative to GDP. During this time, cost of living adjustments were given only for lower income government employees. Current expenditure on the social services, including civil service pensions, provision of free medical care for low-income groups, and education actually increased slightly as a percentage of GDP, while that on housing declined (Table 70). Capital

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1/ With higher elasticity of demand, the volume of exports rises more as the f.o.b. price falls. This increases the incomes of crop farmers from international sources. At the same time, as supply is diverted from domestic to international markets, domestic prices tend to rise, which further augments crop farmers' incomes.

2/ World Bank (1983).

3/ About B 180 million.

Table 69. Thailand: Central Government Expenditure--
Economic Classification, 1980-84

(In percent of GDP)

	1980/81	1981/82	1982/83	1983/84
Expenditure and net lending	18.0	19.8	19.2	19.2
Current expenditure	14.1	15.0	15.2	15.8
Goods and services	11.0	11.8	11.5	12.0
Wages	5.1	5.7	5.9	5.9
Salaries	5.9	6.1	5.6	6.1
Interest	1.8	2.0	2.4	2.5
Subsidies	1.2	1.2	1.2	1.1
Local governments	0.5	0.5	0.4	0.4
Enterprises	0.2	0.2	0.2	0.1
Households	0.4	0.4	0.5	0.6
Abroad	0.1	--	--	--
Other	--	0.1	0.1	--
Adjustment	0.1	--	0.1	0.2
Capital expenditure	4.1	4.5	3.9	3.5
Fixed investment	3.5	3.8	3.4	3.0
Transfers	0.6	0.5	0.3	0.4
Local governments	0.3	0.3	0.1	0.2
Enterprises	0.3	0.1	0.1	0.1
Households	--	0.1	0.1	0.1
Net lending	-0.2	0.3	0.1	-0.1

Source: SM/86/109 (5/23/86), p. 97.

Table 70. Thailand: Central Government Expenditure--
Functional Classification, 1980-84

(In percent of GDP)

	1980/81	1981/82	1982/83	1983/84
Expenditure and net lending	18.0	19.8	19.2	19.2
General services	1.5	1.8	1.8	1.7
Defense	3.7	4.0	3.8	3.8
Social services	5.9	6.0	5.9	6.0
Education	3.5	4.0	4.0	4.0
Health	0.8	0.9	1.0	1.0
Social security	0.5	0.5	0.6	0.6
Housing	0.5	0.4	0.3	0.2
Other	0.6	0.2	--	0.2
Economic services	4.5	4.6	4.2	3.9
Agriculture	2.1	2.1	2.0	2.0
Road	1.4	1.3	1.2	1.1
Inland water	--	--	0.1	--
Other transport	0.2	0.3	0.2	0.1
Other	2.9	3.0	2.7	2.7
Other	2.4	3.4	3.5	3.8

Source: SM/86/109 (5/23/86), p. 98.

expenditure was significantly below program targets, declining in nominal terms and as a percentage of GDP (from 4.5 percent to 3.9 percent). This decline was spread across social, administrative, and economic sectors, reflecting a decline in the acquisition of fixed capital assets as well as in capital transfers. Capital transfers declined as the central government took over some operations and maintenance activities from local governments.

Based on the above, it is apparent that particular measures protected the poor from any adverse impact of the shifts in expenditure policy. In any event, it would be difficult to attribute significant effects on poverty to the expenditure elements of the 1982-83 program.

4. Summary and conclusions

The 1982/83 stand-by arrangement with Thailand was the result of a sharp deterioration in the balance of payments, inflation, and real GDP growth caused by the 1981-82 world recession. The program relied on a number of policy instruments that affected the poor, but exogenous factors also affected them.

Minimum wages were increased, affecting positively the welfare of the low-income groups in the organized sector. The decline in world energy prices was partially passed on to consumers, the decline being larger for fuel oil and electricity than for premium gasoline and high-speed diesel oil, which could also be expected to affect the higher-income groups more adversely.

Concerning revenue measures, the raising of excises on both petroleum and liquors could not have affected the poor disproportionately. Measures with respect to the income tax, some taken during the program year and others a year earlier, were similarly not detrimental to the poor, as they focused on improvements in administration that were geared toward tax collections from the self-employed and professionals, increased taxation of interest income and immovable property, and reduced personal allowances. The reduction of the export duty on rice was beneficial to the poor, since it tended to bring the poor, marginal farmer into production, as well as reducing the regressive incidence of the tax.

The program did not rely heavily on expenditure measures. With only a small decline in capital expenditure targeted, the distributional consequences would be relatively unimportant.

In sum, it does not seem that the stand-by arrangement could have had significantly adverse consequences for the poor. If anything, given the nature of the policy measures, the opposite was likely to have happened.

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