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March 13, 1991

To: Members of the Committee of the Whole for the Development Committee

From: The Secretary

Subject: Financial Implications of Development Policies Aimed at Poverty Reduction

There is attached for the information of the Committee of the Whole a paper prepared by the staff of the World Bank in consultation with the Fund staff on "Financial Implications of Development Policies Aimed at Poverty Reduction."

This paper provides background material for the April 1991 Development Committee meeting, and for the discussion by the Committee of the Whole scheduled for Wednesday, March 27, 1991.

Att: (1)

Other Distribution:
Department Heads
Development Committee Secretariat

Financial Implications of Development Policies Aimed at Poverty Reduction

(Prepared by staff of the World Bank in consultation with the International Monetary Fund)

March 8, 1991

Issues for Discussion

Ministers may wish to focus on the following issues discussed in the paper entitled "Financial Implications of Development Policies Aimed at Poverty Reduction."

(1) The paper argues that substantial domestic resources for implementing programs and policies to reduce poverty may be obtained through greater efficiency in the use of resources, significant reallocations of resources between and within sectors, and, where necessary, greater efforts at domestic resource mobilization. Do Ministers agree with the thrust of this analysis?

(2) The paper argues that a number of factors--including shortfalls in the other external resources for development, an increase in the number of countries pursuing effective strategies for the reduction of poverty, and an increase in the number of legitimate claimants to concessional resources--are highly likely to increase aid volume requirements in the years ahead. Do Ministers agree? Do they have suggestions for ways in which concessional resources might be increased beyond current projections?

(3) The paper recommends that additional concessional assistance should mainly be provided to countries putting in place effective policies for reducing poverty. Do Ministers agree? The paper also argues that there is substantial scope for reallocating aid resources toward poorer countries implementing effective strategies for poverty reduction. What scope do Ministers see for reallocations of aid to such countries?

(4) The paper discusses a number of ways in which the effectiveness of concessional assistance as an instrument for poverty reduction might be enhanced, including the further "untying" of aid, increased funding of recurrent costs, the greater effectiveness of technical assistance programs, and improved mechanisms of aid coordination. How do Ministers assess the scope for policy improvements in these areas?

(5) The paper suggests that, while there is scope for country-specific poverty-reduction targets as part of overall country assistance strategies, global targets and estimates of the costs of attaining them are somewhat less useful instruments. Do Ministers agree?

(6) The paper outlines some of the implications for the World Bank of its renewed attention to poverty and strategies for reducing it. It stresses that all Bank country assistance strategies, including the volume and composition of lending, should reflect and be consistent with a systematic assessment, at the level of each country, of the key factors determining poverty and those likely to lead to its reduction. Do Ministers agree with this central proposition and how do they assess the implications flowing from it?

Financial Implications of Development Policies Aimed at Poverty Reduction

I. INTRODUCTION

1. The international community is giving renewed attention to poverty in the developing world and support for strategies to reduce it more effectively. This is only appropriate, since recent estimates are that 1.1 billion people continue to live in conditions of absolute poverty.

2. Many developing countries have made substantial progress in reducing poverty over the past several decades when measured by increases in per capita incomes. Many have also improved a number of social indicators of development, especially those pertaining to education and health. Nevertheless, an enormous task of poverty reduction remains. Even under the most favorable assumptions, the World Bank's 1990 World Development Report (WDR) on poverty estimated that at least 700 million people in the developing world would continue in absolute poverty in the year 2000--and the numbers could well be much higher. In light of this outlook, the reduction of poverty remains at the top of the development agenda.

3. At its September 1990 meeting, the Development Committee considered a joint World Bank-IMF background paper on strategies for the effective reduction of poverty in the 1990s. In its communique at the conclusion of the meeting, the Committee requested the Bank--in consultation with the Fund--to prepare a paper on the "financial implications of development policies aimed at poverty reduction." This paper responds to that request. It does not pretend to arrive at definitive conclusions regarding the multifaceted issues involved in financing poverty reduction. Rather, it seeks to summarize some outstanding issues and to outline some of the key policy debates. In so doing, it is intended to facilitate ministerial discussion of a relatively neglected aspect of poverty-reduction strategies.

4. The paper follows upon a policy paper discussed by the Bank's Executive Directors on January 24, 1991 entitled "Assistance Strategies to Reduce Poverty" (R90-243). That paper elaborated upon the major operational implications of the WDR for the World Bank, including the implications for the design of country assistance strategies, its economic and sector work, and its efforts to build an information base on poverty. The Board endorsed the policy paper, and Bank management is continuing its efforts intended to operationalize the strategy laid out in the WDR. The operational implications addressed in the policy paper are discussed further in section VI of this paper.

5. The next section (II) of the paper sketches out the principal elements of a strategy for the effective reduction of poverty as discussed mainly in the 1990 WDR and the subsequent background paper for the Committee, and highlights the strategy's main financial implications. These concern, first, the efficiency of resource allocation and use, and, second, the adequacy of the volume of resources that would enable countries to mount an effective attack on poverty. Section III of the paper

discusses the efficiency and adequacy of domestic resources. It suggests how they might be increased through improvements in their allocation and use as well as greater efforts, where required, at domestic resource mobilization. Section IV discusses essentially these same questions regarding external resources, especially concessional assistance. Section V briefly assesses an approach that emphasizes the setting and costing of targets for reducing poverty and improving specific social indicators. The establishment of realistic and viable country-specific targets is viewed as broadly congruent with the approach outlined in previous sections of the paper. Section VI discusses some implications of this approach for the World Bank. Finally, a concluding section (VII) discusses the role of the International Monetary Fund in efforts to reduce poverty, including some financial implications of the Fund's role.

II. A STRATEGY FOR REDUCING POVERTY AND SOME FINANCIAL IMPLICATIONS

6. The 1990 WDR outlined a strategy for the effective reduction of poverty that has important financial implications. The first part of the strategy requires broad-based economic growth. While growth generally reduces poverty, the qualitative nature of the growth process is an important factor affecting its ability to do so. Specifically, growth that is broad-based and that makes productive use of the poor's most abundant asset--their labor--is more effective at contributing to poverty reduction. Especially important is a policy environment that encourages the development of the private sector, since the vast majority of income-earning opportunities for the poor are to be found there.

7. The second part of an effective strategy for reducing poverty requires the provision of social services--especially primary education, basic health care, family planning and nutrition--to improve living conditions and increase the capacity of the poor to respond to the income-earning opportunities arising from economic growth. This has traditionally been the responsibility of governments. The private sector can play an increasingly important role, however, mainly in providing curative health care and secondary or university education, thereby freeing public resources for social-sector activities whose benefits flow mainly to the poor.

8. Third, since some especially vulnerable groups in the population--such as the disabled and the elderly--will not be able to respond to new opportunities, a strategy for the effective reduction of poverty also requires a system of transfers and safety nets as an essential complement to the basic approach.

9. An important conclusion flows from this focus on the poverty-reduction impact of the totality of developing countries' policies, including their growth policies, social sector policies, and policies regarding income transfers and safety nets. It is that policies which might not ordinarily be thought of as "poverty-oriented," including macroeconomic, sectoral, and trade policies, actually have an enormous effect on the extent and depth of poverty. Thus, in any assessment of the

appropriateness of countries' policies intended to reduce poverty, attention must be directed to the full range of macro, sectoral, and trade policies as well as to more narrowly circumscribed "targeted interventions" (i.e., development projects specifically intended to reduce poverty directly). As the background paper considered by the Committee last September emphasized, sound macroeconomic policies geared to preventing excessive external and domestic imbalances are essential to sustained economic growth and hence to poverty reduction. Indeed, weaknesses in macroeconomic management not only prejudice growth prospects, but may also have a disproportionate adverse impact on the poor. Further, it is important to examine not only public revenue mobilization and the allocation and efficiency in the use of public expenditures, but also the effects of government policies on the incentive structure crucial for private-sector development.

10. In reviewing actual country experiences, it is clear that some countries have followed policies that encouraged efficient growth consistent with poverty reduction. At the other extreme, the policies of some countries appear generally antithetical to poverty reduction. There are also a considerable number of intermediate cases, in which parts of a poverty-reduction strategy are being successfully pursued but other parts relatively neglected. Broadly speaking, two factors have been decisive in determining how the poor have fared: the policy environment for private-sector development and the composition and distributional incidence of public expenditures. In cases where both have been supportive of poverty reduction, the poor have naturally made the most progress. Where only one factor has been in evidence, the gains have been less. For example, some countries have adopted policies that have enabled them to grow reasonably well but have largely ignored the social sectors. Others have done more or less the reverse: they have made good progress in education and health, but their growth record and their record of generating employment for the poor are not so impressive.

11. In many countries, public policies have impeded the development of a private sector that makes productive use of labor. Policy-induced distortions and excessive governmental regulations have constrained private investment, created barriers to the entry and exit of firms, made capital relatively cheap and labor relatively expensive, and otherwise encouraged inefficient domestic productive structures. The experiences of a number of developing countries among the most successful in reducing poverty demonstrate, however, that public-sector facilitation of private-sector development is (through putting in place appropriate incentive structures and providing basic infrastructure) a powerful spur to the broad-based pattern of growth required for effective poverty reduction.

12. Also vital, however, are the public expenditure programs of governments themselves. These must be directed toward a number of objectives if they are to be congruent with a strategy for the effective reduction of poverty. For example, there must be sufficient public provision of basic rural and urban infrastructure--including roads, irrigation and extension. It is also vital that the delivery of these and other services not be biassed against the poor. An effective strategy to reduce poverty also requires that public expenditure programs provide infrastructural support to activities in which the poor are particularly

engaged, such as agriculture (and related nonformal activities in the rural sector) and the urban informal sector. Likewise, the provision of social services to the poor must be adequately accounted for in public expenditure programs. A balanced approach is called for; disproportionate emphasis on one or two sectors--the social sectors to the neglect of productive activities, for example--is not likely to lead to sustained poverty reduction.

13. Two questions about public expenditure programs are fundamental. One has already been suggested: Are they appropriate and internally consistent with regard to the objective of reducing poverty? The second is equally important: Are they adequately funded? Often overlooked, however, is the close relationship between the two. Effective and well-integrated policies to reduce poverty might in effect "stretch" the limited amount of resources available--in the sense that, in an appropriate policy environment, a dollar of resources would "buy" more poverty reduction than in a distorted environment.

14. Indeed, primary attention must be given to the scope for improving the efficiency with which existing domestic resources are deployed and utilized. Evidence indicates that such scope is considerable and could go a long way in many countries toward ensuring that domestic resources are adequate. In some circumstances, however, it may prove necessary to mobilize additional public revenues through reform of taxation and other policies. Even with increases in the efficiency and volume of domestic resources, however, external resources will have an essential role to play in supporting most countries' efforts. Few developing countries, and very few low-income countries among them, are likely to have the resources in the foreseeable future to reduce poverty on their own.

III. DOMESTIC FINANCIAL CONSIDERATIONS IN ATTEMPTS TO REDUCE POVERTY

15. There is no simple way of determining precisely the resource shortfalls of individual countries. Conventional measures, such as the ratio of government revenue to GDP, can serve as indicators but suffer from a number of shortcomings. As a practical matter, informed judgments have to be made about the adequacy of resources based upon a broad array of economic and social data. In making such judgments, two considerations are crucial--the scope for improving the efficiency of domestic resources and the scope for increasing the quantum of resources, where necessary. These are discussed in turn.

16. It is widely agreed that the scope for enhancing efficiency in the use of domestic resources is considerable in many countries. There are many ways in which enhanced efficiency might be attained. Two are considered here--shifting resources away from sectors that have relatively little to do with reducing poverty, and switching expenditures within sectors.

A. Reallocating Resources Between Sectors

17. One example of the misallocation of public resources from the standpoint of poverty reduction, increasingly cited by many observers, is that of military spending. Such spending is certainly a legitimate public expenditure, since national defense is one of the primary responsibilities of governments and many countries face real or perceived external threats. Nevertheless, the level of military spending appears excessive in many developing countries (and a debate has long taken place on its levels in industrial countries as well). Defense spending as a proportion of total government expenditures is above 20 percent in a number of developing countries. In recent years, developing countries have spent almost as much on arms imports as on all their health programs. Military expenditures by developing countries are about five times the amount they receive from abroad in concessional assistance. Much of this expenditure is facilitated by the intense competition among arms exporters, and, hence, the easy access to subsidized finance. While there is no simple criterion for identifying an appropriate level of military expenditures, such expenditures need to be assessed on a case-by-case basis to determine the scope for shifting some of them into sectors more conducive to the reduction of poverty.

18. Other intersectoral shifts in resources could also facilitate the reduction of poverty. It is, however, always difficult to decide where the marginal dollar should be spent. Nevertheless, a number of recent studies have tried to estimate the amounts that might need to be spent in different sectors. A major study of health financing in Asian countries concluded that there is reason for concern when countries spend less than two percent of GNP on health. The World Bank's study on Sub-Saharan Africa: From Crisis to Sustainable Growth argued that the percentage of GNP devoted by African countries to investments in human resource development needs to double (to between 8 and 10 percent) from now to the year 2000 and beyond, in order to achieve universal primary education, health and family planning objectives, food security, and improved nutrition. The United Nations Development Programme's Human Development Report 1990 concluded that social expenditures typically require 25 to 30 percent of total development allocations to maintain a proper balance between economic and social progress. While no precision is claimed for these estimates and they should not be considered as proposed targets for spending levels in different sectors, they could assist in suggesting the extent of inter-sectoral resource reallocation that might be called for in individual countries--after taking into account the potential role for the private sector in some of these areas.

B. Reallocating Resources within Sectors

19. A second way of improving the efficiency of resource allocation in developing countries is by switching expenditures within sectors. The potential in this regard is especially apparent in the social sectors but is by no means confined to them.

20. In the health sector, for example, a common pattern is the emphasis of most developing countries on expensive curative care that benefits mainly the rich to the detriment of less expensive primary care that

benefits mainly the poor. A recent study of twelve Asian countries, for example, found that well over half of their government health spending goes, on average, to expensive hospitals. The cost of maintaining a single bed in these hospitals is enormous--about 10 times the countries' average per capita income. Meanwhile, most countries spend meager resources on the prevention of infectious and contagious diseases and other public health measures. Such findings are far from confined to Asia. In the Congo, for example, the cost of operating the main hospital in Brazzaville equals the total Congolese expenditure on primary health care. In Brazil, it is estimated that 78 percent of all public spending on health is devoted to largely curative, high-cost hospital care concentrated in urban areas.

21. The situation is broadly similar in the education sector. India, for example, devotes only 27 percent of its public educational expenditure to the primary level. In Sub-Saharan Africa, the cost for each student-year of public higher education ranges from $895 (in Somalia) to $11,081 (in Zimbabwe). In contrast, the per-student expenditure on educational materials at the primary level is 60 U.S. cents. Similarly, in Brazil, public expenditures for university education are extremely high compared with primary and secondary education.

22. Similar patterns exist in other sectors as well. UNICEF has found that 80 percent of the $12 billion now being spent by developing countries on water supply and sanitation each year is devoted to providing services for better-off urban groups, at an average capital cost of $600 per person served. Only 20 percent is allocated to providing services for the poor, at an average capital cost of $20-$30 per person. Government agricultural programs, public credit programs, programs for industrial development, public housing programs, and a broad array of other government services frequently reflect analogous tendencies.

23. Programs that provide safety nets are another example. A common feature of virtually all general food price subsidy schemes is that the rich receive a greater allocation per capita than the poor. On the other hand, schemes which have sought to benefit the poor by concentrating on foods consumed more by them or regions where they are especially located have in general been more successful in reaching the poor as well as more cost-effective. Some targeted public works programs have also proven successful in providing a source of income for the poor in times of need. A number of such programs in South Asia have helped the poor during droughts and have been successful in preventing famine. Evidence from several countries suggests that similar programs can also be used to protect the poor during economic recessions.

C. Mobilizing Domestic Revenues

24. While much can be accomplished to ensure the adequacy of resources through the kinds of resource reallocations discussed here, in some instances attention will need to be paid to the scope for mobilizing additional public revenues as well. This need not mean tax increases *per se*; rationalization of existing tax structures may be equally or more important. Moreover, whatever measures are adopted, extreme care must be taken to ensure that the growth of the private sector is not impeded through the introduction of new distortions leading to new inefficiencies

in the allocation of resources, and that the poor are protected. Furthermore, measures to enhance public revenues should only be contemplated in tandem with efforts to streamline and rationalize public expenditures.

25. Opinions vary widely on the changes required in tax policy. Some have pointed to the possibilities for broadening the tax base through expanding the coverage of the income tax. In many countries personal income taxes are collected from less than 15 percent of the population; in South Asia and Sub-Saharan Africa the figure is less than 5 percent. Tax avoidance and tax evasion are rampant. The potential revenue from personal taxes is eroded virtually everywhere through loopholes and tax shelters (a situation, it must be noted, far from uncommon in many industrial countries as well). At least as important as extending the coverage of taxes is the rationalization of existing tax rates. Reforming the income tax system may often be difficult, however, for a variety of reasons--technical, administrative, and political. Even if reformed, there is a question about the likely revenue effects in extremely poor countries.

26. Other possibilities for broadening the tax base include taxes on goods and services, especially the value-added tax. When combined with other features of tax reform, such as improved coordination among various taxes--including trade taxes--and a strengthening of tax administration, the broadening of the tax base and the rationalization of tax rates can enhance public revenues.

27. Some features of tax policy can have a direct or indirect impact on the poor, however, and these need to be considered carefully. For example, broadening the tax base through a value-added tax can adversely affect the poor, unless products that are major items of consumption by them are excluded from the base or are taxed at a substantially lower rate. For this reason, consumption taxes recommended by the World Bank generally contain an exemption for products, such as unprocessed food, that account for a large share of expenditures of low-income groups. The Bank also frequently suggests heavier taxation on income-elastic items, such as personal vehicles, petroleum products, and luxury goods, which are consumed primarily by the rich.

28. Another area with potential to enhance revenue is that of user charges for publicly provided goods and services. Charges for infrastructure services in much of Sub-Saharan Africa are lower than economic costs and cannot even finance infrastructure maintenance. Cost recovery in the social sectors, especially for curative medical care and university education, is extremely low in most developing countries. The World Bank estimates that an increase in overall public revenues of 20 to 30 percent would be possible in Sub-Saharan Africa from full-cost pricing of infrastructure services and greater cost sharing for health and education services. As with changes in tax policy, however, increased cost recovery can have adverse implications for the poor if user fees are indiscriminately applied. The poor will in all likelihood need to be excluded from the payment of some fees, or differential rates will need to be charged rich and poor (i.e., cross-subsidization).

29. Policy changes in all of the foregoing areas clearly raise difficult issues of an economic, institutional and political nature. The feasibility and desirability of reforms will vary from one country to another. In all, difficult trade-offs will need to be addressed. This does not vitiate the thrust of the main argument, however. Developing countries could do much to ensure an adequate volume of domestic resources for enhancing growth and thus combatting poverty by undertaking measures to improve the efficiency with which they deploy and utilize the existing resources at their disposal--and, where necessary, to increase public revenues in ways that do not choke the growth of a vigorous, employment-generating private sector.

IV. IMPLICATIONS FOR EXTERNAL RESOURCES, ESPECIALLY CONCESSIONAL ASSISTANCE

30. While reforms that would add to domestic resources are critical to the successful pursuit of poverty reduction, developing countries will still depend on a variety of external resources to supplement domestic revenues. Expanded exports, particularly of products produced mainly by the poor, could have a major impact on reducing poverty. The reduction of debt and debt-service burdens could reduce drains on public budgets that in many countries have adversely affected the provision of social services. Foreign direct investment could play a major role, particularly if additional ways are found to channel it to enterprises that make productive use of labor.

31. The important issues of trade, debt relief, and private direct investment are discussed in separate background papers for this meeting of the Development Committee. These papers argue that expanded trade, additional debt relief, and an increase in private direct investment would all improve developing countries' prospects for sustaining growth and reducing poverty. Indeed, for a number of countries, any of these developments could be at least as important as an increase in concessional assistance from abroad. However, this paper concentrates primarily on the aid component of external resource requirements. For many countries, and for the vast majority of low-income countries, aid is the crucial supplement to domestic resources. Increases in its volume and in the effectiveness with which it is supplied and used could have a major positive effect on their prospects for growth and poverty reduction.

32. The main financial implications for concessional assistance as an instrument supporting the poverty-reduction efforts of developing countries center, as do those for countries' policies, around issues concerning the adequacy of its volume and the efficiency of its allocation and use. According to the poverty-reduction strategy sketched out in the 1990 WDR, concessional resources should primarily flow to countries attempting seriously to reduce poverty--i.e., to countries in which the broad range of government policies is judged to be poverty-reducing. For other countries, the allocational implications would be quite different. In countries judged not to be pursuing strategies for the effective reduction of poverty, the WDR recommended that only limited amounts of aid targeted in a very precise fashion on the poorest and most vulnerable groups be supplied. In intermediate cases, where some parts of a strategy to reduce poverty are

being pursued and others neglected, the WDR argued that the allocation of aid would depend on judgments about the likelihood of countries' efforts to redress these imbalances.

33. In short, judgments about the ways in which concessional assistance can most appropriately support poverty-reduction efforts in recipients must be country-specific and economywide. It follows that a number of important issues regarding the external financing of poverty reduction are also best approached within a country-specific context. One is the volume of requisite resources. A second is their sectoral allocation. The extent to which existing or additional concessional resources should be allocated to the directly productive or social sectors will depend greatly on the circumstances of individual countries. Some will clearly need to make use of aid in order to invest more in basic infrastructure and productive activities, others in health and education. What is important--to reiterate--is the combined impact of policies in many different sectors on reducing poverty, and what is important about aid is the overall contribution it can make to this process.

A. Aid Volume

34. Official Development Assistance (ODA) in 1989 was about $53 billion (including technical assistance, which accounts for about one-fourth of total concessional assistance, and a number of other relatively minor components of ODA flows not included in the resource-transfer data cited in the President's Report to the Development Committee). Expressed as an aggregate figure, the volume of aid may seem large. When compared with other aggregates, however, its volume is seen to be quite small. Expressed as a percentage of the collective GNP of the members of the OECD's Development Assistance Committee (DAC) aid is only 0.33 percent. A number of donors are well below this figure. Moreover, the development assistance provided by industrial country donors in recent years has been only about 5 percent of their total military expenditures. Nor is aid a large claimant on governmental budgetary resources--in recent years, it has represented an average of about 1.4 percent of central government expenditures for DAC members.

35. Alternative views have periodically been expressed on the question of the affordability of increases in aid resources for fighting poverty in developing countries. One view is that substantial increases in aid over the next few years will be seriously impeded by financial stringencies in several major donors. The 1990 WDR concluded, however, that increasing the volume of aid is entirely affordable; doing so is considered mainly a matter of political commitment and a reassessment of donors' priorities.

36. There does not appear to be any precise way of ascertaining developing countries' aggregate "need" for foreign aid, including aid for the initiatives that would be required to reduce poverty. In general, however, the 1990 WDR concluded that there was a high likelihood of additional aid requirements at the global level beyond current projections (which, according to the DAC, foresee a two percent per annum increase in real terms over the next few years).

37. There are several reasons for arguing that additional concessional assistance will be needed. One is the discouraging outlook, at least in the short-term, for other external resources for development, mainly export earnings and savings from debt relief. Another is the encouraging outlook for policy reforms to address the reduction of poverty in many developing countries. If sustained, an increase in the number of countries pursuing policies to reduce poverty would have a concomitant effect on the requirements for external support. Yet another is the increase in the number of countries with need for concessional resources, including a number of countries in Eastern Europe, some middle-income countries that have experienced declines in per capita income and are now eligible for concessional assistance, and some countries emerging from civil wars and other major dislocations. For all these reasons, it is highly likely that the demand for ODA will increasingly outrun its supply--heightening the need to examine ways in which the latter can be augmented.

B. Aid as an Effective Instrument of Poverty Reduction: Some Issues

38. Just as increases in the volume of domestic resources for combatting poverty cannot be considered without attention to questions of the efficiency of their use, so also a number of considerations have been raised about the effectiveness of aid as a poverty-reduction instrument--quite apart from questions about the adequacy of aid volume. It is generally agreed that aid has made many important contributions to growth and poverty reduction, especially when its impact is analyzed at the level of individual countries. The economies of a not inconsiderable number of countries have grown rapidly, thanks in no small measure to aid. Moreover, assessments of aid effectiveness have generally concluded that aid initiatives in a diversity of sectors have helped many developing countries to reduce poverty.

39. However, a number of issues have periodically been cited that appear to lessen aid's effectiveness as an instrument for reducing poverty. One such issue concerns the country allocation of aid. Over 40 percent of all aid is currently allocated to middle-income countries (i.e., to countries with GNP per capita in excess of $580 in 1989 dollars) even though such countries contain between only 5 and 10 percent of the total number of poor people in the developing world. Moreover, there is no systematic relationship between per capita aid allocations and the extent of poverty in recipient countries; many countries with very few poor people continue to receive large volumes of aid on a per capita basis. This situation is largely a result of the many diverse motivations--including political, strategic, and commercial--that bilateral donors have in supplying aid. It is widely acknowledged that such donors have many legitimate foreign policy interests, and that aid is one instrument for pursuing them. Moreover, there are large pockets of poverty in a number of middle-income countries, and many lower- middle-income countries highly dependent in the past on official finance are experiencing severe debt and debt-service burdens. In such circumstances, there are grounds for continuing to provide concessional finance to such countries. Nevertheless, ODA is a very scarce commodity, and further assessments should be made of the scope for shifting more aid to low-income countries, given that such countries contain between 90 and 95 percent of the developing world's poor.

40. A number of issues also arise with regard to the scope for reallocating aid between and within sectors. While questions about the sectoral orientation of aid are most fruitfully addressed at the level of individual countries, it is striking that aid donors supply remarkably little assistance in the aggregate for the social sectors. The proportion of total ODA devoted to education, health, nutrition, and family planning was estimated at less than 15 percent in 1988. In part, this reflects the reluctance of donors to finance recurrent expenditures which, in the social sectors, represent the bulk of public expenditures. Intra-sectoral aid allocations also merit attention from the standpoint of their congruence with effective strategies for poverty reduction. For example, in recent years aid to primary education has represented less than 5 percent of all external assistance to the educational sector.

41. A number of additional tendencies of aid would seem to limit its effectiveness in helping to reduce poverty:

- One is the "tying" of aid, by which about two-thirds of all aid supplied by DAC donors must be used to buy goods and services from the donor countries themselves. Such a practice is alleged to drive up costs for countries that receive aid and may lead to the introduction of goods and services inappropriate for combatting poverty in indigenous contexts. Some donors would argue, however, that there is an important link between such tying and the volume of aid they can provide. In this view, aid volume would be less if commercial interests in donor countries were excluded from the benefits of supplying it.

- A second issue, as noted above, is the reluctance of donors to support the operating or "recurrent" costs of aid-funded initiatives. In general, aid has shown a preference for financing physical capital installations whose construction, when the aid is tied, tends to help consulting firms and exporters in the countries that provide it. Many of the sectors most relevant for poverty reduction make intensive use of recurrent resources--such as textbooks and other curricular materials in education, or medicines in health. Some have argued that aid should fund a much higher proportion of recurrent costs, particularly in countries pursuing strong domestic resource mobilization policies. Others, however, have claimed that such funding should be mainly the responsibility of recipient countries, and that for aid to commit itself to meeting recurrent obligations would be entering a "bottomless pit".

- Third, technical assistance comprises over one-fourth of total ODA and a greater proportion of aid to poverty-oriented programs and projects. But its effectiveness at contributing to the development of indigenous organizational, managerial and other capabilities has often been questioned.

- Fourth, it is important that donors not work at cross-purposes among themselves, or between themselves and recipients, in their efforts to assist countries in reducing poverty. While some coordinative mechanisms are in place, questions arise concerning their adequacy and effectiveness.

42. In short, aid should support strategies for poverty reduction that stimulate growth and expand income-earning opportunities for the poor; contribute to human resource development; and provide safety nets for the vulnerable. In making judgments about aid volume requirements and aid allocations, assessments will need to be made of the full range of countries' policies. The composition of aid, including its sectoral orientation, will also depend on country-specific circumstances. Moreover, just as individual countries can improve the efficiency with which they deploy and use resources, so aid donors can strive to improve their delivery of aid to countries where effective strategies for poverty reduction are being pursued.

V. A TARGET-SETTING APPROACH TO THE FINANCIAL IMPLICATIONS OF POVERTY REDUCTION

43. The approach to the financial aspects of poverty reduction adopted here is, of course, not the only way in which the topic can be addressed. One common approach emphasizes the setting of targets for poverty-reduction objectives and estimates of the costs of meeting them. A number of bilateral and multilateral donors have taken an interest in such target-setting exercises.

44. Their attention has primarily been devoted to global targets, but country-specific targets have also been proposed. While target growth rates have long been a feature of national economic planning, more recent target-setting exercises have focussed on improvements in social indicators, especially in education and health. Efforts to arrive at figures for the global cost of meeting such poverty-reduction targets generally attempt to sum up the per capita costs of low-cost approaches, especially in the social sectors, and multiply them by the estimated number of poor people in the developing world. Thus, one recent study attempts to estimate the global financial requirements of attaining seven "child survival" goals by the year 2000, another estimates the likely incremental recurrent costs of attaining universal primary enrollment in all developing countries by that year, and yet another tries to arrive at the global amount of resources required to meet all the "essential needs" of the developing world's poor by the end of the century. In each case, estimates are made of the proportions of costs that would need to be borne by domestic and external, chiefly concessional, resources. Typically, these attempts result in estimates for external financing for the social sectors that substantially exceed present levels of ODA for these sectors.

45. There are a number of divergent views on the utility of a global target-setting approach. In the view of some donors, such target-setting

can serve as a highly valuable spur to action with strong political backing, suggest what policy efforts would be required to meet established objectives, and provide monitorable indicators against which actual attainments can be measured. The United Nations Children's Fund (UNICEF), for example, has been particularly successful in setting itself global targets for well-focussed programs such as immunization, literacy, or rural water supply as a means of stimulating interest and mobilizing resources in critical areas.

46. On the other hand, there is skepticism in some quarters regarding the establishment of global targets since they conceal the great variability of country-specific circumstances emphasized throughout this paper. Also, the global amount required to meet any given target is difficult to assess without simultaneously addressing questions of the efficiency of resource use--emphasized repeatedly above--that weigh heavily in any calculation of costs. Moreover, there are many externalities among the initiatives required to reduce poverty--an example is the ways in which improvements in basic education might reduce the level of expenditures required for primary health care--which would tend to suggest that the aggregative approach to targeting may overstate resource needs. There is also some concern with the realism of the resource volume requirements frequently derived from global target-setting exercises. These may neglect demand constraints and absorptive capacity issues in recipients. Finally, whether the attainment of goals is feasible by the end of this century or within some other specified period of time is clearly not only a question of finance. Technical, institutional, organizational, and other factors come into play.

47. UNDP, in its Human Development Report 1990, reached the conclusion that implications for human and financial resources must be worked out in detail, country-by-country, before fixing any global targets. A focus on country-specific programs for reducing poverty will yield a divergent set of goals for expenditures and physical targets based on past achievements, relative needs in different sectors, anticipated externalities, and absorptive capacity and demand constraints in the country as a whole and different sectors in particular. As an example, in very poor countries improvement of basic transportation and other physical infrastructure may be a precondition for improving rural health or educational facilities. Other countries may call for quite different emphases depending on their particular circumstances. Viewed this way, country-specific targets are largely congruent with the approach to financing the reduction of poverty outlined in this paper and being implemented by the World Bank--if they flow from a rigorous assessment of the broad array of countries' policies, are cognizant of countries' past trends in both growth rates and social indicators and are thus realistic about what can be attained in the future, and make quite precise links between target-attainments and likely costs.

VI. THE WORLD BANK AND POVERTY REDUCTION

48. Following the analysis of poverty and effective strategies for poverty reduction conducted in the 1990 WDR, the World Bank has intensified the examination of its own role within the context of the international community's increased attention to the plight of the world's poor.

Emerging Bank emphases were discussed with its Board in January of this year, based upon the policy paper on poverty cited above. Operational details and guidelines for Bank staff are currently under preparation.

49. Fundamental to the Bank's renewed attention to poverty is a recognition that all country assistance strategies should reflect and be consistent with a systematic assessment, at the country level, of the key factors determining poverty and those likely to lead to its reduction. There are three key ingredients to an approach to poverty reduction built on this premise.

A. Analysis of Poverty

50. The Bank will design its analytical work to yield periodic assessments of the consistency of each borrower's policies, programs, and institutions with the objective of poverty reduction. This in turn would strengthen the Bank's capacity to make policy recommendations and design its country assistance strategies. Much of this work is already undertaken in the Bank, but it is infrequently brought together to provide a comprehensive account of country-specific trends in poverty and the appropriateness of public policies for reducing it. Such periodic assessments, the first round of which will be completed for all countries (with reasonable exceptions) within three years, will include an analysis and policy recommendations concerning the effectiveness of economic management in generating growth that makes productive use of labor; the adequacy of government efforts to provide social services to the poor; and the extent, reliability and affordability of social safety nets.

B. Design of Assistance Strategies

51. These periodic assessments for all borrowers will provide the basis for a policy dialogue with governments on ways to strengthen their policies and programs for reducing poverty. Bank assistance strategies will be designed to support the policies resulting from this process by ensuring that both the volume and composition of Bank assistance underpin country efforts.

52. Poverty has long played an important role in determining the allocation of resources from the International Development Association (IDA). While it is recognized that IDA's assistance must be directed to support a number of diverse and important priorities in recipients, the Bank is reaffirming the importance of the poverty link. In general, IDA resources should be maintained or increased for those countries pursuing policies consistent with the poverty-reduction strategy outlined in the 1990 WDR. On the other hand, the provision of additional IDA resources is not recommended for those countries whose policies are not conducive to meaningful poverty reduction. Intermediate cases, likely to be numerous, will call for the informed judgments of Bank staff, who will need to give close attention to the likely effects on poverty of the broad range of countries' policies.

53. For IBRD borrowers, funds are not rationed in the same manner as IDA resources. Issues of creditworthiness and exposure are the important constraints on IBRD lending. Within these constraints, however, lending

allocations reflect country performance, including efforts to reduce poverty as demonstrated by economic management, the adequacy of social services, and the reliability and affordability of safety nets.

54. In addition to volume, the periodic assessments, which would also draw on public expenditure reviews, would influence the composition of lending. The balance between adjustment and investment lending would depend on a country's balance-of-payments situation and the strength and nature of its economic program. In either case, however, the type of intervention and the choice of sector to support would depend on the specific situation facing the poor. If, for example, the incomes of the poor are increasing rapidly but their access to social services is stagnating, the Bank will work with the government to redress the imbalance by emphasizing provision of social services. This could be advanced by additional Bank lending to these sectors, or Bank lending could be linked to appropriate actions on the part of the borrower to correct imbalances. Within sectors, Bank lending can be used to influence the pattern of public investment and expenditures by emphasizing programs most likely to benefit the poor.

C. Dissemination

55. To facilitate dissemination of the emphases of this enhanced poverty focus, the Bank intends to:

- share the results of its country-specific poverty analyses with the donor community to assist and influence their efforts to reduce poverty, primarily through consultative groups and other aid coordination mechanisms;

- together with country counterparts and relevant United Nations agencies, prepare and implement proposals to improve the quality, reliability and frequency of data related to poverty;

- issue a handbook of best practice concerning poverty reduction to facilitate the work of operational task managers;

- issue an operational directive to its staff summarizing the Bank's guidelines on a wide range of operational issues relating to poverty.

56. These diverse aspects of the Bank's enhanced work on poverty have a common objective--to contribute to a substantial reduction in the numbers of the developing world's poor over the next decade. The financial implications of meeting this objective are numerous and varied, as this paper has indicated. With support from all parties concerned, however, they do not pose insuperable problems for reducing poverty. To the contrary: financial obstacles to substantial poverty reduction can be overcome through the kinds of measures discussed here. The greater challenge is to mobilize the political commitment without which the

financial requirements are likely to go unmet.

VII. THE FUND AND POVERTY REDUCTION

57. In "Strategies for the Effective Reduction of Poverty in the 1990s," a joint Bank-Fund background paper discussed by the Development Committee in September 1990, staff of the Bank and the Fund outlined strategies to reduce poverty in developing countries and the roles of the Bank and the Fund in helping member countries design and implement them. This section reflects on how the Fund's role relates to the financial implications of the poverty-reduction strategies.

A. The Role of the Fund

58. The Fund's central mandate is to help member countries pursue sound macroeconomic and structural policies through both its surveillance activities and financial support, with the objectives of promoting open trade and payments systems worldwide and sustainable economic growth and financial stability in both industrial and developing countries. Sustained economic growth and macroeconomic stability in developing countries are necessary conditions for lasting poverty reduction in these countries. Growth in industrial countries and open trade systems worldwide create favorable conditions for sustained growth of export markets for the developing countries, thereby enhancing their real earnings and employment opportunities. The Fund's financial facilities support adjustment efforts of member countries to achieve these objectives.

59. While economic policies are aimed at sustainable growth, they need to be designed to reflect specific concerns for the poor through cost-effective social programs, including social safety nets for protecting the poor during economic reform and adjustment. Toward this end, the Fund has been making particular efforts in the following areas: (1) improving its country-specific knowledge of poverty incidence, the impact of economic policies on poor groups, and possible measures to reduce poverty in developing countries; (2) encouraging member countries to strengthen the positive effects of adjustment on the poor and introduce targeted public expenditures and social safety nets where necessary; (3) disseminating the relevant country experiences among the Fund membership--in particular, by directing some of its technical assistance activities to advice on the design and implementation of social safety nets and; (4) catalyzing external financial assistance for economic programs. In these endeavors, the Fund collaborates with, and draws on the expertise of, relevant national and international institutions, including the World Bank and United Nations agencies.

60. The joint paper cited above describes the efforts the Fund has been making to address concerns for the poor in its operations. More recently, in October 1990, Fund staff invited representatives of United Nations institutions to discuss ways to enhance cooperation through the exchange of information and views on the social aspects of adjustment and on policy measures to protect the poor. In December 1990, Fund staff conducted a third internal seminar on poverty in a continuing effort to strengthen its

capacity to advise member governments on ways to protect the poor during economic reform.

B. The Fund and the Financial Implications of Poverty Reduction

61. The Fund's efforts in the following areas have direct and indirect implications for mobilizing resources for economic growth and poverty reduction in developing countries:

(1) Policy Advice

(a) Macroeconomic policies aimed at a stable economic and financial environment conducive to sustained growth of income, employment and productive investment;

(b) Structural policies, including: (i) pricing *and interest rate policies to promote private* savings and their productive use; and (ii) public revenue and expenditure policies aimed not only at nondistortionary mobilization of public savings and their productive use but also at protecting the poor through social sector programs, including social safety nets and other targeted expenditure programs.

(2) Financial Assistance

(a) Financial assistance to support member countries' adjustment efforts (particularly in support for structural adjustment programs of low-income countries through the Structural Adjustment Facility and Enhanced Structural Adjustment Facility);

(b) Efforts to catalyze external financial support for adjustment programs, including support for well-designed measures to mitigate any short-run adverse effects of such programs on the poor.