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

From: The Secretary

Subject: Implications of the Social Summit for the World Bank and the
International Monetary Fund - The Role of Public Expenditures
in Poverty Reduction

Attached for the information of Executive Directors is the text of an issues paper, which is being sent to members of the Development Committee. The paper is a redraft of the earlier paper on "Implications of the Social Summit for the World Bank and the International Monetary Fund (EB/CW/DC/95/2, 8/21/95), revised to reflect comments and suggestions made by Bank Executive Directors in the Bank's Committee of the Whole on September 5, and by Fund Executive Directors in the meeting of the Fund's Committee of the Whole for the Development Committee on September 8.

The main changes in the paper are the following: a change in the title to reflect more accurately the focus of the paper; the format has been changed to make it more reader-friendly by breaking the text into shorter paragraphs and introducing additional sub-headings; the introduction has been expanded to set the topic in the context of the many important issues addressed in the Social Summit's conclusions; the second section now includes more background to help place public expenditure issues in the broader framework of poverty reduction strategy and the various vehicles used to implement it; and there are a number of wording changes in the final issues section.

Att: (1)

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October 9, 1995

Implications of the Social Summit for the World Bank and the International Monetary Fund: The Role of Public Expenditures in Poverty Reduction

(Prepared jointly by the staffs of the World Bank and the International Monetary Fund)

I. Introduction

1. At its April 27, 1995 meeting, the Development Committee agreed to discuss at its next meeting the implications of the recent Social Summit in Copenhagen for the developing and transition countries, and for the Bank, the Fund and donors. This paper provides a basis for consideration of this item by Committee Members. It focuses on a key issue in the follow-up to the Summit, i.e. the role of public expenditures in achieving the Summit's poverty reduction goal.
2. The Summit had three main themes: poverty reduction, employment generation, and social integration. Within these broad themes, many important development issues were addressed: the critical role of investment in the social sectors, the importance of adequate resource flows to developing and transition economies, the need for an improved framework for international cooperation, the role of good governance, the design and effectiveness of economic policy reform and structural adjustment programs, and the importance of institutional capacity building, gender equity and social justice. It is clear that how resources are allocated by donor and recipient governments and international lending institutions will have a direct impact on how effectively the Summit commitments can be implemented.
3. Other implications of the Summit's conclusions deserve further attention. This meeting of the Development Committee focuses on one central aspect of this broad topic, although it should be noted that the agenda for October 9 touches directly on other matters which are central to resource transfers and achievement of Summit goals. Other aspects might well be taken up in other fora, including the Executive Boards of the Bank and the Fund. To facilitate this, a number of Bank- and Fund-related issues and actions under way to respond to them are set out - in matrix form - in the annex to this paper.

II. The Role of Public Expenditures in Poverty Reduction

4. There is a global consensus on the importance of poverty reduction as the major goal of sustainable development. Signatories to the Social Summit Declaration and Program of Action committed themselves to the goal of "substantially reducing overall poverty ... and eradicat[ing] absolute poverty ...". This broad commitment raises issues for industrial countries relating to their own social policies. For the purposes of this Development Committee discussion, it also raises a number of interrelated issues for developing and transition countries, the Bank and the Fund as well as for donors.

5. In recent years, and particularly following the publication of the 1990 World Development Report on Poverty, there has been a broad consensus on the most effective overall strategy to reduce poverty – a focus on labor-absorbing economic growth and investment in human resource development, coupled with safety nets for the poor and vulnerable groups. Poverty reduction also requires macroeconomic stability and the other elements of an enabling environment for growth, particularly by the private sector. Successful countries have moved on all fronts, creating a virtuous circle of human and economic development.

6. Most developing countries need external assistance to help them reach the Summit goals and yet resource availability, especially of concessional funds for the poorest countries, remains a major concern. (The discussion of International Development Association (IDA) replenishment as a separate agenda item highlights the significance of this issue and the urgent need to address the adequacy of official development assistance).

7. Three issues have become particularly significant for developing country governments: (a) how to enhance the effectiveness of poverty reduction efforts; (b) how to demonstrate with concrete policy measures their commitment to the goal of reducing poverty; and (c) how to measure and monitor performance. For the Bank and the Fund, as well as for donors, a fundamental concern is how best to support, in an environment of scarce concessional resources, the efforts of developing countries to reduce poverty – the ultimate goal being the achievement of tangible results on the ground in improving the well-being of the poorer segments of the population and in eradicating absolute poverty.

8. In this context, the way in which public expenditures are allocated plays a crucial role. Sound public expenditure policies are important for achieving and maintaining macroeconomic stability and promoting the efficient allocation of resources which are the foundation of sustainable economic growth and poverty reduction. Public expenditures are essential for human and physical capital formation and for providing income support for the poor. In recognition of this, the signatories to the Social Summit Declaration and Program of Action committed themselves to “increase significantly and/or utilize more efficiently the resources allocated for social development.”

9. The Bank and the Fund, in accordance with their particular mandates, work closely with borrower governments on public expenditure issues; the former, mainly through public expenditure reviews, and the latter, both in the context of surveillance and through the economic and financial programs that it supports. On June 27, 1995, the President of the Bank and the Managing Director of the Fund issued a guidance note designed to strengthen collaboration between their staffs on public expenditure issues. The focus of staff work will be, *inter alia*, on a number of technical questions, including how to improve public expenditure reviews and how to take better account of issues of public expenditure composition in stabilization and adjustment programs.

10. The issues discussed in the next section, and the questions posed there, center on the public expenditure reviews which are carried out from time to time by the Bank, and related issues. The reviews are intended to help governments restructure their public expenditures. Many governments, however, continue to spend excessively on programs which benefit mostly the better-off members of society, on less productive sectors, such as state-owned enterprises, and on non-developmental activities, including the military. But just as developing countries should move away from unproductive expenditures, so too, donor governments have a responsibility to avoid funding low-priority projects and programs (including military equipment). The message from the Social Summit, supported by 117 heads of state and government, is that these policies, by both recipients and donors, must change if more widespread poverty reduction is to become a reality.

11. Linking public expenditure policies more closely with the goal of poverty reduction has important implications for borrower governments, as well as for the Bank and the Fund. Most governments need to shift resources increasingly towards programs of *greater benefit to the poor; that is, basic social services and essential economic infrastructure*. Public expenditure reviews have this as a major objective.

12. Investing in people is a crucial component of the Bank's work. The Bank has increased sharply lending for the social sectors in recent years, now averaging more than \$3 billion a year. It also lends significant amounts in support of other sectors and for economy-wide policy reforms. In addition to its lending, the Bank Group has also expanded its policy advice, technical assistance and donor coordination. In this context, the Bank is working with member governments to: (a) improve the quality of public expenditure reviews, especially by analyzing the extent to which public expenditures in a given country favor the poor rather than the rich; (b) facilitate local ownership of such reviews; and (c) strengthen the cooperative character of these reviews by involving the Fund and donors more closely in the process.

13. At the same time, the Fund, within its mandate which includes focus on macroeconomic stabilization, is in the process of (a) enhancing its surveillance to assess more systematically the cost-effectiveness and fiscal sustainability of social policy options; and (b) paying increased attention to the impact on poverty and employment of adjustment measures in Fund-supported programs, and options for cost-effective social safety nets. These efforts will be continued while promoting greater government ownership of the policies.

14. Both the Bank and the Fund need to do more to assist member governments in building up institutional capacity to better implement carefully crafted public expenditure policies.

15. Public expenditure reviews form an essential building block for restructuring government budgets, but it is recognized that, taken in isolation, they do not provide a full and accurate picture of country performance and commitment to a sound poverty reduction strategy. Thus, for example, poverty assessments/poverty analyses provide an important additional basis for preparation of country assistance strategies, policy reforms,

and the design of development projects--as well as the proper choice of instruments to be used to support these programs.

16. Poverty assessments, which are usually based on household data, are designed to provide detailed analysis of poverty: who the poor are; where they live; what their sources of livelihood are; which types and quality of social services are available and are accessible to the poor, and so on. The insights provided by these studies are valuable not only for the purpose of monitoring the outcome of a country's poverty reduction efforts but also for designing more effective poverty reduction strategies and programs.

17. While the quality of such assessments is improving with experience, more needs to be done and efforts are under way to strengthen their effectiveness. Thus, they are becoming more participatory, with the views of the poor about the opportunities and constraints facing them being sought directly. Indicators of the extent to which poverty is actually being reduced need to be improved as well, as poverty assessments are now often constrained by lack of household survey data, a prerequisite for detailed poverty analysis. To remedy this situation, the Bank works with governments to conduct, or build the capacity to conduct, household surveys which will measure school enrollments, adult literacy, child and infant mortality, life expectancy, access to clean water, and other measures.

18. The fundamental question is whether or not borrower governments and donors, as well as the Bank and the Fund, are prepared to follow the recommendations that emerge from such carefully conducted reviews and assessments.

III. Issues for Discussion

Increased Bank/Fund Reliance on Public Expenditure Reviews

19. In preparation of country assistance strategies, a primary goal for the Bank is to focus on steps needed to help countries reduce poverty and improve living standards. The Fund contributes to this objective by fostering conditions for sustainable high-quality economic growth, which is necessary for poverty reduction over the medium term. Increasingly, the Bank expects governments to demonstrate their commitment to poverty reduction, *inter alia*, by channeling adequate resources into basic social and economic services (primary and secondary education, primary health care, safe drinking water and proper sanitation, rural roads, access to credit and other factors of production, and so on) from which the poor stand to gain the most. These budgetary allocations, however, need to be made within the context of a sustainable overall fiscal policy. These are difficult choices. The Bank and donors rely, in part, on the results of public expenditure reviews to assess a government's commitment to poverty reduction.

20. Do ministers support this increased attention given to the composition of public expenditures as one important measure of performance? Do ministers have suggestions

for alternative and/or complementary tools for measuring commitment and performance with regard to poverty reduction?

Content of IMF Surveillance and Program Discussions

21. In assessing the strength of a country's economic and financial program, the Fund pays special attention to fiscal adjustment and, increasingly, to the implications of adjustment for the poor. While the primary focus is placed on aggregate fiscal measures, the Fund also stresses the importance of the quality of fiscal adjustment, including the composition and sustainability of government revenues and expenditures. In the context of surveillance, the Fund analyzes the fiscal and macroeconomic implications of social programs, including anti-poverty programs and social security arrangements, with emphasis on their cost-effectiveness, longer-term sustainability, and consequences for the functioning of the labor market and unemployment.

22. In view of the Social Summit's call for developing the poor's human capital and improving their access to productive assets, should the Fund in its surveillance and program discussions work more closely with the Bank and other institutions with the necessary expertise to better integrate the results of the work of those institutions into its own analysis of the composition of public expenditures?

Improving Efficiency of Expenditures

23. The efficiency of public expenditures should be improved. In this context, although countries have varied defense and security needs, signatories to the Social Summit Declaration and Program of Action undertook " ... to explore new ways of generating ... resources, *inter alia*, through the appropriate reduction of excessive military expenditures ...". This applies to military expenditures, arms production and trade in all countries. In some countries, the level of military spending has either made increased social spending impossible, or has itself been a cause of unsustainable fiscal deficits. Some countries have shown a readiness to work with the Bank, the Fund, and donors to make appropriate changes in the composition of public expenditures so as to increase allocations for productive purposes.

24. The level of military expenditures for a country is a matter which is typically based on security and political considerations and, as such, falls outside the mandates of the Bank and the Fund. However, these mandates include consideration of the effect of the overall level of public expenditures, including military expenditures, on a country's external obligations, and the adequacy of public expenditures for investments in social and economic development. It also covers analysis of the balance between development and non-development expenditures. The Bank and the Fund provide technical assistance, if requested by a government, in analyzing these issues. They also provide information to the international community. Increasingly, bilateral donors and creditors take into account, in their own lending decisions, a borrowing country's military expenditures as determined, *inter alia*, on the basis of this analysis.

25. To what degree are donors and creditors prepared to avoid funding low-priority spending, including on military equipment, in developing countries? What further role, if any, should the Bank and the Fund play in relation to the analysis of public expenditures for social and economic development as against non-productive spending, such as excessive military expenditures?

Donor Support for Countries Demonstrating Commitment and Performance

26. In many borrower countries, the Bank is a major financier of the government budget -- through project lending, the local currency generated from balance of payments support and technical assistance. The Fund also provides balance of payments support and technical assistance. Other important sources of external support are bilateral donors, the regional development banks, UN agencies and non-government organizations (NGOs). Support from the Bank and the Fund would be more effective if a more coherent set of public expenditure priorities were established by the country concerned. Enhanced collaboration with other agencies would help ensure that those priorities are widely shared by the donors. In the recent Halifax Communiqué, G-7 leaders urged the multilateral development banks to "cut sharply" funding for countries which do not show a commitment to poverty reduction. But often, donors do not themselves follow the recommendations of public expenditure reviews.

27. Are donors prepared, in their own bilateral programs, to adhere to the spending priorities that emerge from public expenditure reviews? Are they prepared to focus additional resources on countries demonstrating commitment and performance, and to reduce resource allocations in countries persistently failing to meet agreed priorities?

28. Another way to support governments which demonstrate commitment to poverty reduction is for the Bank and donors to provide assistance within the framework of sector programs that support agreed strategies, rather than through uncoordinated project-by-project aid. The Bank and donors are beginning to do this.

29. Where governments have demonstrated the ability to set priorities effectively, are donor governments prepared to shift their aid more rapidly to agreed sectoral programs and away from donor-initiated project-by-project commitments?

Social Summit Action Matrix
Proposed Actions by the Bank

Issues	Proposed Actions
<p>1. Improving the quality of social sector spending. The Social Summit called for improving the efficiency, effectiveness, and equity of social sector spending.</p>	<p>The Bank will improve the quality of public expenditure reviews. In particular, it will carry out, subject to data availability, more detailed analysis of the extent to which public expenditures actually benefit the poor.</p>
<p>2. Increased spending on basic social services. The Summit called on governments and the international community to allocate more resources for basic social services.</p>	<p>Within an enlarged resource envelope for the social sectors, the Bank will maintain the trend of increased lending for primary education, girls' education, primary health care, and nutrition programs.</p>
<p>3. Poverty monitoring. As a follow-up to the Social Summit, governments and donors are expected to set up or improve existing mechanisms for poverty monitoring.</p>	<p>The Bank has initiated discussions with UNDP and UNICEF with a view to collaborating with these agencies on poverty monitoring at the country level, as well as the regional and global levels.</p>
<p>4. Structural adjustment and social sector spending. Given the importance attached to social sector spending in the fight against poverty, governments are expected to protect this spending from budget reductions during the implementation of adjustment programs.</p>	<p>Increasingly, Bank-supported structural adjustment programs include conditionality requiring the government to protect, or increase, social sector spending, especially on basic services.</p>
<p>5. Employment. The Summit called upon governments and the international community to promote development strategies and policies that foster employment creation and the reduction of unemployment.</p>	<p>Given the importance it attaches to labor incomes and conditions in poverty reduction, the Bank devoted the 1995 World Development Report (WDR) to the subject of Workers in an Integrating World. Drawing upon the analysis in this WDR, the Bank will pay greater attention to issues of labor policy and institutions in its operations.</p>
<p>6. Cooperation with other UN agencies. The follow-up to the Social Summit envisages increased collaboration between the Bank and other UN agencies.</p>	<p>The Bank will strengthen its collaboration with other UN agencies, particularly UNICEF, WHO, UNESCO, ILO, UNDP and others whose activities are focused on the Summit goals. The Bank will work more closely with other UN agencies to assist governments in designing national strategies for poverty reduction and elaborating expenditure policies in specific sectors.</p>

Social Summit Action Matrix
Proposed Actions by the IMF

Issues	Proposed Actions
<p>1. Surveillance. The Social Summit highlighted the need for monitoring countries' public spending on basic social services; and placed emphasis on employment creation.</p>	<p>Country consultations and economic reports will pay more attention than at present to the composition of expenditure, especially expenditure on the social sectors, and on labor market policies, including labor market efficiency, measures to reduce unemployment, and the impact of social insurance programs on the labor market.</p>
<p>2. Program design. The Social Summit called for incorporating adequate social safety nets in adjustment programs to complement poverty reduction, and for promoting basic social expenditures.</p>	<p>The design of adjustment programs will pay more attention than at present to the implementation of cost-effective social safety nets and to reallocation of public expenditures to better meet the needs of poor and vulnerable groups.</p>
<p>3. Technical assistance. The Social Summit called for ensuring budgetary transparency and accountability in the use of public resources, increasing the quality and effectiveness of social expenditures, and expanding revenues.</p>	<p>The Fund's technical assistance will continue to focus on helping countries to achieve greater budgetary transparency, build institutional capacity to set and implement expenditure priorities, analyze the macroeconomic and budgetary implications of social and poverty programs, and raise revenues in an efficient and nondistortionary manner.</p>
<p>4. Strengthened analysis of social sector spending. The restructuring of public expenditure towards the social sectors requires detailed analysis of the composition of expenditure.</p>	<p>The Fund will rely more on the Bank for information, analysis, and policy options regarding social sector spending and will participate more fully in the public expenditure review process. The recent guidance note on public expenditure issued by the Bank's President and the Fund's Managing Director will facilitate this process.</p>
<p>5. Collaboration with UN agencies. The Social Summit called for increased cooperation between Bretton Woods institutions and the UN agencies in the field of social development.</p>	<p>The IMF will strengthen collaboration with other UN agencies at the country level to seek to ensure that social sector programs, as well as Country Strategy Notes prepared by the UN, are consistent with a sustainable macroeconomic framework.</p>