

Discussion Paper on  
Development Assistance  
No. 2

The “Poverty Trap” and  
“Public Expenditure Management”  
- In Pursuit of a New Development Model -

Shigeru Ishikawa

August 2006

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**– In Pursuit of a New Development Model –※**

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## **I. Introduction**

In the 1990s, the World Bank and the International Monetary Fund (IMF) conducted a review of their past aid policies and concluded by declaring “poverty reduction” to be the primary goal of their development assistance to low-income developing countries, a shift from the previous primary goal of growth promotion in all developing countries. I am in accord with this shift in primary goal as it makes explicit the (natural) ideal of development for low income countries and as such takes an important step in the evolution of international development policy. However, I cannot escape from a strong feeling that the new poverty reduction strategy documents so far published by the IMF and the World Bank do not comprise an effective development model that indicates the set of development and aid policies by which the primary goal of poverty reduction in low income countries can be achieved. The present discussion paper represents a preliminary step toward defining a new development model for reaching that goal consistent with the assumption that “poverty reduction” means “sustainable poverty reduction based on the promotion of growth.”<sup>A</sup>

As a means for attaining the poverty reduction goal, the World Bank devised the Poverty Reduction Strategy Paper (PRSP) process. In a separate discussion paper recently issued, I examined some problems with the PRSP system, focusing on three aspects – “aid systems,” “development models” and “relief systems for highly indebted poor countries (HIPC)” (Ishikawa 2003). The present paper focuses on the development model aspect. Underlying the paper’s analysis is the thesis that resolution of the development model problem is essential (although perhaps not sufficient) for improvement of the PRSP system so it can more effectively facilitate both growth and poverty reduction.<sup>B</sup>

Insufficient understanding of the nature of underdeveloped market economies and industrial structure is at the heart of the development model problem. The PRSP process fails to recognize the decisive importance of measures for nurturing modern industries, including complete product and factor markets, in essence measures to encourage growth and the building of modern industries necessary for sustainable poverty reduction. One consequence of this has been a strong tendency in low-income countries towards the crowding out of investment expenditure fundamental to growth, commonly when countries with low savings rates try to meet high donor demand for poverty reduction measures. There is also cause for concern that the poverty described in official documents is based on presuppositions drawn through desk work in Washington, or in the capital cities of developing countries, and does not accurately reflect the economic

reality of poor people and regions.

When I prepared my previous paper, I had no means for addressing these shortcomings. But since then, I have made progress.

## **1. Discovery of New Analytical Perspectives**

At first, beginning in the mid-1990s, the World Bank conducted country/region specific qualitative research on the poor using the methodology of the Participatory Poverty Assessment (PPA) promoted by the Bank itself. Individual reports of assessment results were made available one after another. I have come to realize that the situations of extreme poverty illustrated in these reports describe poor households caught in poverty traps, or, more accurately, in downward poverty spirals. If this poverty reality could be reflected in a development model that appropriately considers the relative positions of such poor people and regions within their countries, the credibility of poverty reduction as an explicit aim would be enhanced.

Subsequently, beginning in the mid-1990s as well, a considerable literature appeared on “governance-related conditionality” and on “aid coordination”. The governance-related conditionality was for aid to poor countries, especially in Africa, and the aid coordination was aimed at donors providing budgetary support. This literature called on developing countries to strengthen, among other things, the linkages between previously little noticed components of Public Expenditure Management (PEM) — policy making, planning, budgeting and performance monitoring — in particular, the linkages between PEM and poverty reduction. Given these emphases, it seemed to me that important impetus for growth exists in PEM-driven fiscal management, and thus also in the reform of macro-economic management by governments. This complements the reinforcement of industrial policy, which I have been advocating over the years. While there still remains a knot of unresolved issues with regard to macroeconomic management, if PEM reform continues, the effectiveness of macroeconomic management, one of the major pillars for realizing growth-based poverty reduction, will increase.

My paramount challenge in this discussion paper is to launch a reconsideration of the development model issue from a platform created by these two new methodological concepts — PPA and PEM. To do this, I first analyze the economic cycle of households or regions identified by PPA studies as mired in poverty traps or poverty spirals. I proceed from there to an analysis of PEM that appropriately links key

components mentioned above.

This study is preliminary because the country-specific PPA and PEM reports currently available and to which I refer to are limited mainly to Vietnam and Ghana. To generalize significantly the results of my observations, I will need to obtain, scrutinize and summarize reports covering a far greater number of countries. Moreover, the differences between Vietnam and Ghana go beyond their initial conditions as low-income developing countries and may, to some degree, reflect differences between Africa and Asia in nature, culture and tradition as well as differences in political, social and economic stages of national development. If a more aggressive theory, even a hypothetical one, can be constructed that incorporates these differences, it will facilitate future analytical research covering a larger number of countries.

## **2. Organization of the Discussion Paper**

PPA surveys and PEM reform are important new development aid policy instruments initiated by the World Bank and the IMF in parallel with the PRSP system. Because they are little known in Japan, I devote much of Section II and Section III to explaining their importance, the context of their emergence and their main outlines. I then discuss how the knowledge and policy implications to be gained from them can be transformed into elements of a new development model, and, accordingly, contribute to an improved PRSP system.

Findings from PPA surveys strongly suggest that in the poor regions of low-income countries, the considerable number of households that are at the threshold of poverty constitute a group vulnerable to serious shocks, both internal and external. When these households just above the income poverty line do encounter shocks, their position may deteriorate, sending them into a poverty trap, or it may improve, depending on the coping strategies employed. Change in poverty rate at the national level refers to net figures arrived by offsetting increases and decreases. Any new development methodology should acknowledge and incorporate this two-way movement. In addition, the coping strategies adopted by households in vulnerable groups should be identified so that measures supporting them can be prescribed in a practical manner as part of public policy. (Section II)

Important findings from PEM-related materials suggest that fiscal revenue and expenditure mechanisms and cash flows are surprisingly unsophisticated in developing countries, something largely unnoticed when we look at development issues only from

the perspective of the real economy. Behind this situation is an absence of political agreement, leadership and administrative discipline. The PEM program proposed by the World Bank and the IMF is a standard fiscal reform, finding its ideal model in the neo-liberal “New Public Management” (NPM) approach implemented in Western nations since the 1970s. For a PEM program to be successful and release new fiscal resources, a broad range of institutional and organizational reforms are necessary. These reforms include modernization at the political and societal levels, possibly beyond adjustments that might already have been made. Thus, any improved development model must incorporate a comprehensive mechanism that will focus not only on the economy but also on politics, administration and society, beginning with prescriptions for comprehensive institutional and organizational reform. (Section III)

Section IV will deal with an analytic framework for achieving macroeconomic balance, indispensable for a new development model. It will also deal with an analytic framework for debt sustainability which must be realized before analysis and policy management under the macroeconomic framework are implemented in heavily indebted poor countries. Although they are not the main focus of this paper, discussion of these subjects is unavoidable. Take Section II as an example: Public policies to support coping strategies for vulnerable groups include measures that compete for spending, such as strengthening regional communities, assisting agricultural and rural development, building infrastructure, and implementing and supporting industrialization by direct production activities. They also require that a choice be made between the “pro-poor targeting” approach and the “broad-based growth” approach as a way to reduce poverty. Section III highlights the backwardness of public-sector expenditure management in low-income countries in general and the need for PEM reform if such backwardness is to be overcome and if further steps to carry out sweeping structural reform of political and administrative systems are to be taken. But actual conditions differ greatly from country to country, putting constraints on financial, human and institutional resources available for implementation of the above-mentioned public policies. Accordingly, it is clear that decisions based on prescriptions gained from these two sections will not be effective unless they are preceded by macroeconomic balance and debt management. Because these are not central topics of this paper, I will not go beyond presenting and briefly commenting on an outline of the framework prepared by the World Bank and the IMF.

Section V provides a summary of insights into the development model that are yielded by PPAs and PEM.



## **II. The Poverty Trap As Viewed through Participatory Poverty Assessment (PPA) Surveys**

In this Section, I examine, from a new analytical perspective, static and dynamic characteristics of poor households in low-income developing countries as revealed by PPA surveys.

### **1. What is a PPA?**

The PPA is a methodology developed by the World Bank in the early 1990s to examine and analyze poverty. It can be characterized in a nutshell as “an instrument for including the perspectives of the poor in the analysis of poverty and the formulation of strategies to reduce it.”<sup>C</sup> When asked about poverty, the poor see poverty not only from an economic viewpoint but also from political, social and psychological viewpoints, which are more qualitative than quantitative.

PPA surveys go beyond the household unit to the individuals who constitute the household, including male heads of family and housewives. (Gender differences are important, especially in light of social conventions in Africa.) Site selection is purposive and the surveys focus on the properties of the community and region to which the household belongs and which influence it in various ways. They focus also on the static and dynamic mechanisms involved in poverty; i.e., what causes people to become poor or escape from poverty and with what coping strategies.

PPA methods and characteristics are unlike traditional household surveys which focus on physical indicators, such as living standards as defined by income and income distribution. The PPA uses open-ended interviews and discussion topics which the poor can choose. By contrast, traditional household surveys employ a closed-end method, meaning that they are quantitative studies for analyzing the economic activity of all households in a country or region or of sample households selected at random.<sup>D</sup> Since many important elements of poverty are still unknown to statistical researchers, the closed-end method fails to capture the diversity of poverty and elicits limited knowledge about it.<sup>E</sup> Yet, as I have indicated above, the findings of traditional household surveys complement PPAs. (Robb 2003; Narayan 2000 I)

### **2. Poverty Surveys Conducted by the World Bank: The Transition**

The World Bank began to take an interest in poverty issues during the era of

President Robert McNamara and Chief Economist Hollis B. Chenery. In *World Development Report 1990: Poverty*, which clarified the new strategy of incorporating poverty reduction approaches fully into Bank operations<sup>F</sup>, the World Bank took an aggressive approach to its review of international aid policies (Ishikawa 2002 II). The new strategy consisted of two important elements: (a) adoption of a wide range of growth policies to create labor demand, and (b) widespread provision to the poor of basic social services, especially primary education and primary health care, so that they could benefit from access to the results of growth. To promote the implementation of this strategy, a country-specific “Poverty Assessment” was required to be conducted on a regular basis. The objective was to understand the reality of poverty in each country, to determine whether government policies, public expenditure and systems were compatible with the aim of overcoming poverty, and to propose necessary reforms. The Poverty Assessment involved quantitative data, including economic profiles of the poor such as the poverty line, social demographic characteristics, income sources, owned assets, consumption and access to services. The data was obtained through national household surveys.

For three reasons poverty reduction operations could make little progress<sup>G</sup>, especially in the African region. (World Bank Annual Reports 1991, 1992, 1994; Narayan 2000 I), Firstly, there was delay in the implementation of reliable national household surveys (as of the date of publication of the *World Development Report 1990: Poverty*, only 24 countries had conducted poverty assessment); secondly, poverty assessment activities were carried out in a limited number of countries — 20 by the end of 1990 and 39 by the end of 1994; and thirdly, there were the information constraints of closed-end quantitative surveys explained above. It was against this background that after 1994 PPA surveys became important sources of information for poverty assessment. PPA survey data accounted for 20% of all poverty assessments conducted in 1994, and from 1996 to 1998, the rate increased to 50%. In 1999, the number of countries that conducted poverty assessments was 113, covering more than 90% of the world’s poor countries. (Narayan 2000 I; *World Bank Annual Report 1999*).

PPA poverty surveys can be divided into two groups, depending on when they were conducted. Surveys in the first group were conducted in the 1990s and covered 60,000 poor men and women in 60 countries. The second group of surveys took place after 2000. (I have read only some reports of the 2000 results.) It is advisable to further divide the first group and view the surveys conducted in 1999 (targeting 20,000 poor men and women in 23 countries) separately from those conducted earlier. The earlier surveys were called “Consultations with the Poor Study” or “Voices of the Poor Study.”

It is those which served as background for the *World Development Report 2000/01: Poverty*, from which the theoretical foundation for the PRSP system was built.

### **3. Conclusions from PPA Reports - Common Patterns of Poverty**

Deepa Narayan, Economist for the World Bank in charge of PPAs, presented the conclusions from the PPAs of the 1990s in two books. The first book (Narayan 2000 I) covers the whole of the PPAs conducted in that decade while the second book (Narayan 2000 II) focuses on the 1999 survey. Essentially, PPA surveys deal with “contextual” subjects which are greatly affected by country-specific initial conditions. This makes it difficult to generalize their findings. Nonetheless, Narayan’s summary extracts important points from country-specific surveys and puts them together successfully as common patterns irrespective of each country’s situation. Although the summary has to be read with some caution, it is well worth reading for reference. I will briefly introduce five main points from the summary of the first book. From the second book, I will only present the important points that complement the first book.

The five main points from the book *Voices of the Poor: Can Anyone Hear Us?* are as follows:

(1) Poverty is an interlocking multidimensional phenomenon. The bottom line is always hunger — the lack of food. Poverty also has important psychological dimensions such as powerlessness, voicelessness, dependency, shame, and humiliation. Poor people lack access to basic infrastructure — roads (particularly in rural areas), transportation, and clean water. The illiteracy rate among poor people is high. Poor people suffer from poor health and illness. Finally, poor people lack income, not only money but also, and especially, physical, human, social and environmental assets. In many areas, this vulnerability has a gender dimension.

(2) The state has been largely ineffective in reaching the poor. Although the government’s role in providing infrastructure, health, and education services is recognized by the poor, they feel that their lives remain unchanged by government interventions. The poor also report vast experience with corruption as they attempt to seek health care, educate their children, claim social assistance or relief assistance, get paid by employers, seek protection from the police or justice from local authorities.

(3) The role of non-governmental organizations (NGOs) in the lives of the poor is limited, and the poor depend primarily on their own informal networks. Poor people

give NGOs mixed ratings. In some areas, NGOs are the only institutions people trust. However, poor people sometimes also report that, besides being rude and forceful, NGO staff members are poor listeners. Informal associations and networks may help the poor to survive, but they serve a defensive function, and usually do little to move the poor out of poverty.

(4) The household as a social institution is crumbling under the weight of poverty. Men, unable to adapt to their failure to earn adequate incomes under harsh economic circumstances, have difficulty accepting that women are becoming the main breadwinners and that this necessitates a redistribution of power within the household. The result is often alcoholism and domestic violence on the part of men and a breakdown of the family structure. Women, by contrast, tend to swallow their pride and go out into the streets to do demeaning jobs, in fact, to do anything it takes to put food on the table for their children and husbands. However, this neither helps improve women's status in society nor eliminates gender discrimination within the household.

(5) The social fabric — the bonds of reciprocity and trust which is the only insurance available to the poor — is unraveling. The reasons are: (1) only the elite have access to new opportunities in harsh economic environments. the poor are excluded; (2) when men are forced to migrate to find employment, family members left behind are unable to maintain community networks; (3) as a result of the breakdown of social networks, people's awareness of social norms weakens at the community level, leading to increased crime and violence where the police and judicial systems are not working effectively.<sup>1</sup>

#### **4. Poverty Trap and Poverty Spiral**

I want to highlight the significance of the 1999 PPA surveys by describing some points that constitute the dynamic aspect of poverty issues. They are: (1) forms of economic shocks that lock the poor into the poverty trap or become triggers for a downward spiral; (2) coping or survival strategies on the part of the poor in response to the economic shocks; and (3) the importance and effectiveness of institutions for the poor.

##### **Forms of Economic Shocks (or Triggers)**

In the 1999 PPA studies, surveys of shocks (through “analysis of situations”) were conducted for 125 cases. Forms of shocks in the order of frequency recorded are:

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<sup>1</sup> This paragraph was complemented by materials from Chapter 6, Narayan 2000 II.

“disease, injury or death of a breadwinner,” “loss of employment or decline in temporary and seasonal wages,” “expenditure related to life-cycle, excluding aging, such as birth of a child, school fees, dowry, wedding ceremonies, etc.,” “life-cycle related to aging,” “increased living costs,” “natural disasters and environment deterioration,” “divorce,” “decline in profit from farming,” “decline in business profit,” and “decline in income and delay in wage payment.” Gender differences and regional differences affect this ordering. By region, the poor in Asia regard a loss of employment or decline in wages as the second biggest shock, following injury or death of the breadwinner. In Africa, loss of employment is ranked at the bottom, although, as in Asia, injury or death of the breadwinner is ranked highest.

### **Survival Strategy**

When the poor face shocks, the range of survival strategy options available to them is very limited. They often are forced into trade-offs of one bad thing for another. Narayan calls these trade-offs “agonizing choices.” For example, the poor will often sell their production equipment or property to pay medical bills. By doing so, their loved one may be cured but they soon face another crisis — hunger. Data from PPA surveys conducted in many countries show that such trade-offs are frequent.

### **Importance and Effectiveness of Institutions**

In the 1999 surveys, poor people were asked how important, how effective or how ineffective they thought various institutions were.<sup>H</sup> Since the questions were open-ended, judgment criteria varied from person to person. Narayan compiled data from all the surveys and derived the ratings of institutions. The ratings for importance are based on how frequently an institution was mentioned by poor people at each survey point (community). For effectiveness/ineffectiveness of institutions, those listed as important are ranked based on poor people’s evaluation at each survey point. Overall ratings are determined after the institutions are divided into three groups: state institutions, civic institutions (which are further divided into community-based organizations for the poor, NGOs, religious organizations, local leaders and relatives/families), and market institutions (private companies, moneylenders, etc.) What is interesting is that state institutions account for 45% of the institutions considered important, 33% of the institutions considered effective, and a whopping 83% of the institutions considered ineffective. For civic institutions, the rates are 50%, 60% and 15%, respectively. The corresponding rates for market institutions are 7%, 7% and almost 0%.

## **5. Observations from PPA Reports - Those Who Fall into the Poverty Trap and Those Who Move Up from the Trap**

In Section I, I noted that PPA reports provide fresh analytical perspective to establish the new development model which is our aim. The value of the PPA surveys lies in the huge number of findings contained in their country and region specific reports. Although I have not read all of them, those which I have read have given me clear insight in several new directions. In this section, I will explain how we apply PPA perspective to our research, along with related research information, both old and new.

First, it should be noted that according to official economic documents, PRSPs are written to reduce poverty on a headcount ratio basis and in many countries, figures do show improvement. Rapid progress in Vietnam is noteworthy. The country's poverty rate steadily fell from 58% in 1993 to 37% in 1998 and to 29% in 2002.<sup>2</sup> In Ghana, the poverty rate continued to rise from the 1960s to 1983, but declined from 52% to 40% between 1991/92 and 1998/99.<sup>3</sup> (Since the statistical definition of poverty rate varies from country to country, a direct country-to-country comparison is not possible.) This is consistent with the Millennium Development Goal (MDG) of halving the global proportion of people living in extreme poverty between 1990 and 2015, from 30% to 15%.

But there is a problem here because in the backdrop of changes in the overall poverty rate lie three distinct groups of households: (i) households which have climbed out of poverty, (ii) households which have fallen into poverty, and (iii) households which have remained poor. Distinctions among these groups are hidden because the above data represent net figures. PPA surveys reveal the different movement patterns among the three groups which we can then explore. I will discuss the second group, the declining group whose households have fallen into poverty, and then the first group, the rising group whose households have climbed out of poverty.<sup>1</sup>

### **Empirical Confirmation and Mechanism of Declining Households**

For the declining group of households, if the external process of descending into poverty and the relevant mechanism are clarified, and if the details of survival strategies or more general coping strategies of the poor are understood, as well as the experiences of governments, communities and NGOs that have tried to help them, this will help us draft a development model providing effective prescriptions for poverty reduction. Thanks to the PPAs, an increasing amount of empirical research data on aspects of declining households is becoming available.

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<sup>2</sup> Government of Vietnam-Donor-NGO Poverty Working Group (2003)

<sup>3</sup> World Bank (1995), World Bank (2001), and IMF (2003)

When households face shocks in various forms, they may try to cope with them by selling assets (or borrowing money using assets as collateral). That may well be the moment they begin to fall into poverty. As shown above in Subsection 4, “Survival Strategy,” some poor households sell their production equipment and assets to pay medical bills when a family member (particularly the breadwinner) becomes ill. Even if the illness is successfully cured, the family will have difficulty recovering because the equipment and assets are gone. Different situations in different regions of Tra Vinh province in Vietnam’s Mekong Delta illustrate the possibilities. Tra Vinh is one of four provinces covered by the 1999 PPA survey of Vietnam. In the 1990s, in one of the poorest areas of this province, many households in distress borrowed money by mortgaging their farm land, which they had acquired through land reform, to begin shrimp farming. The shrimp farming business was expected to bring in a lot of money if successful, but the probability of failure was high (0.5) and many people lost their mortgaged land. In a fairly rich area in this same province, by contrast, where an irrigation system had been installed through public investment, many of the households turned, not to shrimp farming, but to the cultivation of high-yield varieties of rice. The success rate for this endeavor was 90%, so these households were able to repay their debt and are becoming prosperous.<sup>4</sup>

Coping strategies incorporate not only physical assets owned by households, but also social capital such as embodied in the local community. This is apparent in 1999 PPA case studies covering two other provinces in Vietnam, Lao Cai and Ha Tinh, as well as from 1995 PPA case studies of Ghana (particularly provinces in the northern savannah). Local communities provide important refuge for households facing shocks, but this is not without problems. Reportedly households increasingly pay more (gifts for special events such as weddings and funerals, and various types of contributions) to maintain community functions, thus receiving less net benefit. It is also reported that when breadwinners relocate to distant places due to work, many households lose contact with their local community. (Vietnam-Sweden Mountain Rural Development Program, 1999) (Action Aid Vietnam, 1999) (Norton, Aryeetey, Korboe and Oogle, 1995)

### **“Quintile Transition Matrix” of Household Poverty Status and Dynamics of Poverty**

Detailed, comprehensive empirical research has begun to analyze the mechanism of dynamic change in poor households. The research focuses on specific regions/groups

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<sup>4</sup> Oxfam Great Britain (1999) particularly, Fig.1, Fig.2 and description of the process of households losing land (pp.25-26).

and households. Researchers record the poverty status of households at different time intervals based on household surveys and interviews conducted at the same time. The purpose of the research is to estimate, based on the data collected, the “transitional function” over time with regard to changes in assets, the most crucial factor in the change of poverty status. The results from Vietnam studies were compiled into a “Transition Matrix,” Table 1.

In Vietnam, household living standard surveys (VLSS) and interviews were conducted on 4,304 households, first in 1992/1993 and then in 1997/1998. The transition matrix into which the results were compiled shows changes in the poverty status of households and was disclosed to the public through a brief announcement. Table 1(1) shows that 64% of the households in the “very poor” category in 1993 had moved up by 1998. On the other hand, 34% of the households in the “very poor” category in 1998 had earlier been in the higher categories. Table 1(2) is a more detailed “quintile transition matrix” compiled around the same time by dividing households into five categories on the basis of their expenditures. Here, the same trend can be seen.

For households in the “vulnerable group,” positioned between the poor category and the non-poor category and living on the poverty threshold from which they move up or down, a numerical estimate was made for the first time based on the PPA surveys conducted on the nation’s 43 communes in 2003 and the national household living standard surveys (VHLSS). The estimate was that as of 2002, on a nationwide basis, the vulnerable group accounted for 28.9% of the population who were below the poverty line, 6.7% of the population who were 10% above the poverty line, and 10.2% of the population who own no material assets with which to cope with shocks.<sup>5</sup>

A group at Cornell University surveyed sheep farming communities in the savanna region in northern Kenya and southern Ethiopia. By establishing a similar transition matrix and using it as base material, the group succeeded in estimating for the first time the “transitional function” in this area of research. With regard to shifts between social strata based on the number of livestock owned by sheep-farming households, the Cornell survey found three equilibrium points which are common to both regions. One is a stable, low-level equilibrium (the “poverty trap”), a second is a stable, high-level equilibrium (rich households) and the third is an unstable intermediate dynamic equilibrium in between which is positioned on the threshold. If sheep-farming households cross the threshold upwards, they can wander freely with increased livestock

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<sup>5</sup> Government of Vietnam-Donor-NGO Poverty Working Group (2003), no estimate of a transition matrix was made, but Table 1.4 shows the ratio of quintile expenditures in 1993, 1998 and 2002.



within vast meadowland. But if they fall below the threshold level, they will have to sell their livestock one after another, thus falling into a poverty trap. Such households become settled farmers, owning perhaps one dairy cow and a patch of field, but they soon become unable to support themselves because of their low productivity. (Lybbert, Barrett, Desta and Coppock, Barret and MacRock, 2004.

Table 1

Poverty status of all the households and Poverty Transition Matrix for Vietnam,  
1993 to 1998

## (1) Poverty Status Transition Matrix

	Poverty Status in 1998			
Poverty Status in 1993	Very Poor	Poor	Non Poor	Total
Very poor	8.2	7.6	7.1	22.8
Poor	3.5	9.4	20.3	33.3
Non-Poor	0.8	4.0	39.2	43.9
Total	12.4	21.0	66.6	100.0

Note: 1. World Bank estimates based on VLSS93 and VLSS98.

2. Dark shaded cells indicate the percentage of panel households whose poverty status did not change between 1993 and 1998.
3. “Very Poor” is the group of households below the “Food Poverty Line.” “Poor” is the group of households between the “Food Poverty Line” and the “Total Poverty Line.” “Non-Poor” is the group of households over the “Total Poverty Line.”

Source: Government of Vietnam—Donor—NGO Poverty Working Group (1999).

## (2) Expenditure Quintile Transition Matrix

	Expenditure Quintile, 1998					
Expenditure Quintile, 1993	1	2	3	4	5	Total
1	448	230	124	51	8	861
2	237	259	217	115	33	861
3	113	207	218	230	93	861
4	47	125	214	282	193	861
5	16	40	88	183	533	860
Total	861	861	861	861	860	4304

Note: 1. World Bank estimates based on VLSS93 and VLSS98.

2. Quintile 1 is the poorest and quintile 5 is the richest. Quintiles are defined on the basis of unweighted per capita expenditures for the 4,304 households interviewed in both VLSS93 and VLSS98. About 40% of households were in the same expenditure quintile in both years. These households are shown by the dark-shaded-cells along the diagonal of the transition matrix. The expenditure ranking of another 40% of households moved up or down by one quintile between 1993 and 1998. These households are shown by the light-shaded cells in the transition matrix. The remaining 20 percent of households moved up or down by two or more expenditures quintiles.
3. It is possible that some of the households whose quintile ranking is unchanged between the two years have higher income in 1998 than in 1993, taking account of the increase in per capita income between the two years.

Source: World Bank estimates based on VLSS93 and VLSS98.

### **Promotion of Coping Strategies for the Poor: CDD, Infrastructure Building, etc.**

Livestock assets in sheep-farming regions correspond roughly to the farmland and agricultural production equipment and materials referred to earlier in connection with survival strategies. If we discern the process revealed in the table above which draws households hovering around the threshold level down into the poverty trap, we will have a general understanding of the mechanism of impoverishment. In Narayan's PPA summary of the 60 countries surveyed, social capital such as families, relatives and local communities played the role of assets. Paragraphs (4) and (5) of the PPA note that the loss of access to this social capital precipitates a fall through the threshold into the trap; underlining the importance of public policies that can prevent or reverse this "fall" mechanism.

What public policies would these be? To answer this question, we turn to information in Narayan's report on the 23-country 1999 PPA surveys. This report presents the comparative assessments of poor people themselves of the potential importance and actual availability and effectiveness of the three major types of institutional organizations which impact on their welfare: the state, civil society and the market. Civil society, which includes local communities, relatives and family members, was rated as the most important and effective organization. The state and the market were seen as much less important and effective. Evaluation of the public policies common to the three institutional organizations and their comparative evaluation seems to depend largely on the particular stage of economic and social development of the country.<sup>1</sup> But the results of the 1999 surveys offer insight into public policies that support the role of local communities.

One relevant issue is the Community Driven Development (CDD) program, which has been strongly promoted by the World Bank, especially its Africa Region, over the past few years. This is a rural development program for strengthening local communities by giving them policy-making and implementation authority with a view to achieving substantial reduction in poverty levels (World Bank African Region undated). Some anthropologists have voiced reservations about the CDD approach, apparently on basis of the experience of a French aid organization working in the Sahel region of Africa (Platteau J.P. and F. Gaspart 2003). They claimed that although donor organizations intended to provide benefits directly to the poor, the benefits were appropriated by community leaders acting as intermediaries. The poor were aware of this situation, but did not confront the community leaders as long as they, too, were receiving some benefit, however small it might be, because "it's better than nothing."

This phenomenon is not limited to Africa and can be seen in virtually any aid program of this type. As a counter to this criticism, I refer to a very different situation reported by the PPA surveys of Vietnam. In that country, except for the Mekong Delta region where most of Vietnam's rice for export is grown and where the market economy has developed rapidly in recent years, communities still play an important role in facilitating community engagement to help the needy.

The absolute importance of communities in coping strategies has been decreasing due to continued population pressure on agricultural land; nonetheless, the relationship of trust between community leaders and ordinary community members, together with rich villagers' sense of obligation to others, seems to remain little changed (World Bank and DFID 1999). Another aspect the community role in coping strategies is the building of infrastructure, such as irrigation facilities and farm roads, through community participation. We see an example of this in the southern Vietnamese villages where irrigation has been installed. As noted above, in those villages farmers positioned around the threshold level chose to grow new high-yielding varieties of rice that offer a high success rate; whereas in villages without irrigation farmers tended to choose shrimp farming even though the expected failure rate was known to be high. Although when infrastructure is built on a large scale, such as is the case with modern irrigation systems, sophisticated technology and direct government involvement are required, Japan and China have shown that in the presence of traditional social capital, infrastructure building can be part of community activity (Ishikawa 1968).

### **Escaping and Climbing out of Poverty: Long-term Challenges of Industrialization**

Many researchers write that economic development in general, or the recovery of agriculture (in the case of farming villages), leads to a decline in the poverty rate as measured by macroeconomic statistics. There is little discussion in PPA reports of mechanisms by which households "climb" out of poverty. However, one climbing mechanism already mentioned in this paper is the use of coping strategies to protect against shocks — such as the relatively short term mechanism used by the Vietnamese farmers who switched to high-yielding varieties of rice. A longer term mechanism for escaping poverty identified by numerous studies is industrial modernization and the ensuing collapse of old, rigid systems. The case of farming villages in Japan during the Meiji and Taisho eras (1868 – 1925) provides one illustration of this mechanism. Initially, the rural poor in Japan were usually tenant farmers (*kokata*) who worked under the direction of landlords in the "tenant-landlord system" (*tezukurikosaku-seido*), the basic agricultural production system in Japan at the time. But with the establishment of

industrial zones after the Japanese-Russo War and WWI, many poor peasants moved to larger cities and became urban factory workers. With this huge loss of manpower, the “tenant-landlord system” collapsed and was replaced by a system characterized in Japanese as the “parasitic landlord system,” a quasi-absentee landlord arrangement. The case of caste in India provides another illustration. Poverty in rural areas of India is deeply interrelated with the caste system but the caste system is undergoing change. In particular, people at the bottom (outcastes or untouchables) have been climbing up out of poverty. Their movement together with urban industrialization is eroding the traditional “Jajmani” system under which rural Indians are tied to hereditary occupations and paid in kind. (Ishikawa 1990, Chapter 6)

### **III. Public Expenditure Management (PEM): Hidden Potential Resources**

#### **1. The Advent of PEM and its Three Contexts**

In its *Annual Report 2001* published in September of that year, the World Bank for the first time declared that “effective public spending is crucial for poverty reduction, and strong public expenditure management (PEM) systems are essential to ensure that development assistance is utilized as intended” (World Bank 2001:44). PEM refers to the management of public resource expenditures encompassing fiscal and other spending channels. Official documents of the World Bank and the IMF also often define PEM as the macroeconomic management both of public revenues used to acquire resources and of the private sector. The above quote, however, suggests that the two organizations recognize the potential of improved PEM-oriented macroeconomic management as an additional strategic resource for poverty reduction. My immediate interest in PEM as one of the two analytical perspectives in this paper is its strikingly underdeveloped nature in many low-income countries, and conversely the shape and size of latent resources that may be released through PEM reform.

To explain the possibilities, I review some of the literature on PEM reform, starting with observations on the following three major contexts in which it occurs:

- (1) The issue of governance including PEM reform emerged as a key policy reform item towards the latter part of the Structural Adjustment Lending (SAL) policy period. It has become increasingly important under the PRSP approach that followed. Expectations about the role of PEM reform within governance reform have heightened. During the period 2001-2002, PEM reform came to be identified as an urgent issue affecting the implementation of poverty reduction strategies.
- (2) New Public Management, the advanced PEM reform model widely implemented in developed countries since the 1980s, has influenced PEM reform in low-income countries in diverse ways. The models adopted by the United Kingdom, New Zealand and Australia were particularly influential (JBIC 2001).
- (3) PEM reform became an important prerequisite for major donor agreement on the policy of “general budget support,” the latest type of aid coordination among donor countries.

#### **The Emergence of Governance**

Although the word “governance” was not used specifically in it, the *World*

*Development Report 1997* is often regarded as the first publication in which the World Bank and the IMF acknowledged that governance was a key determining factor for their aid policies (World Bank 1997; World Bank 1998, “Foreword”).<sup>6</sup> In reconsidering the role of the state in development, the report noted that sustainable development could no longer be achieved solely by adopting “good policies.” Supporting institutional arrangements and an established, effective public sector had become equally indispensable. This was the first report in which the World Bank appeared to extend the scope of permissible state intervention in the market to cases involving non-market adjustment methods; for example, “contest-based” competition assistance provided during the “East Asian Miracle”. Yet according to the report of a Harvard University Group (Kapur and Webb 2000) that studied governance-related conditionality under the SAL system, governance issues had come to the fore in World Bank thinking as early as the 1980s as a consequence of a reexamination of its repeated failure to bring about development in Africa.<sup>K</sup> Based on this history, it could be said that governance reform was predestined to become an additional SAL conditionality item when the World Bank established that system in 1980.

The SAL system was adopted following the two oil crises of the 1970s after the World Bank acknowledged that investment project lending, historically the main pillar of assistance to developing countries, was not sufficient to bring about development. The thinking was that market economies would have to be encouraged through reform of the institutional policy frameworks of controlled or planned economies, together with the introduction of programs to support macroeconomic stability and growth. Yet according to assessments made by the World Bank itself, by 1990 it had become obvious that the structural adjustment approach also had failed in low-income countries, not to mention in middle-income ones. (Ishikawa 2001 I). It would have been possible at that time to redress some of the structural adjustment issues through an array of prescriptions designed to induce the growth of market economies; such as the mix of methods or the pace of implementation. Instead, the international aid community relied solely on the addition to existing prescriptions of a new item, “governance,” to bringing about the desired change.

The advent of governance reform as a prescription for aid policies was also directly due to political factors. The above-mentioned Harvard Group report also stressed that the emphasis on governance was a consequence of significant shifts in the international political scene. The end of the Cold War created a need to reconstruct civil

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<sup>6</sup> The first time the term “governance” appeared in a World Bank Annual Report was in the *Annual Report 1998*.

societies in the former Soviet bloc countries. Challenges to the sanctity of national sovereignty which previously had prevented outside interference in domestic affairs (for example, indictments against former Chilean president Augusto Pinochet and Chadian president Hissene Habre from outside the countries where their crimes were committed) were perhaps more significant. The international community's definition of the concept of "governance" was strongly influenced by these and other political factors.

According to Japanese aid researchers<sup>L</sup>, although the specific definition of governance varies among major aid donors and international aid organizations, the term broadly refers to a concept associated with (1) decisions on the type and structure of government; (2) execution of authority to manage economic and social resources for development; and (3) political authority to formulate, plan and implement policies. All three are subject to varied interpretations by stakeholders, but the most significant difference concerns (1) above. Whereas Western nations, the OECD and institutions of the United Nations advocate democratization, the World Bank and international aid organizations have preferred to remain hands-off on this issue. In part because the IBRD Articles of Agreement forbid discrimination in lending policies based on political alignments of recipient countries (Article IV, Section 10), governance provisions of the World Bank have been limited to the efficient and effective pursuit of (2) and (3) above. In reality, however, World Bank activities have gradually come under the strong influences of the major donor countries that constitute its Board of Directors (Shimomura 1999; Kondo 2003).

Major donor countries affiliated with the World Bank incorporated governance in concrete terms into the agreement for the Twelfth Replenishment of the International Development Association (IDA) in 1998, and reemphasized it at the time of Thirteenth Replenishment in 2002. As a result, the World Bank introduced the Country Policy and Institutional Assessment (CPIA) system, a set of performance assessment indicators for borrowers of IDA policy support assistance. The CPIA rates borrower governments according to twenty criteria. Five criteria fall under the cluster of "public sector management and institutions (i.e. governance)," four under "economic management," six under "structural policies," and five under "policies for social inclusion and equity." One economic management criterion is also counted as a governance criterion. The six governance criteria are "property rights and rule-based governance," "quality of budgetary and financial management," "efficiency of revenue mobilization," "efficiency of public expenditure," "transparency, accountability and corruption in the public sector," and "management and sustainability of the development program." (IDA 2002 II).



### **Emphasizing PEM Reform**

It was in this way that governance reform came to be one of the major reform objectives of World Bank and IMF policy support lending from the 1980s onwards. During the period 2001-2002, the debate over governance was brought into sharper focus and PEM emerged as the core issue. This notion is supported in publications related to PRSP co-authored by the IDA and the IMF. A report that reviewed the early experience with PRSPs — covering 42 I-PRSP countries and ten full PRSP countries in the first two years of its implementation — immediately identified near term prioritization of the PEM system as a measure of good practice at the country level to enhance the PRSP approach.<sup>M</sup> A section in the same report titled “Governance and PEM” states the following:

*Good governance and effective public sector performances are central to poverty reduction. As poverty reduction strategies are neither developed nor executed in political vacuums, the overarching political and institutional context sets the parameters and constraints that shape the prospects for economic and social reform.*

In the past, governance was considered too sensitive to be discussed, but this was no longer the case. “The importance of sound PEM is increasingly recognized” (IDA and IMF 2002 I: 7, 55-58) out of all other governance-related issues.<sup>N</sup> A PRSP progress report written later in the same year goes so far as to state that “strengthening countries’ public management systems will be critical for PRSP implementation” (IDA and IMF 2002II). The *World Bank Annual Report 2001* which was quoted at the beginning of Section III also anticipated this development.

What happened in the period between the late 1980s when the issue of governance began to gain prominence and the years 2001-2002 when PEM evolved to become its focal point? An examination of the following developments in low-income World Bank and IMF aid recipient countries provides us with some answers.

(1) Initially, the governance issue was rejected by those countries lacking fundamental structures such as political unity; an established state system; minimum policy agreements within the government, key social strata, groups and political parties; and decision-making, political leadership and policy execution skills. Yet by the period 2001-2002, many of the same countries had reconsidered. The government of Ghana, for example, initially rejected as political interference policy reforms initiated by the World Bank and donor countries. Both the former Rawlings administration and its

successor Kufuor administration which came to power in December 2000 elections opposed the primary goal of poverty reduction, a conditionality of the PRSP approach that followed the SAL regime. However, the British Overseas Development Institute which evaluated the poverty reduction and public expenditure policies of Ghana reported that its research team noticed for the first time in June 2001 that poverty reduction policies were moving up the government's agenda. (Foster, Fozzard, Naschold and Conway, 2002). This suggests that low-income countries will consider governance reform and PEM once the appropriate political conditions have been established.

(2) "New Public Management," an attempt to reform the public sector using private sector management methods, became popular in developed countries during the 1980s. Many low-income countries modeled budgetary management, PEM evaluation and reform proposals, in particular, on the experiences of New Zealand and Australia (JBIC 2001 I, 2001 II). The *Public Expenditure Management Handbook* published by the World Bank in 1998 (World Bank 1998) analyzes in detail the PEM models of advanced countries and discusses "three levels of institutional arrangements to achieve successful budgetary outcomes" necessary for the successful introduction of the models in low-income countries. The three levels are "aggregate fiscal discipline," "strategic prioritization (allocative efficiency)" and "operational performance (technical efficiency)." The *Handbook* discusses and recommends the introduction of the "Medium Term Expenditure Framework (MTEF)" (estimates of sustainable budgetary expenditure over the medium term beyond annual balanced budgets) as a necessary precondition for "strategic prioritization." In reality, PEMs in the low-income countries are ineffectual and far less sophisticated than advanced country models. At the same time, this makes the potential for improvement extremely attractive, once again underscoring the importance of PEM reform within the context of governance reform.

On the other hand, "deep-seated capacity constraints are often not being adequately addressed" when advanced country models are considered for low-income countries (IDA and IMF 2002 I: 58), perpetuating the difficulties from underdeveloped PEMs in the first place.<sup>0</sup> The three levels of institutional arrangements discussed in the *Public Expenditure Management Handbook* is reminiscent of the failures under the SAL system resulting from the mistaken notion that market mechanisms will spontaneously revive once a law is passed prohibiting totalitarianism (Ishikawa 1990). The fact is that in general, the introduction of effective MTEFs is beyond the present capabilities of low-income countries. According to publications at the beginning of 2002, the majority of PRSP countries as well as over four-fifths of HIPC countries have not integrated MTEF into their budgetary formulation processes (IDA and IMF 2002I: 59).

3) The rethinking of international aid policies during the 1990s resulted in a movement toward “aid coordination” among donors and between donors and specific recipient countries. Since then, aid coordination has grown to encompass the harmonization of procurement of aid materials (harmonization); adjustments to development policies for specific sectors (sector-wide approach); and the use of a common basket of assistance funds (common basket). More recently, aid coordination has expanded to include Multi-Donor Budget Support (MDBS) for PRSPs in individual countries. However, a credible standard for budgetary management must exist in developing nations before MDBS can be introduced.

Aid coordination has been implemented in African nations where Western donor influences are strong, but on a relatively small scale. Aid coordination was originally conceived to handle the different procedures required for each recipient country by an increasing number of donor countries and to reduce the burden on competent local personnel caused by the numerous dialogues and negotiations associated with multiple donors (often referred to as “transaction costs”). An additional reason for the existence of MDBS is cited in a World Bank report. ODA funds traditionally flow directly from the donor to the responsible ministry within a recipient government and negotiations for the ODA-assisted project are conducted with the same ministry. This means that ODA cannot be instrumental in correcting one of the significant shortcomings of budgetary management and PEM in low-income countries, namely the lack of linkages among policy making, planning, budgeting and performance monitoring. Multilateral Donor Budget Support, in the World Bank’s view, has the capacity to address this shortcoming. One outstanding issue remains, however; the lack of capability in these countries to implement PEM, itself. The expectation is that this will be corrected through technical assistance provided by MDBS funds.<sup>7</sup>

This concludes the subsection on the three contexts in which PEM reform has appeared. I now make observations on PEM models of developed country models based on the theory of New Public Management and on the current underdeveloped nature of PEM in low-income countries (a generalized pattern).

## **2. PEM Reform Models in Developed Countries**

The 1998 World Bank *PEM Handbook* describes a normative pattern of PEM that

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<sup>7</sup> I am indebted to Mr. Noriyuki Hashimoto, JICA Project Formulation Advisor dispatched to Ghana, for information regarding Ghana.

low income countries can aim to achieve. Its development was based on the World Bank's twenty-years of experience with PEM and the PEM reform models of developed countries. This subsection will examine this normative pattern from the perspective of three items referred to previously: three levels of institutional arrangements to achieve successful budgetary outcomes (i.e., aggregate fiscal discipline, strategic prioritization and operational performance) from the World Bank *Public Expenditure Management Handbook*; strengthening linkages among policy making, planning, budgeting and performance monitoring in connection with PEM; and the Medium Term Expenditure Framework (MTEF). A brief summary of the history described in the *Handbook* of budgetary reforms in developed countries over the past 100 years provides a useful backdrop to understanding the levels of development of PEM in advanced country models and a good introduction to the examination.

### **The History of Budgetary Systems in Western Nations**

Modern budgetary reform began around the turn of the 20<sup>th</sup> century after central budget agencies strengthened their authority. Reform was aimed chiefly at control of public resources and was supported by institutional arrangements whereby all revenues were to be paid into a central fund and drawn on only by authority of the legislature. Over time, traditional line-item budgeting became even more detailed, inhibiting corruption. The strengths of such a system are its simplicity and lack of ambiguity, ease of comparison with prior years, and potential for control of expenditures through detailed specification of inputs. Critics pointed out, however, that line-item budgeting does not insure efficiency, a primary value of budgeting. In other words, budgets organized according to line items give no information about why the money is spent or about the efficiency and effectiveness of the programs it is spent on, and they do not take into account long-term costs associated with growth.

To compensate for these weaknesses, post-war budgetary reforms resulted in the formation of several new types of processes. "Performance budgeting" is a management system which develops and sets measures of workload and unit cost across departmental budgets and provides incentives for performance. "Program budgeting" (or more specifically, the planning, programming, budgeting system — PPBS— adopted by the US administration of Lyndon Johnson) is a resource allocation system that divides the entire budget into programs; measures their input, output and outcome; and allocates money according to each program's marginal value. "Zero-based budgeting," popular during the 1970s, calculates the annual costs and benefits of each program, in contrast to the incremental approach taken by program budgeting. In the end, none of these systems became firmly established, but associated budgetary reform issues, such as efficient

resource allocation, effective management and frameworks to support growth, were carried into the debate on PEM reform.

### **Current Issues on the Reform of Budgetary Systems**

The *Handbook* states that the several objectives of budgetary reform pursued over the past 100 years — “control of public resources,” “planning for future allocation of resources” and “management of resources” — have been reconsidered and reformulated in light of new theoretical developments. The aim has become the establishment of a public sector budgetary process that will improve simultaneously outcomes at the three levels identified earlier: fiscal discipline, prioritization and resource allocation, and efficiency and effectiveness of programs and service delivery. The theoretical basis for this reconsideration is aligned to the thinking behind the New Public Management theory, that the ultimate objective of budgetary reform is to propose and implement rules for official intervention by the public sector corresponding to the “invisible hand” of the private sector. The following commentary on the three outcome levels are based on this perspective.

#### **(1) Fiscal discipline**

The aim of traditional line-item budgeting is to apply fiscal balance to each item of individual budgets at the ministry level for each fiscal year. This is efficient from a fiscal perspective but at the cost of resource allocation and management efficiency. Achieving fiscal discipline with efficient resource allocation requires a budgetary system that determines sustainable total expenditure over a period of several fiscal years. “Sustainability” is measured by the stability of the macroeconomic environment, and as long as this is maintained, budget deficits are permissible. Forward estimates of macroeconomic indicators and fiscal revenues are required to determine aggregate expenditure. This is called “base-line” budgeting.

#### **(2) Prioritization and allocation of public resources**

Politically-determined visions and directions for development play the role of prioritizing the efficient distribution of scarce public resources among competing policies and programs. Line ministries are responsible for deciding which policies and programs to pursue and for providing individual costing, output and outcome information. Macroeconomic outlook and decisions on expenditures follow the same principles set out in Paragraph (1) above. The efficient distribution of public resources depends on the standardization of information, or information and accounting systems. Other requirements will be discussed later.

### **(3) Efficiency of program delivery**

Even when there is efficient resource allocation at the national economy, line agencies and departments in charge of budget execution need appropriate incentives if they are to act efficiently. This is a matter of differentiation in terms of authority between upper- and lower-levels of government and among departments as well as proper management of appointment and remuneration systems for civil servants at each level, based on the principal-agent concept. The *World Development Report 1997* provides an analysis of how the incorporation and privatization of the public sector have, led to improved efficiencies in the delivery of public goods by fine-tuning incentive mechanisms.

Government agencies currently delivering public goods and services are classified into the following three categories: those that are essentially substitutes for markets or the private sector and can be replaced by them; the public sector in the broad sense, whose functions can be assumed by incorporated public sector or performance-based implementing organizations; and the core public sector, where it is difficult to specify output or to enforce performance. The government can choose to retreat from the delivery of public goods and services in the first and second sectors. In the second and third sectors (the public sector in the broad and core senses), the government can increase pressure to improve delivery by providing opportunities for citizens to voice their opinions or it can respond institutionally to encourage loyalty among civil servants. New Zealand, regarded as the model country that successfully implemented New Public Management, is known to have offered performance-based contracts even in its core public sector.<sup>8</sup>

### **Linking Policy, Planning and Budgeting**

Policy, planning and budgeting form the core of the “planning and resource management cycle”<sup>p</sup> of the total economy or of sectors. This represents the total process. The failure to link these three elements may be the single most important factor contributing to poor budgeting outcomes at the macro, strategic and operational levels in developing countries. Successful linkage indicates an established political leadership under which ministries in charge of policy, planning and budgeting — especially planning ministries (which held absolute power in former socialist countries), line agencies and finance ministries — distribute their responsibilities and are mutually cooperative. The Cabinet or Council of Ministers is the nexus between politics and government and it functions well when this cooperation is maintained.

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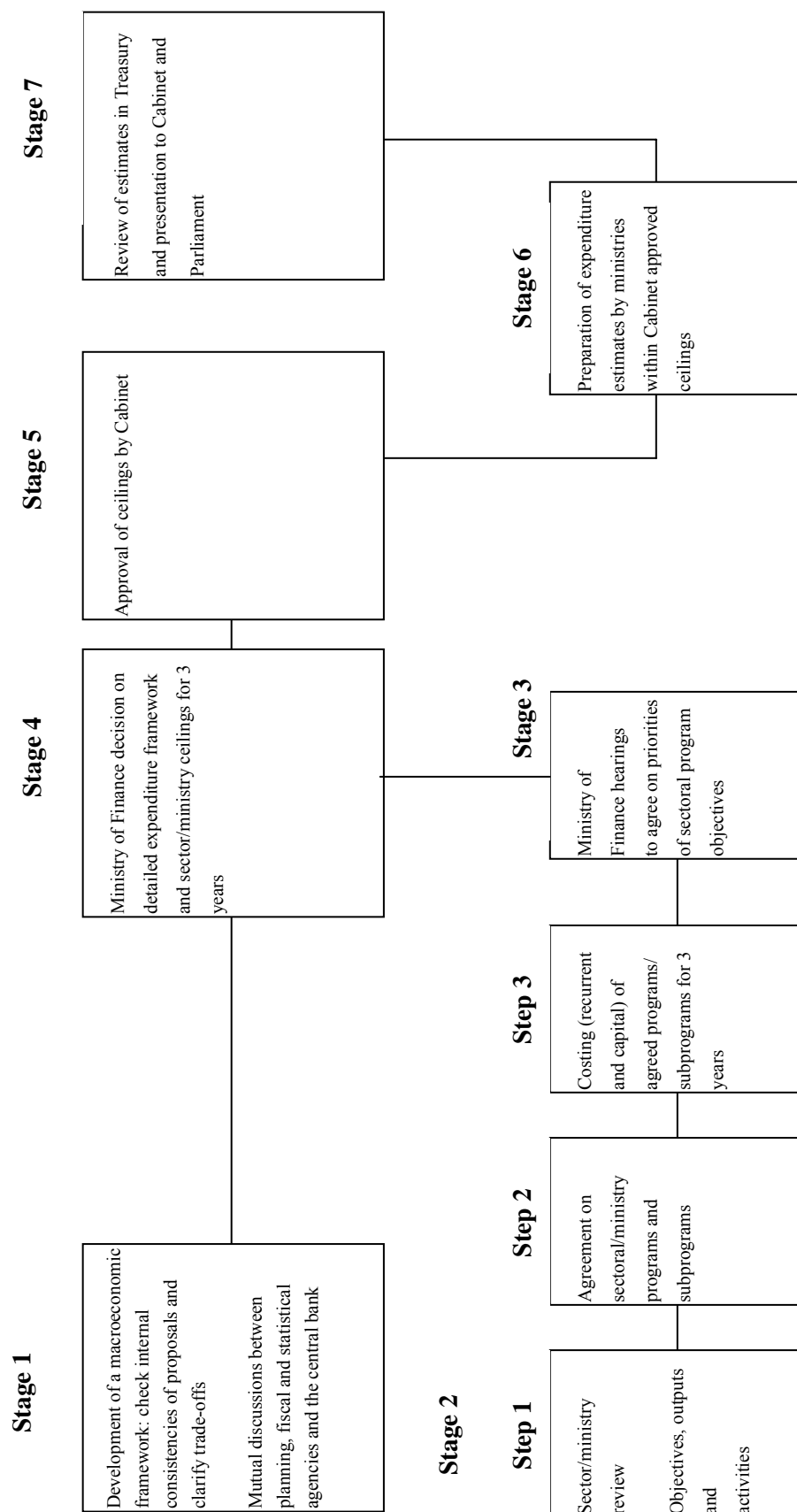
<sup>8</sup> Line-item budgeting in developed countries is known as “program budgeting.” Please refer to the *Handbook* (World Bank 1998:13) for reasons for its failure.

### **The Role of the Medium Term Expenditure Framework (MTEF)**

The *Handbook* strongly advocates the introduction of the MTEF as a means of achieving successful budgeting outcomes at the three levels discussed above. Fiscal discipline supports the baseline budgetary process when fiscal objectives are targeted towards sustainable aggregate expenditure over a period of several years. Decisions on efficient resource allocation follow the theoretical steps of the MTEF. In terms of operational efficiency, MTEF guarantees that predictable annual budgets will be decided, thus removing one of the difficulties of this level.

Table 2 below is reproduced from the *Handbook*. It is a schematic diagram representing the seven major stages for preparing and implementing the MTEF. Preparatory steps start with the planning process of **Stage 1**. This involves developing macroeconomic projections of revenues and expenditures over the medium term (three years) and constructing models to check the internal consistency of proposals and illustrate trade-offs between alternative uses of resources. In **Stage 1**, the planning ministry works together with the finance ministry, the statistical agency and the central bank. **Stage 2** is the process of sectoral review, program setting and program costing. It is the budgeting process of the line ministries and runs parallel to **Stage 1**. The finance ministry integrates the results of these two processes through **Stages 3 and 4** in which a detailed expenditure framework and sector based ceilings are decided and submitted to the Cabinet. The most decisive is **Stage 7**, where a decision-making body such as the Cabinet, acting as a link between politics and government, determines medium term sectoral resource allocations based on affordability and inter-sectoral priorities.

**Table 2: The Medium Term Expenditure Framework: Five Stages of a Top-Down Process**



Source: World Bank (IBRD), 1998, Figure 3.3



### **3. PEM Issues in Low-Income Countries: Gap with Developed Country Models**

I summarize here the various issues concerning PEM in low-income countries that have come to light in debates over PEM reform. Before proceeding, three points must be clarified: Firstly, even though PEM performances appears to vary widely from one low-income country to another, my premise is that the underdeveloped nature of PEMs in low-income countries, as cited by World Bank and IMF documents, reflects common failures in catching up with developed country models. Demands from donor countries to implement inappropriately advanced models in low-income countries may have had a negative effect, yet it is difficult to differentiate these two factors.

Secondly, I draw attention to two criteria used by the World Bank when assessing PEM: 1) whether or not expenditures are poverty-focused; and 2) evaluation of institutions and policies in terms of efficiency of resource allocation, independent of whether expenditures are in line with policy objectives (in other words, “policy neutral”). I adopt the second criteria. However, I realize that interest in policy prioritization, a key step in PEM, and perhaps even enthusiasm to achieve PEM reform, may be lost unless government agencies orient themselves to specific policy goals and pursue them with enthusiasm. I assume this to be what the World Bank means when it discusses poverty focus in the context of PEM analyses.

The third point is that the urgency or difficulty in resolving PEM issues is influenced not only by PEM itself but also by fiscal revenues and macroeconomic management. Tax reform, macroeconomic stabilization policies (growth and inflation rates, foreign exchange policies), and aggregate domestic and external debt issues are intimately linked with PEM. These are country specific issues that need to be dealt with separately. This perspective is incorporated into my examination of the scale and nature of PEM issues with reference to PEM literature,

Given the above qualifications, following is a summary of current PEM issues in low-income countries:

(1) PEM issues cannot be readily classified by categories or by factors, but their most fundamental characteristics can be observed in the following two quotes from the World Bank *Public Expenditure Management Handbook*.

*Policy making, planning and budgeting take place independently of each other. Planning is often confined to investment activities, which in many developing*

*countries refers to a series of donor-funded projects. Capital expenditures are already largely accounted for through the planning process, and a large portion of recurrent expenditures are pre-committed to the wage bill. For these reasons, annual budgeting is reduced to allocating resources thinly across donor and domestically funded “investment” projects and to the non-wage portion of the recurrent budget. In addition, line agencies tend to budget and spend on an ad-hoc basis because even small discretionary allocations are rarely predictable. (World Bank 1998:31)*

*In the absence of effective decision-making processes, policy making and planning are disconnected from each other and from budgeting, and they are not constrained by resource availability or by strategic priorities. Overall, this leads to a massive mismatch between what is promised through government policies and what is affordable. The annual budgeting process therefore becomes more about scrambling to keep things afloat, rather than allocating resources on the basis of clear policy choices to achieve strategic objectives. (World Bank 1998:32)* (Effective decision-making processes referred to in the *Handbook* are the activities taken by a decision-making body such as a cabinet or council of ministers that links politics and government in stages 5 and 7 in the MTEF process depicted in Table 2.)

- (2) We can derive from these quotes some of the shortcomings of PEM, explained in the following paragraphs:

**Weak political leadership.** The above quotes imply weak control by political leaders (presidents and secretaries-general) over administrative ministries. But the situation is even more problematic. Since the 1980s, Africa has seen rapid progress towards political liberalization. In many countries, multi-party politics have been accepted and general elections have been held to select presidents and members of parliament. However, a democratic system, or its equivalent, is yet to become firmly established and the foundation for civil society remains weak. Under these circumstances, it is still early for political leaders to have espoused seriously and to use as a basis for leadership the development goals laid down by international organizations and aid donors,.

**Aggregate fiscal discipline.** Many developing countries are not yet ready to embrace the Medium Term Expenditure Framework (MTEF); therefore, they have little choice but to set annual budget goals. This means that balanced budgets

occur rarely, as revenues are difficult to estimate. But there is an even more decisive issue from the standpoint of fiscal discipline: the central government (i.e., the Ministry of Finance) lacks decision making power over key expenditure items. Most government investment projects are financed by ODA which is channeled directly from donor countries to relevant line ministries. This ODA financing, and other non-budgetary activities, are outside the control of the central government. Fixed costs, including public servant wages and compensation as well as interest payments that are high in countries with large amounts of domestic and external debts, also are often beyond the control of finance ministries. The bottom line is that the ratio of central government discretionary spending to overall expenditure can be pitifully low. In Ghana, the ratio of discretionary spending to total real expenditure was 53.1% in 2000, of which non-wage recurrent expenditure amounted to only 7.1% (Foster and Zormelo, 2002).

A critical weakness is the absence, caused by a lack of political leadership, of **linkages across ministries** with regard to expenditures. A typical example is the relationship between the planning ministry that formulates plans and the finance ministry responsible for budgeting. Each independently prioritizes policies resulting in important mismatches between decisions on investment expenditures for investment projects (planning ministry) and recurrent costs once the project is up and running (finance ministry). (Lack of funding for the latter drastically decreases the capacity utilization rate of the project.)

**Public expenditures are monitored hierarchically and inconsistently** in the administrative institutions. Independent monitoring by civil societies, NGOs and think tanks is desirable, but the capabilities of these organizations are severely restricted.

(3) Statistical data on public expenditures and related areas are indispensable to PEM reform. The *Handbook* devotes one chapter to describing an advanced model of the “Financial Management Information System (FMIS).” The FMIS provides a set of tools to support control of aggregate spending and the deficit, strategic prioritization of expenditure across policies, programs and projects for allocative efficiency and equity, and better use of budgeted resources, i.e., to achieve outcomes and produce outputs at the lowest possible cost. The *Handbook* recommends building the entire system sequentially and computerization is not considered an urgent issue. However, the *Handbook* does not address the state of FMIS in low-income countries.

Vietnam is one developing country whose PEM system is working well for a country at its stage of development according to 2000 Public Expenditure Review (PER prepared jointly by the Donor Consultative Group (CG) of Vietnam and the Vietnamese government. It is fair to assume, therefore, that the situation in Vietnam is better than the average for a low-income country. Nonetheless, there are limitations in Vietnam's PEM. For one, sectoral breakdowns of total budgetary spending cover only three quarters of total expenditures, leaving one-quarter which cannot be defined by spending type. For another, the lack of a consolidated budget makes it difficult to determine total revenues and expenditures. The paragraphs below provide some detail related to this latter problem. The data used for the PER is from 1997 and 1998 national budget statistics, which is available in much greater detail than the June 1999 General Statistics Office publication of budgetary information. (Government of Vietnam and Donor Working Group 2000).

**Items covered by Vietnam PER:**

- a. Recurrent expenditures (i.e., wages and wage-related expenditures plus goods and service expenditures for operations and maintenance).
- b. Capital expenditures (funded by government resources, ODA grants and loans, including domestic and external ODA loans).

**Items not covered by Vietnam PER**

- a. Recurrent and capital spending by ministries from "off-budget funds" encompassing the following seven accounts: "Social Security Insurance Fund," "Health Insurance Fund," "National Development Support Fund (NDSF)," "Export Support Fund (former Price Stabilization Fund)," "State-owned Enterprise (SOE) Restructuring Support Fund (to cover the cost of workers made redundant by SOE reform, to resolve SOE debt and to provide support for SOE investment), "Sinking Fund" (for that portion of ODA which must be repaid to the donor by the government) and "Reforestation Program Lending Fund." According to the Ministry of Finance, transactions in these seven accounts amount to only about one percent of GDP. Most are dependent on specific sources of revenue, and the accounts cannot go into deficit by law. Unforeseen fiscal risk is limited, excluding the NDSF. The NDSF was established in 2000 and provides financing for public purposes through the issuance of bonds.
- b. Investments by SOEs from retained earnings.
- c. Investments by SOEs using ODA (some portion of which must be repaid).
- d. All expenditures by communes (except payments made to them by higher levels of government).

e. Certain ‘fees’ and ‘voluntary contributions’ collected by local governments, mainly at the commune level, for local services such as water and electricity, educational contributions, contributions to local infrastructure, child assistance and the local militia. These amounted to 23% to 61% of revenue in four out of the six communes studied for the PER.

(4) Vietnam is burdened by the critical weakness of poor linkage across ministries described above. It has a system of “dual budgeting” which incurs high costs because budgeting for capital expenditures related to investment projects is undertaken by a separate ministry (Ministry of Planning -- MPI) from that which budgets recurrent expenditures (Ministry of Finance -- MOF). As examples of wastages, almost half of the national road network is in “poor” or “very poor” condition, and one quarter of the bridges have considerably reduced load bearing capacity. The situation of provincial, district and commune road networks is even worse. As a result, the World Bank estimates that vehicle operating costs are higher by US \$150 million each year than they would be otherwise. Furthermore, most of the roads are eventually rehabilitated at a cost several times higher than that which would be incurred as part of a proper maintenance strategy. This is true also for inland waterways and irrigation works. The balance of capital and recurrent expenditure in the health and education sectors are relatively good.

#### **4. Observations from PEM Literature: Political Will and Institutional Reform**

In our efforts to construct a development model, what insights into a new analytical perspective have been gained from the above review of PEM reform? As stated in Section I, the emergence of PEM literature has made us aware that there is a surprisingly high level of hidden potential resources in the fiscal balance mechanisms of low-income countries. In order to release this potential, there must be PEM reform that is deep-rooted, encompassing not just technical and regulatory reform in the narrow sense but also fundamental change at the level of economic, social and political institutions and organizations (i.e., attitudes of leaders). This is logical when one considers that the essence of development is not progress within the existing institutional and organizational framework, but advancement accompanied by changes to the institutions and organizations themselves.<sup>9</sup> I stress, therefore, that institutional and organizational change centered on PEM reform must be recognized as one component of a development model and must be incorporated into any such model.

For reference, this subsection introduces some of the problems with PER reform encountered by five African nations based on research by the Overseas Development Institute (ODI), a British think-tank, followed by further discussion of the case of Vietnam.

##### **ODI and Experiences in Five African Nations**

The common objective of the five case studies — conducted by ODI on Ghana, Malawi, Mozambique, Tanzania and Uganda — was to determine the success of each country in linking PEM reform with poverty reduction policy goals.<sup>Q</sup> I draw on the Institute's Ghana report (Foster and Zormelo, 2002) as well as its report covering all five countries (Foster, Fozzard, Naschold and Conway, 2002). The research started in the mid-1990s, and from the beginning it reflected a deep understanding of Africa. The studies were based on two hypotheses:

- (i) In order for public expenditure to better serve the interests of the poor, political will is necessary to confront difficult choices.
- (ii) But political will alone is not sufficient. To implement the intended policies it must be aligned with more effective public expenditure management, macroeconomic and budget stability, and budgetary systems that turn policy analyses into actual cash spending. These in turn must be linked to policies that

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<sup>9</sup> Joseph Stiglitz is perhaps the strongest proponent of this view in recent years. Amartya Sen's capability approach for development also supports this notion. Please refer to Ishikawa 2002 I.

strengthen the incentives of organizations to implement expenditure programs.

Some of the discoveries related to the hypotheses are as follows:

- (i) **Political will.** The most important issue seems to be the consistency displayed by the leadership towards poverty reduction policies.

*Amongst five countries, the strongest and most coherent national leadership in the direction of poverty reduction has been in three reforming formerly socialist countries. Mozambique and (to a lesser extent) Tanzania have, like Uganda, enjoyed strong public signals that poverty reduction is the strategic goal of policy and public expenditure management, in part because such signals are consistent with an embedded political tradition, even if the proposed means to the end have changed.*

The World Bank and the IMF consider Uganda under President Yoweri Museveni's administration to have achieved the best performance out of the three countries. In 1986, when President Museveni gave priority to economic growth under the SAL system; growth was regarded as a means to achieve social justice and poverty reduction. In none of the five countries, including Uganda, are domestic unity and agreement among the different social strata firmly grounded. In Uganda pressure on the fiscal deficit comes from increases in expenditure items which threaten poverty reduction related spending and from corruption and cover-ups involved in the misuse of public funds. However, President Museveni's political determination and the abilities of a handful of technocrats have been given credit for Uganda's continued positive economic achievements. Commitment to poverty reduction in the other countries is more fragile.

Ghana and Malawi have been subject to the "election cycle," where macroeconomic and fiscal stabilities are compromised whenever there is a presidential election. Planning documents in all five countries emphasize the importance of economic growth to achieve poverty reduction, but this seems to be based on the realization that poverty reduction without growth will require politically difficult choices in the redistribution of resources.

- (ii) **Introduction of the Medium Term Expenditure Framework.** In the early 1990s, patterns of public expenditure were extremely inefficient in all five countries. Governments were involved in too many areas, some of which should

have been assigned to the private sector. Annual budgetary processes were incremental in nature, with any expansion in the total budget spread evenly across all spending categories. Inter-annual variations between sectoral or geographical patterns of spending were primarily determined by the ebb and flow of donor project aid. There was thus a pressing need to fundamentally change the pattern of public expenditure and the process by which these were determined. The MTEF is the most effective tool to achieve this goal.

The MTEF approach is used in each of the five countries but the results differ. Uganda has again taken positive steps to establish priorities within available public investment resources, a determinant for the success of the MTEF. In Uganda, the Ministry of Finance, Planning and Development was established in the central government to oversee the entire process from policy decision making, to planning to budgeting, ensuring that the priorities which emerge from the Poverty Eradication Action Plan (PEAP) are reflected in the proposed expenditure allocations for the MTEF. In Ghana, planning and finance are split. The Ghanaian National Development Planning Commission has been given the authority to consolidate these activities but it is weak and has not been able to secure the necessary engagement of the finance and line ministries. Planning documents have lacked realism and have little influence on expenditure priorities. The finance ministry also lacks the capacity to provide strategic analysis of spending priorities. Ghana's MTEF follows a technocratic bottom-up approach, but does not display strategic resource allocation focus. A similar situation prevailed in Mozambique, and in 1994, the Ministry of Planning and Finance was established. Planning and budgeting are not consolidated, however, and responsibility for planning and financial management instruments continues to be divided between separate departments within the ministry.

(iii) **The most fundamental consideration** in the budgetary process is that the totality of revenue and expenditure are captured in the national budget. Only partial information is offered here about the coverage of donor aid flows. In Ghana, donor flows are all off-budget items, with the exception of the health sector, and the government receives only limited information. In Tanzania, half of the aid is outside of the annual budget and in certain sectors up to 90% of the development budget is provided by external funding. This makes strategic resource planning and pro-poor expenditures extremely difficult.

### **Commonalities among African Institutions and Organizations**



There is another ODI research publication relevant to the African countries highlighted above. It concerns institutional and organizational characteristics common to African nations. (These are characteristics rooted in evolving stages of political, social and economic development and influenced by cultural attributes, but this interesting area is outside the scope of the discussion here.) The ODI conducted a case study of eight African countries (the above five countries excluding Uganda, plus Benin, Kenya, Mali and Rwanda) as an interim report on the institutionalization of PRSP mandated under the HIPC rescue scheme (Overseas Development Institute 2000). It is not so much the report itself, but rather the five characteristics of the eight countries provided as supplementary information that is of relevance for the purposes of this paper.

- (i) The eight countries are all semi-democratized states with completely fragmented policy making processes; i.e., low coordination among different centers of decision making and between the formulation and implementation of policies.
- (ii) Domestic politics is patronage-based; i.e., the political party system is fragmented, and civil societies are weak.
- (iii) Each country has high levels of institutional aid dependency with corresponding low domestic accountability.
- (iv) Public expenditure and revenue management systems have been driven by public policy only in few instances, at least until recently.
- (v) The administrative systems are similarly characterized by low morale and weak performance incentives.

#### **PEM in Vietnam: “Political Will” and the Three Year Reform Plan**

The experience of Vietnam is in marked contrast with that in Africa described above. While shortcomings remain, PEM in Vietnam is driven by strong political will, a prerequisite for reform.

The Vietnamese government initially was critical of making poverty reduction its primary goal, believing instead that economic growth should be the primary goal leading to sustained poverty reduction (Ishikawa 2002 II). In recent years, the government seems to have fallen into line with the World Bank’s poverty reduction policies, but this perhaps is more a shift in World Bank’s thinking, that growth is a prerequisite for poverty reduction. In 2000, acknowledging weaknesses in the PEM established at the time, the Vietnamese government adopted the “Action Plan of Measures to Improve PEM with Decided Timetable for the Next Three Years.” This was

revealed in the “Report and Recommendation of the President of the IDA to the Executive Directors on Proposed Poverty Reduction Support Credit of SDR 197.2 Million to the Socialist Republic of Viet Nam” (World Bank 2001). This report recommends the following measures:

- (i) Increase public transparency by releasing budgetary data early. A sectoral breakdown of 75% of all expenditures should be available before the start of the subsequent fiscal year.
- (ii) Designate Treasury within the Ministry of Finance as the supervising agency directly responsible for maintaining comprehensive public accounts (including expenditures from aid) and implementing the completely integrated Public Financial Management System. The latter includes Treasury’s integrated accounting system.
- (iii) Integrate budget and expenditure information including the off-budget government account balance.
- (iv) Integrate capital spending and current expenditure spending during the budgetary formulation process and implementation phases to guarantee improvements to the budgetary balance.
- (v) Adopt the “Medium Term Sectoral Expenditure Program” for each sector. Start with basic education.

This Three-Year Plan is a key condition (*ex post*) for the World Bank’s concessionary Poverty Reduction Strategy Credit (PRSC), agreed only after Vietnam completed its full Comprehensive Poverty Reduction and Growth Strategy (CPRGS), which is the official name for that country’s PRSP. Undoubtedly, both the World Bank and the Vietnamese government are highly confident of the success of the plan and hold great expectations for its outcome.

## IV. Framework for Macroeconomic Balance

The preceding two sections have identified policy issues that the a development model must address. We learned in Section II that Participatory Poverty Assessment (PPA) reports suggest various public policies to support coping strategies for households confronting the poverty threshold, including strengthening the regional community, promoting agricultural and rural development, developing infrastructure and providing industrialization assistance. Section III, “Public Expenditure Management,” dwelt on issues of institutional and organizational policies related to surprisingly inefficient fiscal expenditure activities, as well as the underlying problems of political unity and leadership formation.

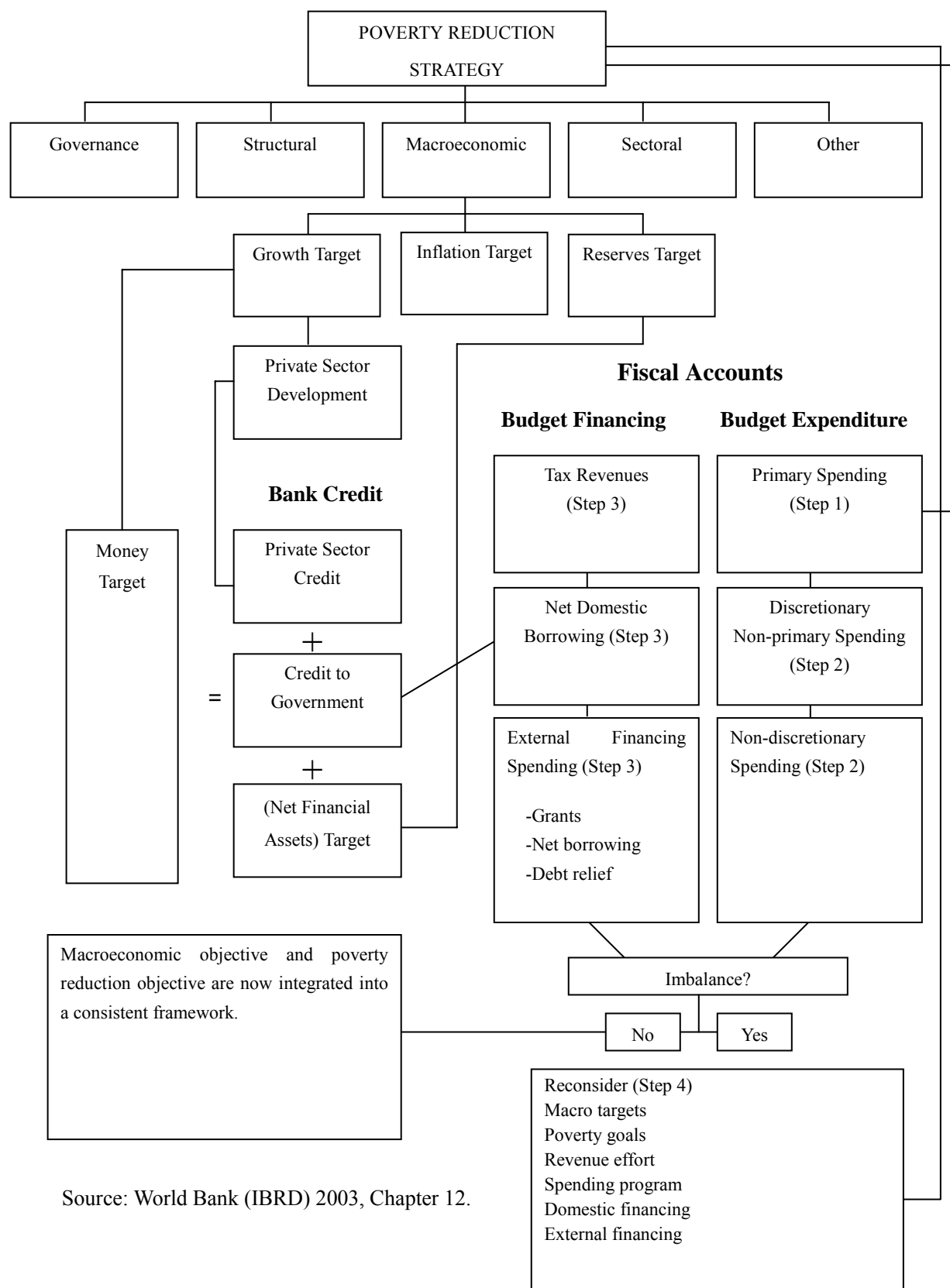
Section IV proceeds to a discussion of a comprehensive macroeconomic framework for the issues raised in the two previous sections. Most of the issues that arise from PPA studies must be resolved through public investment funded by government finances or through private sector investment financed by private banks and the capital markets. The latter may compete with the public sector through demands on currency and capital. Regardless of the sector, a check of the macroeconomic balance is necessary when the construction of infrastructure or modernization of industrial production facilities is dependent upon long-term and costly investments. As for Public Expenditure Management, if it is underdeveloped, macroeconomic management must make the best use of the fiscal resources effectively available in a way that corresponds to the level of underdevelopment. As institutional and organizational reforms progress, a more complex macroeconomic management system and better results can be expected. In other words, progress in integration and adjustment through macroeconomic management must straddle both PPA and PEM.

I draw on Chapter 12 (“Macroeconomic Issues”) of the *Poverty Reduction Strategy Source Book*, co-authored by World Bank and IMF staff, as a reference.<sup>10</sup> From this source I adopt as Figure 1 below the diagram “Financing Poverty Reduction in a Sustainable Manner” (macroeconomic factors) as the standard methodology for the macroeconomic check. I also provide supplementary commentary. The actual macroeconomic check based on this method is country specific, but in this section I discuss only the general framework.

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<sup>10</sup> Chapter 12 (World Bank IBRD 2003: Figure 12-1) is co-authored by B. Ames, W. Brown, S. Devarajan and A. Izquierdo.

**Figure 1 Growth and Poverty Reduction Scheme Built in the PRSP System:  
Macroeconomic Balance Basis**



Source: World Bank (IBRD) 2003, Chapter 12.

## 1. Concepts of Stability, Poverty Reduction and Structural Reform

Before explaining Figure 1, I would like to introduce some of its underlying concepts. (The underlined sections are my comments on the concepts.)

(1) *The Poverty Reduction Strategy Source Book* (World Bank 2003) identifies three issues in the relationships among the concepts of stability, growth and poverty reduction: Economic growth is the single most important factor influencing poverty.

Macroeconomic stability is essential for high and sustainable rates of growth. Macroeconomic stability should be a key component of any poverty reduction strategy. The IMF has advocated consistently since June 1999.<sup>11</sup>

(2) Along with macroeconomic stability, structural reform is decisive factor for high and sustainable rates of economic growth. Key measures include regulatory reform, privatization, civil service reform, improved governance, trade liberalization and banking sector reform.

(3) Macroeconomic stability exists when there is a sufficient degree of balance within and among key economic elements: aggregate domestic demand and output; balance of payments; fiscal revenues and expenditure; and savings and investment. There does not have to be exact balance. Some imbalances, such as fiscal and current account deficits, are compatible with economic stability provided they can be financed in a sustainable manner.

(4) Generally speaking, the framework contained in the *Source Book* is pessimistic about government capability and the functions of governmental organizations, while optimistic about the capabilities of private enterprises and the functions of the private sector. The *Source Book* expects that growth will be achieved mainly through increased bank credit to private enterprises that emerge through privatization. To allow this to happen, the government sector must not only scale back state-run enterprises but also pursue sustained restrictive fiscal policies to minimize the possibility that private bank financing of fiscal deficits crowds out private credit. Other prescriptions are needed if private sector capabilities are inadequate or if there is a high levels of independence or desire to learn in the government sector.

(5) The framework in the *Source Book* also deals with macroeconomic policies that are suitable for countries that have achieved fundamental macroeconomic stability. A

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<sup>11</sup> Refer to Endnote I.

very different prescription will be necessary for developing countries still saddled with high inflation (Source Book, Table 12.2). Countries that are characterized by a market economy, cyclical macroeconomic structure (possibility of soft landing) and sustained deflation — such as China after 1996 — will require Keynesian-type effective demand expansionary policies.

## **2. Coexistence of Growth and Poverty Reduction: Macroeconomic Policy Framework**

Figure 1 depicts a framework that emphasizes a broad-based approach to development centered on the assumption that poverty reduction follows as a consequence of economic growth. “Poverty Reduction Strategy” is the apex of the framework. The major variables indicated are mutually interdependent components of any strategy for which poverty reduction is the ultimate goal of development policy. The items in the first row immediately below the apex reflect a comprehensiveness that extends beyond the economic; for example, governance reform is a non-economic element. Operationally, however, analysis is conducted on the economic sector and is measured in terms of the economic items in the following row — growth, inflation and reserves targets. “Pro-poor” targeted expenditures, where spending is directly targeted at poverty reduction, are implicitly handled as items within priority spending budgets.

Government fiscal accounts, private sector activities and financial sector activities drive the implementation of macroeconomic policies. The three blocks under the budget expenditure category in the fiscal accounts have been discussed under PEM in Section III. The conclusion was that great potential exists to increase fiscal resources but execution is difficult. An important challenge is to prevent the budget deficit from widening but nondiscretionary spending including interest payments takes up a significant proportion of any given amount of revenue, and civil servant wages, although considered a discretionary non-priority spending item, is effectively a fixed cost. Thus, it is difficult to allocate priority spending to poverty reduction, infrastructure and structural reform. Revenues are on a steadily decreasing trend because of inefficiency in the public sector and badly performing state-owned enterprises. ODA often carries the risk of “Dutch disease.”<sup>12</sup>

The main underlying issue in the financial market sector is modernization, particularly modernization of the banking system. As modernization progresses,

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<sup>12</sup> “Dutch disease” refers to the harmful effects of rising real currency values on industrialization and development of the real economy.

monetary policy increasingly will affect levels of and changes to output. There is a risk that private enterprises will be crowded out when monetary and fiscal policies converge. The development of financial markets is limited as shown by the fact that the ratio of M2 to GDP is less than 30%. Taking into account the need for increased investment in capital markets, there is little scope for monetary policy to promote stable growth unless it is accompanied by a rise in the total savings rate that will then improve economic strength.

If the implementation of macroeconomic policies results in fiscal imbalances that threaten the achievement of macroeconomic stability and growth, there is no choice but to lower growth and poverty reduction targets. Theoretical models are often used in macroeconomic analyses, and it is desirable to develop alternative scenarios factoring in different growth rates. This is recommended by the *Source Book*.<sup>R</sup> Some of the bottom blocks in Figure 1 are premised on this assumption.

### **3. “Debt Sustainability” in Heavily Indebted Countries**

In addition to the annual cash flow suggested in Figure 1, as part of their macroeconomic balance check, countries with a heavily indebted public sector must also prepare an outlook program to reduce the current debt level down to at least sustainable levels. External and domestic debt will be considered separately. (i) According to the Enhanced HIPC Initiative of 1999, the “sustainable external debt level” of each of the 41 participating countries is determined when they become eligible to join the scheme (“decision point”).<sup>S</sup> Debt relief for amounts above this level is provided at the “completion point,” theoretically in three years time. The initiative and its effectiveness were part of a previous discussion on the effectiveness of the PRSP system (Ishikawa 2003). For the purposes of this paper, external debt is assumed to be processed in this way. (ii) In addition to external debt, some countries are burdened with excessive amounts of domestic debt. In Ghana, for example, the external public debt stock amounted to 150% of GDP and domestic public debt to 65%, of which central government debt excluding SOE debt was 29%. For these countries, accumulated interest and principle payments exert tremendous direct and indirect pressure on already low levels of fiscal revenue. (Principal is normally financed by fiscal surpluses, or by increased deficit financing when the fiscal balance is in the red.) Important fiscal expenditure items such as for investment or poverty reduction may be crowded out, or increased money supply may lead to higher inflation. To avoid this situation, further increases in domestic debt levels must be prevented, meaning that further debt reduction efforts are required. Only then can the macroeconomic balance framework discussed

above be applied effectively towards public policies for development.

Measures to cap the increase or to reduce accumulated debt are fundamentally the same for both external and domestic debt. I refer to an IMF framework entitled “Fiscal Sustainability” (Chalk and Hemming 2000). Theoretically, assuming a closed economy, for each period (t) the sum of interest payments (interest rate r) on debt stock during the period ( $B_t$ ) plus the primary deficit ( $D_t$ : fiscal deficit excluding interest payments) determines the amount of increase of debt stock in the current period. In other words,

$$B_{t+1} - B_t = r_t B_t + D_t \dots\dots\dots(1)$$

This equation can be converted to the difference equation of the form:

$$B_t = R_t B_t + D_t, \text{ where } R_t = 1+r_t \dots\dots\dots(1)'$$

This difference equation is solved in such a way that an intertemporal budget constraint equation is derived. This equation is pragmatically interpreted and expressed as:

$$B_t = \sum_{j=0}^{\infty} R(t, t+j)^{-1} D_{t+j} \dots\dots\dots(2)$$

where  $R(t, t+j)^{-1}$  is the discount factor applying between periods t and  $t+j^T$ . This formula of present value of budget constraint (PVBC) is applied again pragmatically in policy implication. One way is to use the primary gap indicator as a sustainability indicator tool for domestic debt management. The primary gap indicator is the difference ( $d - d_t$ ) between the notion of the value of domestic primary balance to output (d) that provides stability through all periods for annual domestic debt burden ( $b_t$  or  $B_t/Y_t$ ) and the ratio of actual value of domestic primary balance to output ( $d_t$  or  $D_t/Y_t$ ). d is represented numerically as<sup>U</sup> :

$$\bar{d} = (n_t - r_t) b_t \text{ (note } n_t \text{ is GDP growth rate)} \dots\dots\dots(3)$$

Because  $b_t$  is assumed to be fixed in this equation, it may differ from the theoretical model, thereby causing policy distortion<sup>V</sup>, but it is used widely because it is said to be instinctively easy to understand.<sup>W</sup>

I conclude this section by directing the reader to the extensive endnotes examining the case of Ghana<sup>X</sup>, a country encumbered with a massive domestic debt burden, and the



case of Vietnam<sup>Y</sup>, whose situation is less grave, as practical cases where the macroeconomic balance frameworks have been implemented.

## V. Conclusion

There are shortcomings in the low-income country development models advocated under the PRSP system by the World Bank and the IMF. The objective of this paper was to uncover ways to improve the model. An understanding of the issue was developed by reviewing a range of new research available from PPA reports and PEM research, two concepts born out of new policy focuses of the Bank and IMF.

The PPA reports reveal that households in poor regions that cross the poverty threshold may move downward, either descending gradually or falling precipitously into a “poverty trap;” or conversely, they may move upwards into a wealthier stratum. The reports focus on the need for public policies to support coping strategies for households facing the poverty threshold. Examples include strengthening regional communities as a refuge of last resort; supporting agricultural and rural development; constructing social and economic infrastructure; and implementing or assisting industrialization that directly results in output. PEM literature reveals that the fiscal accounts of low-income countries are surprisingly underdeveloped. In order to rectify this, institutional and organizational reforms to the fiscal expenditure system, including the modernization of political and administrative systems and organizations, become indispensable steps for any development model.

Achieving different public policy objectives may mean competing for limited resources. A check for maintaining macroeconomic balance will ensure that the allocation of resources is aligned to multilayered institutional and organizational policies. In heavily indebted poor countries, measures to reduce debt and to attain fiscal sustainability are prerequisites for a macroeconomic balance check.

The deficiencies of the PRSP development model need to be addressed to assert that analyses and policies from the above perspectives will lead to its reform. (Ishikawa 2002 I, 2003).

Finally, I conclude by commenting on two points raised in the introduction.

### (i) The Importance of Case Studies

The true significance of specific information derived from PPA and PEM is evident only when based on an understanding of the country or regional context. This paper discussed the general importance of specific information and its role in development without reference to particular context. Country and region specific

information has frequently been used to facilitate the understanding of the points under discussion, but this does not mean the position of these issues in the development model has been clearly established. Additional information from other areas related to development mechanisms must be also reviewed before such a result can be achieved. The cases of Ghana and Vietnam have been cited, but information on these countries is still incomplete.<sup>Z</sup> In other words, case studies on the development mechanisms of specific countries must be undertaken repeatedly, each time incorporating new information gained from PPA and PEM, before a successful development model can be constructed.

(ii) Differences between African and East Asian Development Models

The opinions and interpretations of background information regarding country specific PPA and PEM case studies in this paper are fragmentary and incomplete. Nonetheless, dissimilarities between African and Asian cases are clearly evident, particularly in reference to the oft-cited Ghana and Vietnam. These countries reflect respective differences in the political, social and economic stages of development, cultural traditions, and colonial policies and structures. Future case studies of specific countries will benefit from discussion of dissimilarities in the development mechanisms between the two continents. Over time, it has become clear that Japan's position on development cooperation policies has been influenced by the East Asian experience, in contrast with the Western countries which have been influenced by African development. A clear understanding of this will make it easier for Japan to play a more significant role in shaping the international aid systems.

In the near future, I hope to see further case studies conducted for a small number of countries premised on the use of country specific PPA and PEM data.

## Postscript

First, I must describe (1) some of the characteristics in which development assistance strategies had been formed and evolved in the international aid community in the stage as of the end of 2003 when this paper was written and (2) the motives in which I wrote it (this paper). In 1999, The World Bank and IMF launched a new framework in which concessional loan assistance would be provided to low income developing countries only in accordance with their poverty reduction strategies. Nevertheless, by that time period (the end of 2003) they had not yet put forward a development model that convinces us that the strategy can produce sustained poverty reduction and economic growth that supports it in many low income countries. Despite that, however, in between these two periods (1999 and 2003) was recognized the emergence of two events that this paper focused on. First, from the large number of by-country World Bank studies on the poor based on Participatory Poverty Assessment (PPA) approach it has become, for the first time, possible to derive useful information on the dynamic changes over time in the status of poor households. Second, through the efforts of Public Expenditure Management (PEM) reform in low income countries, again led by the Bank, we have learned also for the first time that public finances in many low income countries are utterly underdeveloped. Although these two findings might not have been sufficient to immediately produce the necessary development model, they were expected to be important components of the model that should be forthcoming. The motives of my writing this paper was, with this expectation in mind, to clarify the implications of these two events, mainly for the consumption of the Japanese leaders, this paper discussed the importance of macroeconomic balance in addition to the two factors above with the intention of demonstrating that, before all of these main components can be put in place, a system of macroeconomic checks is needed to ensure that they will be effectively combined and realized.

Meanwhile, the search for the development model that determines the success or failure of the poverty reduction strategy has been carried on in earnest by the international aid community, major donors and scholars in the related fields. This afterword describes the new movements in this search by major donors and researchers. In terms of major donors, we will discuss The World Bank and IMF as well as the Department for International Development (DFID) of the United Kingdom which seems to be trying to lead the international aid community with its unique international development policy developed since the end of the 1990s. I gained many insights from the DFID's search for its development model, and recently and finally developed my own prototype model. Mine is a "basic development model" that can incorporate the

three factors discussed in this paper--the dynamics of poverty reduction, the mechanism of PEM and the macroeconomic balance--as its important components.

### DFID-ODI's aid philosophy and pursuit of political change

DFID's search for the development model began when the Labour Party took control of the government in 1997 and announced its new international development strategy. The search was aided by the London-based think tank Overseas Development Institute (ODI) and its formidable capabilities for theoretical and empirical research on development assistance. The main focus of their research has been Africa, the UK's new aid target. The new strategy, detailed in the DFID's *1997 White Paper on International Development - Eliminating World Poverty: A Challenge for the 21st Century*, promised to apply the concept of helping the socially excluded (especially a huge number of young people including the NEET and job-hopping part-timers) with public policies ("social inclusion" and ensuring the "equality at the starting point" as a way to achieve it). This concept was the essence of the Labour Administration's new welfare state philosophy (as exemplified by Tony Blair's "The Third Way"). This aid philosophy of the *1997 White Paper* closely resembled the concept of poverty alleviation in ethical economics based on Amartya Sen's "capability" approach. Sen's concept of poverty is a condition where a person's capability does not reach a certain "threshold" or "basic capability." Capability is defined as a combination of a certain level of income wealth and "utility functions" with which people use that wealth to live the lives they see as desirable (called "functionings"). This bundle of utility functions is nothing but existing social systems. Therefore, reforming and improving social systems to overcome social exclusion is an important component of poverty alleviation as defined by Sen. The Bank's *World Development Report 2000/01* states that the report is based on Sen's capability approach, and its three pillars of attacking poverty--expanding opportunity, empowerment and security--are indeed the content of the social system reform and improvement in this sense. (Many Japanese interpretations of Sen's capability approach do not understand this point sufficiently.)

Despite this lofty aid philosophy, the British government's new international development policy has not shown any signs of success in its main battlefield, Africa. Moreover, most of the recent international aid performance reports warn that Africa's performance in development and poverty reduction is actually getting worse. (For example, see *Joint World Bank/IMF 2005 PRS Review*, 2005.4.19.)<sup>13</sup> The innovative

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13 IMF and the World Bank, *2005 Review of the Poverty Reduction Strategy Approach: Balancing Accountabilities and Scaling up Results*, Aug. 15 2005.

proposals to revitalize low income countries that the British government has made to the international aid community in quick succession since 1999--the Enhanced HIPC Initiative (1999), the IFF proposal (2004), the publication of *Commission for Africa Report* under the initiative of Prime Minister Blair (March 2005), the announcement of the PRBS (general budget support) policy (May 2004), the New Partnership for Poverty Reduction policy (March 2005) and the proposal to double the amount of ODA to Africa at the G8 Summit (July 2005), among others--have probably been motivated by its urgent desire to overcome this underachievement.

However, another characteristic of the UK's international aid activities was that the DFID effectively utilized the excellent research capabilities of the ODI (Overseas Development Institute) and other private think tanks and contributed to the assessment of this underachievement, analyses of its causes and search for corrective measures. The analyses utilized not only the methodologies of economics but also those of sociology and political science.

Studies on Africa by the ODI and others are often conducted as comparative study projects involving several countries under the direct or indirect commission by the DFID. A survey of these works reveals the following three characteristics:

(1) In diagnosing the current situation, they try to understand the complex mechanism that has brought developmental challenges to African countries in a coherent manner by considering their premodern political systems as the root cause. This is a novel attempt that we have not seen in the studies of developing countries within the discipline of development economics. The premodern political systems in African countries take a hybrid form of "neopatrimonialism," where "patrimonialism"--a typological concept in Max Weber's sociology of domination--has undergone changes under the mantle of modern state systems introduced after their independence. Under this hybrid system, the President, who is the ruler, typically governs the nation on one hand (formally) by endowing official posts and salaries to administrative officers of central and local governments, and in turn securing the provision of administrative services. But on the other hand (informally), the President appoints his/her private clientele to official positions with many perquisites, and in return receives their personal allegiance. There have been several attempts since the early 1970s to analyze the functionings of African states with this Weberian concept of neopatrimonialism. Towards the end of the 1990s, this effort took a more systematic form as part of comparative democratization studies in the third world (as exemplified by the works in 1997 of the Bratton and van de Walle group of Michigan State University). The ODI gained insights from these works, but its own research made a contribution as well by finding that the effects of

neopatrimonialism spread to the economy, distorting the mobilization and distribution of the state's fiscal resources and having a critical and negative impact on growth and poverty reduction.

(2) In terms of policy prescriptions, the ODI's research circa 2000--when African studies was beginning to gain momentum--only went as far as emphasizing that aid would not succeed unless political leaders recognize the importance of the goal of poverty reduction and publicly commit to it. (For a comprehensive survey of various research projects in this period, see David Booth ed., *Fighting Poverty in Africa: Are PRSP Making a Difference?* ODI, 2003.) However, the DFID, ODI and other think tanks soon began to shift their attention to overcoming the premodern nature of the political system itself. Their effort bore fruit as the "Drivers of Change (DOC)" research project. This project was aided by the strong leadership of Clare Short, the former Secretary of State for International Development who contributed to the launch of the DFID as a cabinet-level ministry. Within the DFID, specific divisions and teams were identified to take charge of the DOC project. Field studies are conducted by the ODI and many other think tanks on a contract basis. As of October 2004, field studies had been completed in 11 countries (Ghana, Kenya, Malawi, Nigeria, Uganda and Zambia in Africa) and two regions (Asia and Asia/Caucasus); studies were ongoing in nine countries and being planned for Vietnam and Middle East and North Africa. In the DOC project, researchers are not satisfied by simply explaining the failures of poverty reduction programs by a lack of political will to implement them. They go one step further and look for the reasons for the lack of political will. More specifically, the DFID's interest with regard to poverty reduction used to be in finding strategies for pro-poor changes, and to do so they tried to shed light on the current status of sustained economic growth, access to markets and public services, empowerment and security. In contrast, the DOC approach expands its analysis to an entire country. To establish a foundation for this project, the DFID commissioned Oxford Policy Management, a think tank led by Alex Duncan, to construct a conceptual framework for the DOC analyses based on a DOC study on Nigeria. The resultant conceptual model consists of institutions including economic and social structures and political and administrative processes (i.e., official and unofficial rules that determine the behavior of agents) and agents (i.e., individuals and organizations that pursue certain interests, examples of which include the political elite, public officials, political parties, local governments, the military, media and the private sector). (The foregoing is based on Debbie Warrerer, *The Drivers of Change Approach*, ODI, Synthesis Paper 3, Nov. 2004.)

Among the DOC country studies, the one I looked at relatively closely was the ODI's Ghana project. It describes the establishment of patrimonialism in the context of

the history of Ghana's state, economy and culture after the colonial rule. (Especially, the relationship between patrimonialism and fiscal management and the formation of the private sector is described with clarity.) On the economic front, it identifies the following as the drivers of change: (1) international trade and competition, (2) financial systems, (3) foreign direct investment and (4) development of Ghanaian entrepreneurs and growth of large and small enterprises. On the political front, the identified drivers are: (1) stronger competition among political parties, (2) free flow of information and critical mass media and (3) the process of emigration and remigration of the Ghanaian diaspora<sup>14</sup>. The study states that these drivers generally need to be put in place at the same time but the political drivers play a more critical role than the economic ones.

### My prototype development model

The process of elevating the discussions in this paper to the construction of a development model with the insights gained from the DFID-ODI studies can be described in two stages. The first stage, which was inspired by a series of ODI's studies on development aid to Africa, involved researching the structure and historical background of the DFID's international development policy itself, and contrasting them with the outcome of the policy's application in Africa. The result of this work was published in *GRIPS Development Forum Discussion Paper No. 9* and *JBIC Discussion Paper No. 8* ("Supporting Growth and Poverty Reduction: Toward Mutual Learning from the British Model in Africa and the Japanese Model in East Asia," March 2005). I concluded in this paper that, despite its lofty aid philosophy, the UK's aid to Africa had failed because a development model for poverty alleviation which operationalizes the philosophy had not been constructed. (I will not touch on the East Asian model of Japanese aid here. Also, the UK's research on aid to Africa I considered for this paper had still been at an early stage where political leaders' commitment to poverty reduction was considered as key to successful policies.) In the second stage, I used this insight as a part of the groundwork to construct my own prototype development model. I introduced this model in the first chapter of my book, *Kokusai Kaihatsu Seisaku Kenkyu (Studies on International Development Policies)* published in January 2006 by Toyo Keizai Inc. The model was described as constituting the "basic framework" for the studies on international development policies together with the "studies on the international aid systems." My development model is largely constructed based on the historical school's view of development stages, and it attempts to analyze the development process of present-day developing countries under three large pillars: "political, social, economic and other sectoral development stages and the identification

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<sup>14</sup> Tony Killiak, What Drivers Change in Ghana? - A Political Economy View of Economic Prospects, July 2004 (mimeo).



of current stages,” “the mechanism of transitioning between the stages” and “the process of growth (poverty reduction) in the given (mixed) development stages.” What is especially novel in this framework is the fact that the “political system” is expressly considered in addition to the “economic system” and “production vitality” in the assessment of sectoral development stages. With regard to the political system, I identified the following development stages (in order of progression): the premodern “patrimonial system,” “non-patrimonial, non-democratic system” and “democratic system.”

Now that I have stated the foregoing, I can finally explain why the studies in this paper which focused on the poverty trap and public expenditure management served as an important step in the search for the development model. I would like to point out two things.

(1) In light of the “basic framework” development model, the processes of poverty reduction (including the poverty trap) and growth as its prerequisite are “the process of growth (poverty reduction) in the given (mixed) development stages.” Public expenditure management reform is an attempt related to “the mechanism of transitioning between stages.” And these two factors, if combined with an analysis of overcoming patrimonialism which enables the political system to transition from premodern to modern, will be driven by the analysis and begin to work together, making it possible to achieve sustainable poverty reduction. (This will be the theme of my next paper.)

(2) Within the sequential reform and improvement process that progresses from “transition of the political system” to “fiscal system reform” to “promotion of growth and poverty reduction,” the first two steps play the role of the “system reform” in Sen’s capability approach and are appropriate suggestions for low income countries. In his recent paper, David Booth of the ODI commented on my 2005 paper mentioned above. He stated that “It [Ishikawa’s paper] holds that the development aid policy based on the ideologies of Sen and Blair has failed in Africa by hitting the wall of neopatrimonial politics, and that our New Aid Agenda has the same ideological foundation.” That, however, is a misunderstanding. I think it is desirable for a country’s aid policies to have a particular aid philosophy, and it is compatible with the evidence-based diagnoses and policy planning Booth advocates. With regard to Sen’s approach, I think it is a manifestation of efforts to pursue ethical legitimacy in designing economic policies, and is a precondition for obtaining a broad-based consensus for poverty reduction<sup>15</sup>.

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15 David Booth, “Is the New Aid Agenda Anti-Trade?” in Sheila Page and David Booth, eds. *Aid and Trade Cohabitation or Divorce?* ODI, 2005. This comment contains several interesting arguments in addition to the point mentioned here, but I’ll wait for another opportunity to comment on them. The discussions on Booth’s cited paper (03) between are summarized in *GRIPS Development Forum Policy Minutes No.20* (July 2005) pp.27-31.

As an additional note, Duncan's conceptual framework for the DOC project itself may have a role in substituting my development model. I am yet to see its details, but it seems to be constructed in a sociologically comprehensive manner. Although my development model incorporates elements based on political concepts, its basic framework is economic and can withstand economic analyses.

### The World Bank and IMF's search for the "road map for poverty reduction"

The World Bank and IMF's search for a new development model can be observed in a nutshell based on two documents. I will briefly discuss them.

The first are documents by their independent evaluation departments, namely the IMF's Independent Evaluation Office (IEO) and the Bank's Operations Evaluation Department (OED: recently renamed as Independent Evaluation Group (IEG)), that evaluated the effectiveness of each organization's activities to support Poverty Reduction Strategies (PRSs). In these documents, the OED points out that the Bank failed to sufficiently emphasize growth which is necessary for poverty reduction. (The Bank's management rebutted by saying that the evaluated documents (PRSPs) had been prepared not by the bank but by recipients. This argument is not persuasive, however, because if the PRSPs were as deficient as claimed, it only means that the Bank's advice was not sufficient.) On the other hand, the IEO's evaluation document states as follows: "[M]ost PRSPs fall short of providing a strategic road map for policymaking, especially in the area of macroeconomic and related structural policies. The focus of most PRSPs is on the composition of public expenditures, especially social sector spending, with much less emphasis on other aspects of a broader strategy to encourage poverty-reducing growth[;]" and "The [PRS] approach has so far not contributed significantly to understanding the linkages between growth, poverty incidence, and macroeconomic policies at the individual country level."<sup>16</sup>

It is quite significant that the evaluation divisions of the IMF and the Bank gave such harsh criticism to the PRSP approach only five years after it was launched in 1999 under the Bank's initiative. However, the important question is, given this assessment, what reform and improvement policies can be proposed and implemented. As the IMF is in charge of macroeconomic policies, it naturally seems to be working to elaborate its

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<sup>16</sup> Related reports are as follows: World Bank(OED), *Improving the World Bank's Development Effectiveness: What Does Evaluation Show?* 2005; World Bank, *2004 Annual Review of Development Effectiveness: The World Bank's Contribution to Poverty Reduction*, 2005; and IMF (IEO), *Evaluation of the IMF's Role in Poverty Reduction Strategy Papers and the Poverty Reduction and Growth Facility*, 2004.

macroeconomic analyses which served as the backdrop for the criticism. From the perspective of the Bank, which is in charge of development and structural adjustments, to the extent that its evaluation report is presented as cross-sector lessons, its reform and improvement policies center on institutional development (including public sector reform and private sector development) and human and institutional capacity building<sup>17</sup>. However, to understand the latest efforts of the Bank as a whole to support growth-based poverty reduction, we should at least take a quick look at *World Development Report 2006: Equity and Development* which was prepared under the new President (Paul Wolfowitz) and new Chief Economist (Francois Bourguignon).

The concept of “equity” included in the title is a broad amalgam of related concepts put forward by John Rawls, Amartya Sen, Ronald Dworkin and John Roemer--the four scholars who represent the post-Kenneth Arrow, non-welfaristic Ethical Economics or Welfare Economics. Equity here is defined by two principles: “equality of opportunity” which leaves equality of income to individual efforts and “avoidance of absolute deprivation” which eliminates deprivation resulting from differences in circumstances beyond individuals’ control. (It seems similar to the combination of Rawls’ principle of equality in the obtainment of “basic social goods” and the Difference principle to deal with the differences in circumstances which should be redistributed in accordance with the maximin principle.) The report, however, states that it did not raise the concept of equity to propose a new framework for development, but as the foundation on which various existing approaches can be integrated and expanded. In the “Epilogue” of this report, these various approaches to development are summarized as four major “strands of thinking and action” that the Bank itself has used in several of its annual World Development Reports: (1) the market mechanism, (2) human development, (3) institutional development and (4) empowerment of the poor. We must note that each of these strands of thinking was a synthesis of lessons learned in the context of development issues and actions that were prevalent at the time, and that if we are to use them at some point of time, a further synthesis is necessary. One such synthesis was the *WDR 2000/01*’s advocacy for the poverty reduction policy based on expansion of opportunity, empowerment and security. More recently, the former World Bank Chief Economist Nicholas Stern suggested a synthesis into the two pillars of “good investment climate” and “empowerment of the poor.” Without these efforts towards synthesis and integration, elements of different development experiences are isolated and cannot complement each other to produce a holistic development process. Either in the *WDR 2000/01* or Stern’s paper, the forces of such syntheses are still not

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17 This is also true with the following report which summarizes the OED’s activities up to 2003: Bjai Chhiben et. al, *Reform and Growth, Equality World Bank Experience*, Transaction Publishers.

strong enough. In that, the WDR 2006 seems to be implying, lies a new role for its concept of “equity and development” to play.

I am impressed by the novel proposal of the *WDR 2006*, but the question is whether that proposal can be a force to remedy the “lack of strategic road map for growth and poverty reduction” as observed by the IEO and OED. In this regard, I am reminded of the fact that, faced with a severe underachievement in growth and poverty reduction at the forefront of African aid, the DFID-ODI proposed, as a bold initiative for breakthrough, to overcome the neopatrimonial, premodern political systems. My own prototype development model is inspired by this bold initiative. In contrast, in their effort to overcome the crisis of the PRSP approach, the IMF and the Bank are reluctant to step into the territory of political analyses involving the modernization of political systems. While they are willing to go as far as “governance policies,” they have not stepped out of the traditional territory of economics. Neither camp, however, is yet to come up with an effective road map for growth and poverty reduction.

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## Endnotes

<sup>A</sup> The primary goal under the PRSP process, announced as the result of a review of Structural Adjustment Lending (SAL) during the 1990s, was “poverty reduction” instead of the “continuation and promotion of growth” under the SAL system (Ishikawa 2002I). However, it should be remembered that from the beginning, the World Bank considered growth to be a prerequisites of poverty reduction. With regard to the IMF, current publications noted that it “broadened the objective of its concessionary lending in September 1999 to *include an explicit focus on poverty reduction in the context of growth-oriented policies*” [emphasis added]. In order to reflect the broadened objective, the IMF “Poverty Reduction and Growth Facility (PRGF)” replaced the previous “Enhanced Structural Adjustment Facility (ESAF).” In addition, IMF policy supports the PRSP process only when it the two objectives of a healthy macroeconomy and growth are both satisfied (Robb 2003). World Bank literature also shows that the Bank’s view of the role of growth relative to poverty reduction was gradually approaching that of the IMF. The International Development Association (IDA) report on the “Thirteenth Replenishment, Supporting Poverty Reduction Strategies,” presented to the IDA Board of Governors, placed the promotion of “*sound policies that will lay a secure foundation for productivity growth and poverty reduction*”[emphasis added] first on a list of four objectives of the replenishment.

<sup>B</sup> My previous paper points out that the biggest problem with “aid systems” lies in the current mechanism that “buys reform with aid” by making use of conditionality, and expects the donors and recipients to resolve the problem by returning to their original means – “policy dialogue” based on a relationship of mutual trust. As for the problem with “HIPC relief systems,” the paper notes that the level of “sustainable debt” to be met at the “point of completion” of relief is set unrealistically high, and proposes lowering the level to a workable one. If these solutions are successfully applied, what will remain to be addressed will be the problem of the “development model.”

<sup>C</sup> This explanation was given by Robb (Robb 2003). According to Narayan (Narayan 2000 I), those interviewed in PPAs are multiple stakeholders (who are involved in poverty issues). Among them, the most important stakeholders involved in the research process are poor men and women. PPAs also involve decision-makers from all levels of government, civil society and the local elite. According to Robb, stakeholders other than poor people are involved in the design of PPAs.



<sup>D</sup> “Robb 2003” reflects IMF’s interest in research on the impact of various macroeconomic policy decisions on poverty reduction results. As a method of measuring the impact, the World Bank (Africa Region) uses the “Poverty and Social Impact Analysis (PSIA)” method from PRGF. This method lists the following tools and techniques mobilized from many areas of social science: social/environmental tools (PPA, social impact analysis, village-based research, gender analysis, social capital evaluation, etc.), economic tools (benefit incidence analysis, poverty mapping, public expenditure tracking surveys, etc.), partial-equilibrium tools (multiple market models) and general-equilibrium tools (CGE: Computer General Equilibrium) model, social accounting matrix).

<sup>E</sup> But the problem with the open-ended approach is the difficulty in pre-identifying poor people to be interviewed. They may somehow be identified through trial and error, but in this approach, the “definition of poverty” cannot be determined until PPAs are completed. The multiple dimensions of poverty, in Narayan’s Summary Section 1, can be described as the definition of poverty obtained after completion of PPAs.

<sup>F</sup> This new strategy was based on the report compiled in 1987 by a special task force comprising World Bank’s senior staff to review past poverty-related activities and propose new activities. The report emphasized the need to design clearly-defined poverty reduction activities that would complement economic growth, saying that the World Bank could not depend on economic growth alone to eradicate the worst form of poverty in developing countries by 2000 although it was an important factor in large-scale poverty reduction in the long term. (World Bank Annual Report 1991)

<sup>G</sup> For the countries where no “poverty assessment” was conducted, the World Bank’s general approach was to design an “adjustment program” to solidify the base of sustainable growth of production and employment. At the same time, it introduced a “program of targeted intervention (PTI)” to protect the most vulnerable stratum. The PTI program includes projects, such as a “project aimed at alleviating poverty (helping small farmers to improve production and providing primary education, primary health care, nutrition service, water supply, environmental hygiene and basic infrastructure for poor regions) and a project targeted at regions where the proportion of the poor among all beneficiaries is much higher than that of the poor in the entire population. PTI lending as a share of all IDA lending increased from 44% in 1992 to 65% in 1999. For the World Bank as a whole, including IBRD, the share increased from 25% to 51%. (World Bank Annual Reports 1992, 1999)

<sup>H</sup> There is no knowing what criteria poor people used in evaluating institutions. Taking schools or hospitals as an example, Narayan states that they might have been considered ineffective because the quality was not good or access to them was not good even if they were important. At the same time, Narayan states that the message from poor people is sobering and the pattern of institutional ratings confirms the need of more detailed analysis of how poor people described their interactions with institutions. (Narayan 2000 II)

<sup>I</sup> In some countries, the poverty status of many households has remained unchanged over a long period of time. This is probably due to special factors, such as the pervasive influence of the caste system or a severe economic slump, and requires separate consideration.

<sup>J</sup> The governments of countries at advanced stages are able to establish safety nets and institute other social security policies, But this is not a subject for the present paper. This paper; rather, considers the mechanism by which poor households escape from poverty and better their condition.

<sup>K</sup> An overview of the backwardness in African development which has led to periodic reforms of World Bank and IMF international development policies can be obtained by examining the analyses and prescriptions contained in major and comprehensive research reports on African economic development issued by the World Bank. “Sub-Saharan Africa: from Crisis to Sustainable Growth, A Long Term Perspective Study” (World Bank 1989 I) was the first report to point out that long term growth trends measured by annual average growth rates per capita in Africa (abbreviation of Sub-Sahara and hitherto referred in the same way) entered a growth phase during 1961 to 1971, remained static between 1973 and 1980, and critically declined during the period 1981 to 1987. The decline was studied from the perspective of the real economy. The report concluded that healthy macroeconomic policies and effective infrastructure development were essential but not sufficient to escape from the crisis, requiring the development of capabilities supported by appropriate governance.

The “African Adjustment and Growth in the 1980s” (World Bank and UNDP 1989), published jointly by the World Bank (African Region) and the UNDP in the same year, offers a slightly different prescription. According to this report, the situation in Africa is more complex and less bleak than its frequent depiction as a continent offering little hope and suffering many cruel setbacks. From a long term perspective of 15 to 20

years, the drastic drop in growth during the 1980s in fact prefaces a return to a long term growth trend. The report divides Africa into countries that are actively undergoing policy reforms and those that are not. In the former, the situation is not seen to be as urgent and crises can be avoided by giving priority to ODA to these countries.

Yet two ensuing comprehensive research reports published in succession in the mid-1990s titled “Adjustment in Africa: Reforms, Results, and the Road Ahead” (World Bank 1994) and “A Continent in Transition, Sub-Saharan Africa in the Mid-1990s” (World Bank 1995) indicate that predicted growth in fact never occurred. The former publication states that strong leadership and good governance must accompany any policy reform. The 1995 publication expresses hope that good governance may emerge following political liberalization that began in the early 1990s and the ensuing development of opposition parties and dialogues between political parties.

<sup>L</sup> Amongst research on governance by Japanese development aid scholars, Shiratori (1994), Shimomura (1999), and Kondo (2003) discuss governance reform in a political context. Chapter 1 of Shimomura’s research (2002) is a detailed and persuasive argument about the link between governance and overall reform in an economic context.

<sup>M</sup> Later this would include “monitoring and evaluating, and their capacity building,” and “strengthening and institutionalizing participatory processes with respect to a broad range of domestic stakeholders and development partners.”

<sup>N</sup> The following governance-related issues were not addressed in the PRSP document: “corruption and accountability,” “reform to the civil service system,” “intra-government relations and decentralization,” “public expenditure management,” and “legislative and judiciary systems.”

<sup>O</sup> Low income countries that have adopted the PEM models of developed nations but characteristically lack PEM reform capabilities need to be examined by separating them into former socialist transitional countries that have executed standard planned economy models and all other low income countries. It cannot be stated *a priori* how this difference will impact the acceptance and implementation of PEM models of developed nations. In a planned economy, resource allocation for the entire economy is based on distribution plans of major production capital based on data from individual material balance tables. The system is institutionalized to ensure it would work, at least in the modern sector. Given material planning, fiscal and monetary policies play supportive roles. In a market economy, market mechanisms fundamentally dictate

resource allocation, and the public sector steps in to correct “mistakes of the market.” In general, the economic systems of low income developing countries can be characterized as “developing market economies.” The traditional economy can compensate for resulting distortions to resource allocation but early intervention by the public sector is not readily allowed. This difference must be duly considered when analyzing capabilities for transition.

<sup>P</sup> This cycle comprises the following items: review previous policy; set and plan policy (establish resource framework, set out objectives, policies, strategies and expenditure priorities); mobilize and allocate resources (prepare budget); implement planned activities (collect revenues, release funds, deploy personnel; undertake activities); monitor activities and account for expenditure; and evaluate and audit.

<sup>Q</sup> As discussed in the previous subsection, PEM reform is evaluated from the perspectives of whether public expenditure is poverty focused, and the effects of improvements to resource allocation efficiency. It is often difficult to distinguish between the two perspectives, which I bear in mind when reviewing ODI research.

<sup>R</sup> Ishikawa (2000 I) proposes the use of the CGE model to optimize the process of trade-off between growth and poverty reduction rates.

<sup>S</sup> Under the Enhanced HIPC Initiative, the “sustainable official external debt” of individual HIPC (present value) must be less than 150% of the value of total annual exports, or 250% of annual fiscal revenue in each country. These figures were derived empirically from a set of hypothesis and there is some debate as to their appropriateness.

<sup>T</sup> The present value of budget constraint across all periods obtained by solving the difference equation (1) should be the equivalent of adding  $\lim_{T \rightarrow \infty} \bar{R}^{-1}(t, t+1) B_{t+T+1}$ . This additional item represents the present value of “terminal debt stock.” “Equation (2) presumes that the value of this additional item is zero in reality. The reason is as follows: (1) a positive value means that the indebted country government continues to hold on to debt. No rational borrower is willing to hold its liabilities indefinitely.” (2) A negative value means that the government is a creditor to the private sector which is also not realistic.

<sup>U</sup>  $\bar{d} = (n_t - r_t) b_t$  is derived as follows. Stabilization of the domestic debt burden

means that  $(\dot{b}_t) = (\dot{B}_t/Y_t) = 0$ . However,  $(\cdot)$  indicates annual growth rates. This equation can be developed as follows:  $(\dot{B}_t/Y_t) = \dot{B}_t/Y_t = \Delta B_t/B_t - \Delta Y_t/Y_t = (D_t + r_t B_t)/B_t - n_t = (d_t/b_t) + (r_t - n_t) = 0$ . Therefore,  $d_t = (n_t - r_t) b_t$ .  $n_t$  and  $r_t$  on the right side of the equation is determined exogenously. On this account,  $d_t$ , derived by assuming  $b_t$  is fixed, is the value  $\bar{d}$  which is the value of the policy goal.

<sup>v</sup> Theoretically, no hypotheses exist that determines the limits to the value of  $b_t$ , or its fixed value. In reality, developing countries with extremely low  $b_t$  value could increase the value over time and fiscal policy may become sustainable. For heavily indebted countries with large  $b_t$  value, sustainable fiscal policies may require debt reduction (Chalk and Hemmings, 2002).

<sup>w</sup> Let us consider IMF policy research on Ghana that uses the sustainability indicator (IMF 2003). The table below calculates the domestic primary balance value necessary to stabilize the domestic debt burden based on real GDP growth (top row, across) and real interest rates (left column).  $b_t$  is assumed to be fixed at 0.289 based on its true value in 2000. (IMF 2003, III. The Challenge of Fiscal Sustainability on the Post HIPC Era in Ghana)

Domestic Primary Balance Necessary to Stabilize Domestic Debt Burden (%)				
	Real GDP Growth (%)			
Real Interest Rate (%)	3	4	5	6
1.25	-0.5	-0.8	-1.1	-1.4
8.00	1.4	1.2	0.9	0.6
12.00	2.6	2.3	2	1.7
16.00	3.8	3.5	3.2	2.9

Other “sustainability indicators” include the “Domestic Primary Gap Indicator” and “Tax Gap Indicator.”

<sup>x</sup> Ghana’s macroeconomic balance check policy becomes clear by referring to the following from the “Medium Term Macroeconomic Strategy” and “Medium Term Fiscal Targets” contained in the “Fourth Review under the Poverty Reduction Growth Facility (PRGF) Agreement on Ghana: Three Year Plan” (May 1999 to May 2000) conducted by the IMF. The reports clearly show that Ghana, facing a crisis stemming from extremely low domestic savings rate and accumulated external and domestic debts, has adopted the “sustainable debt” model and a PRSP Source Book type

macroeconomic framework to perform macroeconomic checks on reform efforts identified through PPA and PEM. (Ghana relies upon the HIPC initiative to resolve its external debt problem and it is not adequately addressed in the medium term strategy.) It remains to be seen whether Ghana can escape from its economic crisis as a result of the macroeconomic check and get on track for economic growth (including higher savings) and poverty reduction, which is dependent upon the future implementation of these strategies.

“Ghana’s Medium Term Macroeconomic Strategy is intended to take the economy out of the trap of rising domestic debt → interest costs → escalating inflation, which have hindered private sector development and consumed public resources that the government needs to improve the provision of social services and public infrastructure. This broad approach was endorsed in the course of discussions during 2001 on the Ghana Poverty Reduction Strategy (GPRS), and the specific macroeconomic goals have been designed as an integral part of the strategy to reduce poverty in Ghana.

The Medium Term Fiscal Targets are to generate domestic primary surpluses sufficient to cover all domestic debt service, approximately halving the ratio of domestic public debt to GDP by 2003 from its end-2000 level of 29% of GDP. Reduced reliance on the banking system budgetary and parastatal financing, combined with positive real interest rates, are expected to curtail monetary growth and bring inflation down to single digits by the end of 2003. The framework allows for rising non-interest government spending as a share of GDP, as well as substantial expansion credit to the private sector in real terms (annual increases of 10% to 15%), in support of the targeted growth in real GDP of 5% from 2003.” (IMF 2002)

<sup>Y</sup> According to the IMF, the ratio of combined domestic and external official debt to GDP in Vietnam in 2000 was 63%, certainly not an insignificant amount. Nonperforming loans owed to commercial banks by the SOEs make up most of this figure. Although this is a major medium term fiscal risk, it can be dealt with separately under the medium term macroeconomic strategy. 3% of government debt is domestic, and 27% is external, both which are sustainable under high economic growth and low interest rates. The main focus of the medium macroeconomic framework supported by the IMF in the PRGF (2001-2003) of Vietnam is the realization of high economic growth rates and sustainable poverty reduction, as seen below, and to this end, the PRGF advocates the maintenance of prudent fiscal and monetary policies and the support of private enterprises through low inflation.

“The goal of the medium term (2001-2003) PRGF-supported (macroeconomic) program is to put Vietnam’s economy on a higher growth path, for a lasting reduction in

poverty. Stronger growth with low inflation will need to come from maintaining macroeconomic stability, and from accelerating structural reforms (to boost private investment and competitiveness of the economy). The main forces for growth and employment are expected to come from the private SME sector and FIEs. This strategy for the proposed PRGF-supported program is consistent with the medium-term structural and macroeconomic framework set out in the I-PRSP.

Key policy elements to spur private investment include reforming the banking sector and further liberalizing the business environment to level the playing field vis-à-vis the state sector. Domestic competition would be bolstered through promoting the private sector and reforming the SOE sector, and external competition strengthened through trade measures. Macroeconomic vulnerability would be addressed through prudent fiscal and monetary policies, and by stemming the losses of SOEs and strengthening the performance of the SOCBs (state-owned commercial banks).” (IMF 2001)

<sup>Z</sup> I will give the example of Vietnam. In Chapter II, PPA research revealed that major coping strategies for households at the “poverty threshold” included shrimp-farming and high yield rice cultivation on collateralized land in Tra Vinh province, and seeking refuge in regional communities in Lao Cai and Ha Tinh provinces. At the same time, household-based living standard surveys in 1992, 1998 and 2002 revealed that the national poverty rate (head count) saw a dramatic decrease over the ten year period, to 58.1%, 37.4% and 28.9%, respectively. Estimates from the Quintile Transition Matrix (table 1) are also available for the period between 1992 and 1998. For 2002, in addition to 6.7% or 10.2% of the aforementioned “vulnerable group,” figures for the ratio of the quintile for landless households can be obtained. For all of these, a breakdown by the 8 regions nationally is also available.

At a minimum, the following observations can be made from this information. (i) Poverty reduction policies based on broad based growth pursued by the Vietnamese government since the 1990s have been more effective than pro-poor targeting. (ii) These policies were strongly pursued in the “Mekong Delta region” in southern Vietnam and the “south-western region” with bipolarized results; the loss of assets as coping strategies were most marked in these two regions. (iii) In remote mountainous areas, particularly in the “northwestern region” of North Vietnam and the “central plateau region” of central Vietnam, pro-poor targeting investments to strengthen the regional community have meant that the asset loss ratio for households were extremely low, but the poverty rate was the highest in the country. (iv) Both the poverty and asset loss ratios were exceptionally low only in the “Red River delta region.”

The above are rare instances where accurate assessments were possible because of the availability of different types of information, yet information is still insufficient to formulate future policy prescriptions. More information on local agricultural cooperatives in regional villages, industrialization of rural areas, infrastructure and urban industries is needed for a balanced prescription.



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