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Some remarks on the *World Development Report 2000/1. Attacking Poverty*

I. General Assessment and Comments

It is indeed very important that on the turn of millenniums the *World Development Report* addresses again – after 10 years since the previous WDR on this subject was published – the issue of counteracting poverty. This is expected both by the nations and people which are still coping with vast poverty and following social hardship as well as by the international organizations involved in the process of acting against poverty. There is several arguments supporting comprehensive consideration of this topic, yet certain among them are new and hence must be considered with special attention.

First, the globalization has got momentum and the international community expects a clear explanation what are the links between globalization and poverty. Recent debate, being influence too by growing pressure from the non-governmental organizations (NGOs), shows that there is a great deal of misunderstanding vis-à-vis the mechanisms and implications of globalization. Is globalization – i.e. still further going liberalization of the capital flow, free trade and free exchange of information due to the information technology revolution – contributing to increasing poverty, or to the contrary – does it lead to counteracting it? Or is it, from this perspective, a neutral process?

The draft of WDR 2000/1 must answer this question in the most convincing and well supported way. For this reason it should be stated clearly that globalization indeed contributes to both growing inequity and to growing income, but not to increasing poverty. Therefore, not the poverty is spreading owing to globalization, since the latter facilitates the

long-term growth, but inequality. It is so, because during globalization the income of more skilled labor is growing faster than at the same time is growing the income of people lagging behind with their ability to earn money.

It is necessary to drive more attention the growing inequality within particular nations and economies than between them, since the former is the leading factor causing growing inequity on the international scene and in certain cases even still increasing absolute poverty.

As for the implication of globalization, the WDR2000/1 must address also particular issue of so-called 'new architecture of the international financial architecture' and its influence upon the redistribution of the flow of income on the international scale. There is such a link between the former and the latter and this years, i.e. 2000-01, and this edition of the *World Development Report*, happen to be precisely the right time and the right place to address these topics in a comprehensive and forward-looking manner.

Second, the problem of spreading poverty in transition economies in East Central Europe and especially in the republics of former Soviet Union must be dealt with more deeply and comprehensively. I think a special section in WDR 2000/1 should be devoted exclusievely to this problem, since that is a new challenge, which has emerged together with the postsocialist transition. Hence there was not such problem a decade ago, when the previous WDR on poverty had been presented to the world public opinion.

Unfortunately, there is a causal link between transition to market economy in this part of the world and growing poverty (Kolodko 1999). Despite it has been admitted already in other documents of the World Bank, now there is the best excuse to explain why it has happened. Was it unavoidable "by-effect" of otherwise welcome introduction of the market economy, or was it also – and to what extent – due to wrong policy advice and the policies' failure?

I am considering this particular issue more in details in the further part of these remarks, yet I believe it should be admitted exactly in the *World Development Report* that a great deal of

hardship occurring in transition economies has been due to the wrong set of policies aiming at structural adjustment in those countries (Kolodko 2000). These policies were for too long period of time following so-called Washington Consensus and, unfortunately, the World Bank was not able to influence this process sincer the beginning in a correct way.

The mortality crisis, resurgence of illiteracy, high unemployment, vast crime, extreme inequality in some countries (including two biggest postsocialist economies with about 200 million population, i.e. Russia and Ukraine), etc. – all these are the new developments in that region and they are direct or indirect results of transition. Proper diagnosis of such malaise is necessary not only for the reason of answering the question, why it has occurred, but mainly for the purpose of attacking poverty in the coming years.

If transition in East Central Europe and the former Soviet Union is an integral part of ongoing globalization – and indeed it is – then it must be admitted that the latter at the current stage, i.e. in the course of 1990s, did contribute to spreading poverty and increasing inequality. Yet in the future, the more the fruits of liberalization and integration with the world economy will appear, the less of poverty suppose to be there. That is going to take place only on the path of sustained growth and only if the governments and their policies will take care of equitable growth. That was hardly the case of the first decade of transition to market economy.

Third, there is not only the 'new economy' in the rich countries, especially in the USA, but there are also 'new poor' in those countries. Thus, it would be interesting to discuss the issue of the impact of so-called 'new economy' upon both, the growth and the equity. Undoubtedly, it influences the growth in a positive way, yet it must be explained how it affects the income distribution and is there a link – and if so, of what kind – between fast growth and sustaining areas of poverty in certain advanced economies.

Fourth, the report ought to stress more clearly that the division for the 'haves' and the 'have-nots' is not going along the line of the traditional distinction between the poor and the reach

countries. In the former, both because of healthy developments – as for instance growing number of the skilled labor and, in some countries, the fast and sustained growth – and because of wealth' accumulation through theft and vast corruption, there is a group of the *nouveaux riches*. In the latter, because of sometimes increasing exclusion and insufficient government's involvement in attacking poverty, there is a group of the *nouveaux pauvres*.

In sum, the map of the wealth and poverty is quite different than it was a decade ago and therefore the picture of the global economy seen from this perspective is much more complex too. This map and this picture must be presented at the onset of the WDR and only then the detail aspects of the causes of poverty and increasing inequality, on the one hand, and the ways for attacking the poverty, on the other hand, should be discussed.

II. Attacking poverty and inequality in transition economies in East Central Europe and the former Soviet Union

Income distribution under the centrally planned system was more equal than it is during the transition period as well as if compared with the market economies. In the late 1980s, the Gini coefficient varied from a low of 20 (for the Slovak Republic), to 28 (for Uzbekistan), mostly being between 23 and 24 points. Compared with the advanced market economies, on average the countries of Eastern Europe (excluding the former Yugoslavia) had the Gini coefficients of 6 percentage points less than Western European countries.

It is difficult to say whether the people were more concerned about the level of their income or the way it was distributed, however it is likely that the latter played a greater role in sparking transition. Desire for fair and equal income distribution was very strong, and social dissatisfaction and political tensions were rising due to the growing disparity in real income. At the beginning of transition, there was widespread

conviction that this process would quickly bring both higher income and more fair distribution of the fruits of a better-performing economy.

Although income distribution varies among countries, all transition economies have some common features; income inequality is rising in all these countries. Fluctuations in people's income – first it fell, then it grew – and in its distribution have led to higher income inequality. The greatest changes occurred during the early stages of transition, when real income contracted significantly, yet at a different pace by income group. Hence, in a matter of couple of years, the income proportions have changed significantly.

Lately, the process has taken another route. Although in most of these countries income inequality has continued to grow, albeit at a much slower pace than before, in a few it has stabilized. In recent years, this inequality has hovered around the dispersion structure that resulted from the changes that followed the earlier shocks.

Although the transition economies are going through a vast, intensive process of liberalization, they still lack sophisticated market institutional arrangements. Thus, their common feature is an extensive shadow economy, consisting of unregistered economic activities, the income from which is significant but impossible to estimate.

The range of the informal sector, with all its merits and drawbacks for income dispersion, depends on maturity of institutional arrangements, on the one hand, and developments in the real economy, on the other. In economies with relatively more advanced market institutions and a higher market culture – for example, in the countries invited to begin their accession negotiations with the EU – the scope of tax evasion is much smaller than in the countries lagging behind. Although it is difficult to measure and impossible to quantify, it seems to be feasible to claim that the shadow economy is larger in Ukraine than in Poland, larger in Armenia than in Latvia, larger in Romania than in Hungary, and larger in Croatia than in Slovenia.

It is recognized that the shadow economy contributes to the higher income of all social strata, but it is impossible to estimate precisely how it influences the final proportions of disposable real income. Although the informal sector contributes to higher production and welfare as a whole, it also transfers part of the income from some households to others. Because one cannot map these income flows, one can only draw general conclusions. It is not a zero-sum game. Income redistribution conducted within the borders of the parallel economy – as well as between the parallel and the official economy – can enhance overall growth. Thus, in the long run, it can contribute to a higher standard of living for the whole society. Parallel economy, through its contribution to actual national income and its impact on its redistribution, raises both the average income and the inequality. Thus it can be seen as a means of attacking poverty, yet not inequality.

Particularly important for income distribution has been the fact that a majority of the subsidies and allowances – previously provided by the state to some social groups to support their consumption – had been radically reduced or eliminated completely. Since the beginning of transition, the removal of subsidies has been seen as absolutely necessary by various international organizations, especially by the IMF. The Fund was willing to back only structural adjustment polices that led to the liquidation of all subsidies. This external pressure was mixed with domestic tugs-of-war between the countries' political extremes, that is between the old left and the new right populists on one side, and the free-market zealots on the other.

Inflationary income redistribution – executed through the downward adjustment of real income by different rates per household group – significantly increased income inequality in the early 1990s. This process is far from over in countries less advanced in liberalization and stabilization (e.g. Belarus, Bulgaria, Macedonia, Romania, Ukraine, and especially Kazakhstan, Turkmenistan and Uzbekistan).

With extremely high inflation, real income distribution had depended on the indexation procedures used at the time of the stabilization policy. The actual indexation was always a function of political compromise, not necessarily a logical consequence of strictly economic arguments.

Another aspect of inflationary redistribution that affects equity and equality deals with household savings. Because of the shortages under the centrally planned system, there was always some disposable net income that could not be spent on desired goods and services. This set in motion forced substitution and boosted the parallel market. Households were left with some residual, “disposable” income that was not “real” since it was not possible to spend it. So, it was involuntarily saved. When eventually the time for structural adjustment arrived, the prices were freed and raised to the market clearing level. However, the purchasing power of money balances, including those held in banks, was protected only partially. They were indexed, but only to some extent.

Economic reforms liberalized the wage setting in the state sectors. Regardless of the initial pace of denationalization, by the mid-1990s, in most transition economies, more than half the labor force earned their salaries in the state sector. Whereas under the socialist system the dispersion of wages was quite limited, a much wider dispersion has been accepted during the transition. Thus, income has become more tightly linked to qualifications, experience, occupation, and performance. The transition means too a closer relation between an individual’s past investment in human capital and its current remuneration, which has led to greater wage dispersion.

Even more significant for rising income inequality is the shift of labor from the state to the private sector. Not only is the dispersion of wages in the latter larger than in the former, but the average income earned is higher. This is due mainly to the higher labor productivity in the private sector as the state is in control of a number of obsolete, noncompetitive industries and poorly managed, relatively low paid services, such as education, health care, and central and local administrations. Because of the meager

budgetary situation, these sectors have not been able to compete with remuneration provided by other industries, performing profitably on a commercial basis. Therefore, the rising share of labor engaged in the rapidly growing private sector has raised income inequality.

When an economy moves from the centrally planned to the free-market system, the most revolutionary and fundamental changes take place in asset ownership. The basic features during transition are denationalization, privatization, property restitution, participation of foreign direct and portfolio capital and the development of financial intermediaries to accompany private sector's expansion. These events have a major impact on changes in income distribution. At the time of transition, the share of wages in total income decreases, while that of capital gains – for example, profits, dividends, interest, and rents – increases. This process itself contributes significantly to growing inequity. The fundamental shift of assets from state to private hands has been followed by a shift in the income earned on these assets in the same direction. Obviously, these changes have also increased the inequity as well as have driven some people into poverty.

Whatever the explanation for the great trasitional recession, the fact remains that the officially registered GDP of 25 countries in Eastern Europe and the former Soviet Union has contracted by almost 30 percent (weighted average) in the first ten years of transition. Of course, it must be therefore accomapnied by spreading poverty, considering that these countries were of middle- or even low income before the transiton took off.

During transition, income policy must deal with many contradictions. Although the drive to encourage saving suggests more lenient taxation of some types and sources of income, growing inequality suggests the opposite. How to solve this trade-off, that is precisely a matter of policy options. If the economy is expected to recover quickly and expand, then some fiscal preferences for capital gains have to be introduced. This

option is politically difficult not only because of quite strong populist temptations in the postsocialist societies as well as among influential politicians, but also because it is strange to tax unemployment benefits or minimal pensions yet not capital gains on speculation, for instance on the stock exchange.

Under central planning, there were poor and rich people. Determining the number of each depends on how they are counted. Whatever method is used, it is undeniable that the market transition has increased the number of both rich and poor. Because inequality has been increasing, so has the number of people at each end of the spectrum – the poor and the rich. The range of poverty in the transition countries – due to the decline in output and the long-lasting crisis – has increased significantly in the 1990s.

Poverty has widened in all transition economies, including those leading in both systemic change and growth, because of the time lag between recovery and growth and following it improvement of the living standard for society's poorest. First the real output recovers, then employment grows, and finally the budget allows for better financing of the social needs of the poorest, if the policy is favorable for such a distribution. Hence, an economy may be on the rise, but poverty will not decline for several years.

Thus far, transition has brought mixed results. Although inequality has increased in all transition countries – from Albania to Estonia and from the Czech Republic to Mongolia – in some it even has doubled (e.g., in Russia and Ukraine); in some it has grown by only a couple of points (e.g., in Poland and Slovenia); and in yet others it has stabilized (Slovakia).

The biggest challenge for policymakers is how to deal with growing inequality and widening of poverty. This challenge is made more difficult by the interrelationship between the two as well as a severe, long-lasting recession. Hence, growing inequality

is not only a political issue that will provoke tensions and conflicts, but also one that creates an economic obstacle to durable growth.

One should not confuse the means and the ends of economic policy. Income distribution and a socially acceptable distribution of wealth are just some of the important long-term policy targets. From this perspective, the goal of transition is not only systemic change, but, more important, greater efficiency, increased competitiveness, faster growth, and more sustainable development. Thus, transition is expected to improve the standard of living for all, or at least for the overwhelming majority. Otherwise, the exercise would not make much sense.

When a policymaker trying to catch up with a more advanced world faces a trade-off between faster growth with higher inequality (but less poverty) and slower growth with lower inequality (but widening poverty), he can be happy because his choice is clear. Policy should facilitate sustainable growth, and income policy should support that goal. Then, in the longer run, everyone's standard of living may improve and the scope of poverty will be dimminished. After the initial surge of inequality, and when the economy is on the rise, it may be even possible to reduce disparity without harming the ability to expand. This seems to be even more true for inequity. Therefore, the more the transition advances and the stronger the foundations for fast and durable growth, the weaker is the trade-off between equity and efficiency and the more successful the fight against popverty is going to be.

References

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