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Does Macroeconomic Adjustment Benefit the Poor?

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Does Macroeconomic Adjustment Benefit the Poor?

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The short-run and long-run effects of adjustment policies' go in opposite directions. A cyclical boom created by expansionary economic policy is associated with improved conditions for the poor in the short run. However, low inflation and stable aggregate demand growth are associated with improved the economic condition of the poor in the long run.

Poverty is the most pressing economic problem of our time. And because rising inequality, for a given level of income, leads to greater poverty, the distribution of income is also a central concern. At the same time, the adjustment programs are the modern age's most potent tools for managing crises.

There are important links between economic policy and benefits to the poor in both the short run and the long run. Expansionary economic policy aimed at rapid output growth is associated with improved conditions for the poor in the short run, but prudent economic policy aimed at low inflation and steady output growth is associated with enhanced benefits of the poor in the long run.

Economic policy can affect output, unemployment, and inflation in the short run. As a result, if poverty and inequality respond to these variables, economic policy can affect the benefits of the poor. Furthermore, because unanticipated inflation can redistribute wealth from creditors to debtors, economic policy can also affect distribution through this channel.

Poverty falls when unemployment falls. However, we have no evidence of important effects of cyclical movements in unemployment on the distribution of income. We find some evidence that unanticipated inflations narrows the income distribution, though we can detect no noticeable impact on poverty. Finally, we find that the potential redistributive effects of unanticipated inflation on the poor through capital gains and losses are very small.

Economic policy can generate a temporary boom, and hence a temporary reduction in poverty. But, as unemployment returns to the natural rate, poverty rises again. Furthermore, the expansionary policy generates inflation. If a monetary contraction is used to reduce inflation, the negative effects on poverty even the temporary reduction in poverty during the earlier boom.

In the long run, monetary policy most directly affects average inflation and the variability of aggregate demand. There are indeed important negative relationships between the income of the poor and both average inflation and macroeconomic instability.

Controlling inflation and output variability through adjustment programs is likely to result in higher income for those at the bottom of the distribution in the long run. For this reason the economic policy that aims to restrain inflation and minimize output fluctuations is the most likely to permanently improve conditions for the poor.

Expansionary economic policy raises both output and inflation in the short run. These short-run effects of economic policy can influence the benefits of the poor through three channels.

First, the rise in average income in a cyclical expansion directly reduces poverty. For a given distribution of income around its mean, an increase in the mean reduces the number of people below a fixed cutoff. That is, a rise in all incomes together increases the incomes of the poor, and raises some of their incomes above the poverty level.

Since expansionary economic policy raises average income in the short run, this is a powerful mechanism through which the economic policy can immediately benefit the poor.

Second, there may be cyclical changes in the distribution of income. The declines in unemployment and increases in labor force participation and in real wages in an expansion are likely to be concentrated disproportionately among low-skilled workers. Thus the income distribution may narrow. In this case, there are short-run benefits of expansionary policy to the poor beyond its effect on average income. On the other hand, transfers are less cyclical than labor income, and the poor receive a large fraction of their income from transfers than do the remainder of the population. If this effect predominates, the income distribution could widen in a boom. In this case, the benefits of expansionary policy to the poor are smaller than what one would expect given the impact on mean income.

Third, the inflation created by expansionary economic policy has distributional effects. Inflation can harm the poor by reducing the real value of wages and transfers. Finally, unanticipated inflation benefits nominal debtors at the expense of nominal creditors. If the poor are nominal debtors, inflation can help them through this channel.

If output and unemployment are at their normal or natural levels, and policymakers undertake an expansionary policy the result is a period of bellow-normal unemployment and above-normal output. This cyclical expansion raises the incomes of the poor and lowers the poverty rate.

But the boom cannot last. The economic policy can push unemployment below normal and output above normal only temporarily. The low unemployment and high output cause inflation to rise. Output and unemployment, inevitably return to their normal levels. When this happens, poverty returns to its initial level. Even if policymakers are willing to tolerate the higher inflation, all the expansionary policy has achieved is a temporary period of below normal poverty ate the cost of permanently higher inflation.

A more likely outcome is that policymakers will choose not to accept the higher inflation. In this case, they will adopt contractionary policies to bring inflation back to its initial level. The result is a period of below normal output and above-normal unemployment and poverty. In this case, policy has had no impact on the average level of poverty; it has only rearranged its timing.

What economic policy can control in the long run is average inflation and the variability of aggregate demand. These can affect the benefits of the poor both by influencing long-run growth and by influencing the distribution of income.

High inflation creates uncertainty, generates expectations of future macroeconomic instability and distortionary policies, disrupts financial markets, and creates high effective tax rates on capital.

It thereby discourages investment of all types: physical capital accumulation, human capital accumulation, innovation and research and development, and foreign direct investment and technology transfer. As a result, it can retard growth. Because macroeconomic instability is also likely to discourage investment, it can have similar effects. Furthermore, to the extent that high inflation and high variability generate uncertainty about the return to productive activities and increases the scope for activities that are privately but not socially beneficial, they may lower work effort and lead to rent-seeking. This can also erode a country's average standard of living.

High inflation and macroeconomic volatility can also affect the poor through the distribution of income around its average. There are at least five channels through which economic policy can affect long-run income distribution. First, the redistributions caused by swings in unanticipated inflation directly raise inequality. Second, the reductions in physical capital investment caused by uncertainty and financial-market disruptions raise the average return on capital and depress wages; thus they widen the income distribution. Third, offsetting this, inflation may shift the burden of taxation away from labor and toward capital. Fourth, the uncertainty and reduced effectiveness of financial markets caused by inflation and macroeconomic instability reduce not just physical capital investment, but human capital investment. This towards an important mechanism by which inequality can be mitigated. And finally, inflation and macroeconomic volatility may harm some sectors of the economy disproportionately. For example, they may be particularly harmful to simple manufacturing or export-oriented industries. Depending on the relative position of the workers in these industries, this can either increase or decrease inequality.

However, high inflation cannot be eliminated in isolation. If there is high inflation because a lack of fiscal discipline or of an effective tax system is leading the government to rely on monetary finance, for example, reducing inflation requires eliminating the underlying fiscal problem. More generally, inflation reduction is often part of a comprehensive package of policies involving fiscal discipline, macroeconomic stabilization, and microeconomic liberalization.

Finally, there are two conclusions about the interaction between adjustment programs and the benefits of the poor.

First, the usual emphasis on the short-run effects of economic policy on poverty is fundamentally misguided. It is certainly true that expansionary policy can generate a boom and reduce poverty temporarily. But the effect is unquestionably just that – temporary. Economic policy cannot generate a permanent boom. When output returns to the natural rate, so will the poverty rate. Moreover, the cost of such a boom is that inflation is permanently higher. If the higher inflation creates a consensus for tight policy to reduce inflation, the resultant rise in unemployment leads to a rise in poverty that offsets even the temporary reduction generated by the boom.

Second, the cross-country real relationship between economic policy and poverty suggests that economic policy that aims at low inflation and stable aggregate demand is the most likely to result in genuinely improved conditions for the poor in the long run. It is, that the relationship between prudent economic policy and higher incomes for the poorest that we find is not causal. Nevertheless, the typical package of reforms that brings about low inflation and macroeconomic stability will also generate improved conditions for the poor and more rapid growth also generate improved conditions for the poor and more rapid growth for all.