Policy Research Working Paper 4763

# Bailing out the World's Poorest

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The World Bank
Development Research Group
Director's Office
October 2008

Policy Research Working Paper 4763


## Abstract

While the 2008 financial crisis is global in nature, it is likely to have heterogeneous welfare impacts within the developing world, with some countries, and some people, more vulnerable than others. It also threatens to have lasting impacts for some of those affected, notably through the nutrition and schooling of children in poor families. These features point to the need for a differentiated social policy response, aiming to provide rapid income support to those in most need, while preserving the key physical and human assets of poor people and their communities. The paper points out some mistakes in past crisis responses and identifies key design features for safety net programs that can help compensate for the likely welfare losses in the short-term while also promoting longer-term recovery.


This paper—a product of the director's office of the Development Research Group—is part of a larger effort in the department to use research findings to better inform policy discussions about social protection. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org. The author may be contacted at mravallion@worldbank.org.

# Bailing out the World's Poorest

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[1] These are the views of the author and need not reflect those of the World Bank or any affiliated organization. For helpful comments the author thanks Harold Alderman, Kathleen Beegle, Quy-Toan Do, Ariel Fiszbein, Beth King, William Martin and Dominique van de Walle.

While the current financial crisis started in the US housing market it could soon reach deeply into the lives of many of the four fifths of humanity living in developing countries—the vast majority of whom live below the US poverty line, with a sizeable minority living in conditions of extreme poverty that are unknown in the North America or Western Europe.[2] And this crisis comes in the wake of steep increases in international food, fuel and fertilizer prices that have clearly increased poverty in the world.[3]

Western governments have learnt from experience that a slow and/or failed response to a crisis will have deeper and lasting impacts on their citizens' lives. Similarly, inaction to protect the world's poorest, or the wrong policies for doing so, risk not only a large increase in poverty in the wake of a crisis but a more lasting legacy of lower growth and greater poverty. Current responses have implications well after the crisis headlines have vanished.

The right policies can go a long way toward mitigating the welfare impacts on the world's poorest families. An effective response package should be consistent with restoring economic growth, and may even help promote more rapid growth in the future, by helping to redress some of the inequalities of opportunity that constrain both growth and poverty reduction.[4] By contrast, the wrong policies could actually make things worse in the longer term.

The policy responses of both developed and developing countries matter. Recessions in the US and Europe will probably reduce demand for exports from the developing world, and this could be made worse by if OECD governments introduce trade protection. Also, foreign aid flows will undoubtedly be under some pressure. Foreign investment in the developing world might also suffer as internationally mobile capital switches to the new safe havens in the US and Europe.

The focus of this paper is on the direct interventions by developing country governments that might be implemented to help protect their poor from the crisis now spilling over from the US economy. A public safety net is only one element of a comprehensive response; other policies to restore economic growth will be crucial. The highest short-term priority is to avoid

[2] In 2005 96% of the developing world's population lived below $13 per day, which is the average US official line, while 25% lived below $1.25 per day, which is the average line for the poorest 15 countries; see Shaohua Chen and Martin Ravallion, "The Developing World is Poorer than we Thought, but no Less Successful in the Fight Against Poverty," Policy Research Working Paper 4703, 2008.
[3] See Marcos Ivanic and Will Martin, 2008, "Implications of Higher Global Food Prices for Poverty in Low-Income Countries," Policy Research Working Paper 4594, World Bank, Washington DC.

doing damage to the existing public programs that matter to the poor; alas, the historical record suggests that such damage can readily happen in crises. Nor is the safety net the only element of the package of policy responses that needs to consider implications for the poor. The macroeconomic stabilization effort should not ignore distributional impacts; it cannot be realistically assumed that other policy instruments (notably taxation and spending) can deal fully with adverse distributional impacts. However, a public safety net is likely to be an important element of a sound policy response to the crisis, even in the poorest countries. What principles should guide policy making? What do we know about what works and what does not?

## An economy-wide shock with heterogeneous and long-lasting impacts

The fact that this is a global crisis will constrain the set of options for response. It is hard to pool risks when everyone is under threat. The scope for external assistance to the developing world from OECD countries struggling to stabilize their own economies may well be more limited, although the IMF and World Bank appear to be in a good position to help.

Not everyone is vulnerable. Some developing economies face more worrying implications for their real economies, notably through their dependence on global trade and foreign direct investment and the fragility of their financial sectors (stemming in part from differences in their direct exposure to the US subprime sector). Differences in pre-crisis household savings rates and in the accumulation of foreign reserves will also mean that some countries face more severe fiscal adjustment problems than others. And even an economy-wide shock is likely to have heterogeneous impacts within any given country, depending on (*inter alia*) household demographics, education attainments and location.

The impacts will not be confined to the poorest, and not all of the poor will be affected. Indeed, some will be protected by the same things that have kept them poor in the first place—geographic isolation and poor connectivity with national and global markets. Research on Indonesia's severe economy-wide crisis of 1998 found sharp but geographically uneven increases in poverty, reflecting both the unevenness in the economic contraction and the differing initial conditions at local level.[5] Proportionate impacts on poverty were greater in

[4] On inefficiencies, and (hence) costs to economic growth of inequality of opportunity in the developing world see the 2006 *World Development Report: Equity and Development*, New York: Oxford University Press.

[5] See Martin Ravallion and Michael Lokshin, "Lasting Impacts of Indonesia's Financial Crisis," *Economic Development and Cultural Change*, 2007, 56(1), pp. 27-56.

initially better off and less unequal districts. Another study of the same crisis found that most households were impacted, but that it was the urban poor who suffered most; the ability of poor rural households to produce food mitigated the worst consequences of the high inflation.[6] By contrast, the rural poor bore a heavier burden of the shock in Thailand around the same time, in part because of their greater integration with the urban economy than in Indonesia.[7]

Such research findings lead us to expect that, at any given level of living, some people will lose more than others and some may even gain. Thus it can be deceptive to focus solely on an aggregate measure of income poverty, for which the impact might be modest and yet there are large welfare impacts under the surface. For example, while the 1998 financial crisis in Russia saw only a modest 2% point increase in the poverty rate, longitudinal data (tracking the same households before and after the crisis) revealed substantial losses and gains.[8]

It is also important to understand that the welfare losses can last a lot longer than the crisis itself. The poorest can be particularly vulnerable to even small shocks. Productive activity is simply not feasible at low levels of nutrition; this "threshold effect" means that a negative shock of sufficient size can push a poor household past its tipping point and so put it on a path to destitution, while the same household bounces back in due course from even a slightly smaller shock.[9]

Research on past crises has found lasting impacts. A study of the East Asia crisis found that about half of Indonesia's poverty count in 2002 was attributed to the 1998 crisis even though macroeconomic recovery had been achieved well before 2002. Many of the things poor families have to do to help protect their current living conditions have lasting consequences. Debts often rise; key productive assets (such as livestock or land) are sold. And kids are taken out of school to save money and add to the family's current earnings. And these adjustments are often difficult to reverse.

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[6] See Jed Friedman and James Levinsohn, "The Distributional Impact of Indonesia's Financial Crisis on Household Welfare," *World Bank Economic Review*, 2002, 16(3): 397-424.

[7] See Fabrizio Bresciani, Daniel Gilligan, Gershin Feder, Tongroj Onchan and Hanan Jacoby, "Weathering the Storm: The Impact of the East Asian Crisis on Farm Households in Indonesia and Thailand." *World Bank Research Observer*, 2002, 17, pp. 1-20.

[8] See Michael Lokshin and Martin Ravallion, "Welfare Impacts of Russia's 1998 Financial Crisis and the Response of the Public Safety Net", *Economics of Transition*, 2000, 8(2), pp. 269-295.

[9] This is an example of a dynamic poverty trap associated with multiple equilibria; for an overview of such models see Partha Dasgupta, "Poverty Traps", in David M. Kreps and Kenneth F. Wallis (eds) *Advances in Economics and Econometrics: Theory and Applications*, Cambridge: Cambridge University Press, 1997.

The impacts of a crisis on children are understandably of great concern. When poor families are compelled to cut short their kids' schooling in response to a shock this creates a lasting impact on poverty (since school drop outs tend to earn less as adults). This impact will also vary, depending on the extent of the shock and initial conditions. Declining wages make child labor relatively less attractive, and schooling more so, but (at the same time) lower parental incomes increase the value of the extra money that children can bring to the family budget if they work. The balance of these economic forces will vary from place to place. There is evidence that in low income countries schooling tends to decline in a macroeconomic or agro-climatic crisis while in middle- and high-income countries schooling rates increase.[10] Impacts on the nutrition of young children in poor families are also of special concern. A number of research findings suggest that poor nutrition in the early years of life retards child growth, cognitive and learning ability, schooling attainments and (in all likelihood) earnings in adulthood.[11]

While there are persuasive ethical arguments for focusing the social policy response on the poorest amongst those who are vulnerable, there are also instrumental arguments for such a focus, related to the longer term implications of the crisis. The expectation is that it will be the children of poorest families who are most likely to be taken out of school and see a decline in their nutritional and health status. Thus the shock can create more persistent poverty across generations unless short-term assistance is directed to the poorest amongst those whose livelihoods are under threat.

## Tradeoffs?

Since resuming aggregate economic growth is important, the issue of tradeoffs cannot be ignored. Two "big tradeoffs" have been prominent in past policy discussions: the equity-efficiency tradeoff and the insurance-efficiency tradeoff.[12] Proponents of the first tradeoff see safety nets for the poor as harmful, or at best neutral, to economic growth, while the second warns that bailouts in a crisis encourage excessively risky behavior in the future.

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[10] See Francisco H.G. Ferreira and Norbert Schady. "Aggregate Economic Shocks, Child Schooling and Child Health." Policy Research Working Paper 4701, August 2008.

[11] See for example, Harold Alderman, John Hoddinott and Bill Kinsey, "Long-Term Consequences of Early Childhood Malnutrition," *Oxford Economic Papers* 2006, 58(3): 450-74. Also see Ferreira and Schady *op cit*.

[12] For an overview of the arguments and evidence on these tradeoffs in a developing-country context see Martin Ravallion, "Transfers and Safety Nets in Poor Countries: Revisiting the Tradeoffs and Policy Options," in Abhijit Banerjee, Roland Benabou and Dilip Mookerjee (eds), *Understanding Poverty*, Oxford University Press, 2006.

It has long been recognized that when public spending in a crisis reaches the poorest it brings a larger stimulus to aggregate demand, and hence output, given that poor people tend to have a higher propensity to consume. The tradeoff argument has been seen to carry more weight in thinking about longer-term growth prospects.

However, recent economic theories and evidence call into question the view that safety net programs for the poor entail a significant tradeoff against efficiency and (hence) longer-term growth and poverty reduction. Development policy thinking has also come to question the separation between social protection and broader development goals.[13]

At a theoretical level, the idea that there is an inevitable long-run tradeoff between economic growth and greater equity can be questioned.[14] The inevitable threshold effects on productivity when nutrition levels fall too low mean that high inequality is detrimental to aggregate output; an economy can generate massive unemployment under one distribution of assets, while a more equitable distribution yields full employment and higher output.[15] Credit market failures leave unexploited opportunities for investment in (physical and human) capital. The loss of output from such market failures is likely to be greater for the poor, so poverty may well impede aggregate growth. Similar results can stem from the political economy, notably the way that the initial asset distribution influences the balance of power over public spending. High inequality can also make it harder to achieve efficiency enhancing cooperation amongst people, such as providing public goods or achieving policy reform.[16]

The implication is that failure to address the short-term needs of the poorest victims of a crisis not only dulls the macroeconomic stabilization achieved by current public spending but also risks increasing poverty and inequality in the longer-term, with negative consequences for longer-term growth.

[13] See for example Andy Norton, Tom Conway and Mick Foster, "Social Protection: Defining the Field of Action and Policy," *Development Policy Review* 2002, 20(5), pp.541-567. Also see the discussion in Stephen Devereux, "Can Social Safety Nets Reduce Chronic Poverty?", *Development Policy Review* 2002, 20(5), pp.657-675.
[14] On the adverse effects of high inequality on economic growth see Philippe Aghion, Eve Caroli and Cecilia Garcia-Penalosa, "Inequality and Economic Growth: The Perspectives of the New Growth Theories", *Journal of Economic Literature* 1999, 37(4), pp. 1615-1660. Also see Chapter 4 of the 2006 *World Development Report*, *op cit*.
[15] For further discussion of the how this can happen see Partha Dasgupta and Debraj Ray, "Inequality as a Determinant of Malnutrition and Unemployment", *The Economic Journal* 1986, 96, pp. 1011-34.
[16] For a survey of the arguments and evidence on this point see Pranab Bardhan, Samuel Bowles and Herbert Ginitis, "Wealth Inequality, Wealth Constraints and Economic Performance," in A.B. Atkinson and F. Bourguignon (eds) *Handbook of Income Distribution Volume 1*. Amsterdam: North-Holland, 2000.

Turning to the second big tradeoff, bailouts in a crisis raise concerns about moral hazard. Using public money to help those who took high risks, and lost out, can encourage excessively risky behavior in the future. However, such concerns carry rather less weight when talking about bailing out the poorest in the wake of the current crisis. It was not their risky behavior that precipitated the crisis, though (without effective public action) they may well end up carrying a significant share of the welfare impact, including beyond the crisis. More fundamentally, uninsured risk spills over into production and investment decisions of poor people in ways that can severely impede longer-term prospects of escaping poverty. (This is not a new point; indeed, the idea has roots in the writings of classical political economists such as Adam Smith and Turgot.[17]) Lack of insurance for the poor is arguably a more important reason for persistent poverty than too much insurance. (I return to this point.)

Tradeoffs will be faced in formulating policy responses to a crisis, but arguably they are found one or more levels below these "big tradeoffs" that have been so prominent in policy discussions. Governmental budget constraints will loom large, forcing hard choices and creating a pressing need for cost effective interventions. The choices made in program design reflect important tradeoffs, such as between current and future poverty. The rest of this paper points to some relevant lessons from past research that might help guide public action.

## Objectives for social policy in a crisis

The special role of the safety net in this context is insurance for those who are relatively uninsured. It should not be assumed that the poorest are uninsured. Even poor people are engaged in self-insurance, both on their own, and in groups, such as through village-based risk-sharing. That is no excuse for inaction. The covariate nature of the shock creates less scope for co-insurance (relative to idiosyncratic shocks) and mutual insurance arrangements may well break down when faced with a large external shock. For example, research on the impact of the 1995 "Peso crisis" in Mexico (resulting in a 9% decline in GDP in that year) revealed that many of the normal coping strategies of poor households (such as seeking credit, extra work or private transfers) failed during this large macro shock.[18] Also, even the best means available to poor

[17] See Emma Rothschild, "Social Security and Laissez Faire in Eighteenth-Century Political Economy," *Population and Development Review*, 1995, 21(4), pp. 711-744.
[18] See David McKenzie, "How do Households Cope with Aggregate Shocks? Evidence from the Mexican Peso Crisis," *World Development* 2003, 31(7), pp. 1179-99.

people for self-insurance are often quite inefficient and costly. For example, outmoded agricultural technologies persist because they are less risky and credit is scarce. Similarly, credit-constrained households need to hold unproductive liquid wealth, such as high foodgrain stocks.[19] Poor families must pull their kids out of school to provide labor when there is an income shortfall. As long as one is averse to risk, one will be willing to incur a cost of insuring against it; but that cost can often be very high for poor people.

A key issue for policy is whether the costs of credit and insurance for the poor can be reduced, to allow gains to those currently insured, and broader coverage. There are almost certainly unexploited opportunities for pooling risks in developing countries. It is sometimes argued that public safety nets should avoid displacing indigenous arrangements for risk-sharing and smoothing. That is the wrong way to think about it. If the existing arrangements are more costly than a publicly-provided alternative then displacement is a good thing.

Making sure that a safety net program provides effective insurance also helps assure its sustainability beyond the crisis; since there is always some degree of idiosyncratic risk, the potential set of beneficiaries is much larger than the actual set of participants at any one date.

If it is to provide effective insurance, it is crucial that the safety net responds flexibly to the needs of the poor, and not rely heavily on administrative discretion. When we look at the "safety nets" found in practice, few appear to serve this insurance function well since they do not have the flexibility needed to adapt to changing circumstances. Relief transfers, workfare and credit are too often rationed amongst those in need, and hence provide unreliable insurance. Nor is the rationing necessarily targeted to those in need. Unless the public safety net is genuinely state-contingent it cannot help much in reducing the costs of insurance facing the poor. However, flexibility may come into tension with other goals in the fight against poverty, such as when strict but relatively rigid eligibility criteria for cash transfer programs help reduce leakage to the non-poor or when absorbing large amounts of labor in a relief work program means that the assets created are of less lasting value.

In discussions of safety-net reform, much attention is often given to the problem of how to concentrate benefits on poor people, and avoid "leakage" to the non-poor, i.e., how to achieve

[19] On how poor households respond to risk, and evidence from rural China, see Jyotsna Jalan and Martin Ravallion, "Behavioral Responses to Risk in Rural China," *Journal of Development Economics*, 66, 2001, pp.23-49.

better "targeting." The attraction of targeting lies in the fact that the aggregate "poverty gap" (sum of distances below the poverty line) is often rather small. For example, the poverty gap for the developing world using the $1.25 a day poverty line—the average poverty line of the poorest 15 countries—is less than 1% of the GDP of the developing world.[20] And it is one third of one percent of global GDP. If one could only fill those gaps exactly, it seems that poverty would be eliminated at modest cost.

However, it is far from clear what is so "perfect" about "perfect targeting." Importantly, its incentive effects would discourage longer-term poverty reduction. Indeed, in its purest form, perfect targeting based on actual incomes creates a poverty trap in that recipients face a 100% marginal tax rate, which is clearly a disincentive against taking any effort to escape poverty by one's own initiative. The final cost of bailing out the poorest could then be very high indeed; the policy itself would have created a large part of the poverty problem it was designed to address.

This may be a moot point in practice, given that the information constraints are often so severe. Perfect targeting—filling all poverty gaps exactly—requires a means test based on accurate income information. And to provide effective insurance the information needs to be updated regularly. And the information problems are compounded in a crisis, in which it is hard to know where the short-term impacts are greatest.

There can be little doubt that some of the policies that are implemented in the name of "social protection"—such as the generalized food and fuel subsidies (or any subsidy to a normal good) that are still found in a number of developing countries—do not have an incidence that favors the poor, and that there are potential gains from better targeting. However, it should not be forgotten that poverty reduction is the objective of a safety net, not finer targeting *per se*. Empirical research has confirmed theoretical arguments that finer targeting is not necessarily consistent with a greater impact on poverty, and may even have perverse effects, such as when fine targeting undermines political support for the program.[21] Sustainability depends on having broad political support, which can be at odds with fine targeting. Also coverage of the poor is often weak in finely targeted programs.[22] Avoiding leakage to the non-poor often requires that

[20] See Shaohua Chen and Martin Ravallion, *op cit.*
[21] On this point see the discussion in Jonah Gelbach and Lant Pritchett, "Indicator Targeting in a Political Economy: Leakier can be Better. *Journal of Policy Reform* 2000, 4, pp. 113–45.
[22] As argued by Giovanni Cornia and Frances Stewart, "Two Errors of Targeting," in D. van de Walle and K. Nead (eds) *Public Spending and the Poor*, Johns Hopkins University Press for the World Bank, 1995.

help is severely rationed even amongst those in obvious need. Furthermore, better targeted programs are not necessarily more cost-effective. A recent study of a large transfer program in China found that standard measures of targeting performance (including those widely used by the Bank) are uninformative, or even deceptive, about the impacts on poverty, and cost-effectiveness in reducing poverty.[23] In program design and evaluation, it is better to focus directly on the program's outcomes for poor people than to rely on prevailing measures of targeting.

It must also be acknowledged that conventional assessments of "targeting performance" typically rely on rather narrow definitions of household "consumption" or "income," based on survey data. While they may accord well with how an economist would define these concepts given the available data, it is quite possible that policy makers have a different and broader concept in mind, reflecting (say) living standards over a longer time period or the assets held by the household. The program's apparent "mis-targeting" could simply reflect the fact that the survey-based measure of "income" is not a sufficient statistic for deciding who is really "poor".[24]

While better targeting can sometimes help, it is not the objective. Yet policy-oriented discussions continue to make the mistake of assuming that more targeting is always better.

## To protect the poorest, start by doing less damage during the crisis

Those countries facing fiscal adjustment will probably need to re-deploy their public spending. That does not come automatically; indeed, there is evidence from some settings that it is the types of spending that benefit non-poor people that are most protected at such times—with the brunt of fiscal adjustment born by the poor.[25] While macroeconomic adjustment programs often emphasize the need to protect social spending from cuts, and to protect pro-poor spending in particular, the reality is often very different. A study for Argentina found that social spending was not protected historically.[26] The study also found that a relatively well-protected share of the

[23] See Martin Ravallion, "How Relevant is Targeting to the Success of an Antipoverty Program?" *World Bank Research Observer*, forthcoming.
[24] For further discussion, and a robustness test, see Martin Ravallion, "Miss-Targeted, or Miss-Measured?" *Economics Letters*, 2008, 100, pp: 9-12.
[25] See Martin Ravallion, "Who is Protected from Budget Cuts?" *Journal of Policy Reform* 2004, 7(2), pp.109-22.
[26] Martin Ravallion, "Are the Poor Protected from Budget Cuts? Evidence for Argentina" *Journal of Applied Economics* May 2002, 5, pp. 95-121

benefits from the country's main anti-poverty program went to the non-poor. This appears to be a political economy constraint. Research for Peru found that public spending on health contracted sharply during the crisis in the late 1980s, and this appears to have been part of the explanation for the sharp rise in infant mortality during the crisis.[27]

Research on past crises has also revealed that the shift in public spending needed to compensate poor losers need not be large. In a study of Russia's financial crisis of 1998, it was found that safety net spending had contracted (along with other components of spending), but that a seemingly modest expansion in total outlays on the safety net—less than would have been needed to restore aggregate outlays to their level two years earlier—would have been sufficient to avoid the immediate increase in income poverty.[28] However, countries experiencing larger shocks than Russia's will naturally require larger adjustments to the composition of spending.

Social spending decisions have become increasingly decentralized within developing countries. Local resource constraints appear to be playing a more important role, with corresponding concerns about inadequate spending in poor areas. In this setting, achieving more pro-poor and countercyclical spending on safety nets will probably call for greater flexibility and geographic targeting of federal spending during the crisis. This can be thought of as a form of insurance, and there have been cases in which central governments have used explicit insurance triggers to fund local programs. For example, under the FONDEN program in Mexico, the federal government essentially acts as an insurance provider for local governments, thus pooling risk.[29] (FONDEN deals mainly with repairs to infrastructure stemming from natural disasters.) This can work well when the shocks are confined to specific areas (though covariate within those areas); many natural disasters fall into this category. Dealing with an economy wide crisis is clearly a rather different matter, though the likely heterogeneity in impacts of such a crisis suggests that there may still be scope for geographically targeted responses.

In practice, a common problem is the lack of reliable information on what components of spending are most important to the poor. The incidence of the benefits from public spending can

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[27] See Christina Paxson and Norbert Schady, "Child Health and the 1988-92 Economic Crisis in Peru," *World Bank Economic Review*, 2005, 19(2), pp. 203-223.

[28] See Lokshin and Ravallion, *op cit*.

[29] For a discussion of this program see Jerry Skees, Panos Varangis, Donal Larson and Pual Siegel, "Can Financial Markets be Tapped to Help Cope with Weather Risks," Policy Research Working Paper 2812, World Bank. For an overview of the issues that arise in financing counter-cyclical safety net programs see Harold Alderman and Trina Haque, "Countercyclical Safety Nets for the Poor and Vulnerable," *Food Policy* 2006, 31, pp. 372-383.

be difficult to assess rigorously, although governments and citizens often have (strong) priors, which may well contain information but still need to be tested against data.[30] The case of assigned programs (in which some individual units participate and some do not) is somewhat easier than economy-wide programs, although even for assigned programs one cannot assess incidence without knowing impact, which requires a sound method for assessing the counterfactual of what the participant's income (or other relevant outcome indicator) would have been in the absence of the program.[31] An important part of crisis preparedness is having made the investments in data and evaluative research (both quantitative and qualitative) that are needed to have a reasonable idea of which public programs will need to be protected at a time of crisis; naturally that investment brings benefits for policy making at normal times.

Policy mistakes can stem from poor information about program performance. Ten years ago it was rare to have good survey-based evidence on who participates in specific programs and the impacts on poverty. Thankfully that has changed, though there is still much to be learnt.

## Options for social policy reform

If an adequate safety net exists then of course it should be supported for protecting the poor in the crisis. If does not exist then a crisis may well create the political space for creating it. Crises have given birth to some of the worst "social protection" policies, as well as some of the best. Governments have sometimes been drawn into introducing generalized food and fuel subsidies that have come at a huge fiscal and economic cost, and are not easily reversed, yet have had at best modest impact on poverty. However, some of the best safety net programs also emerged from crises, going back (at least) to the famine relief programs created in India in the late nineteenth century. Some developing countries have been able to turn a crisis into an opportunity for dismantling inefficient subsidies in favor of more effective safety net programs. For example, during the Tequila financial crisis of 1994, the Government of Mexico realized that it lacked an effective safety net for the country's poor, which led to the famous *PROGRESA* program (which I return to).

[30] For a review of the problems see Dominique van de Walle, "Assessing the Welfare Impacts of Public Spending," *World Development*, 1998, 26(3), pp. 365-379.
[31] On the methods available see Martin Ravallion, "Evaluating Anti-Poverty Programs," in *Handbook of Development Economics Volume 4*, edited by Paul Schultz and John Strauss, Amsterdam: North-Holland, 2008.

The starting point for many developing countries will be a weak safety net, with limited potential for protecting the poor from an economy-wide crisis. There will also be limited information concerning the likely profile of welfare impacts, though an effort should still be made to anticipate the types of households and places that will be most vulnerable, using the best available data and analytic tools available. Crises have often also presented opportunities for setting up better information systems for monitoring progress and for future preparedness.

In thinking about reform options let us start with the simplest possible scheme. A "poll transfer" provides a fixed cash transfer to every person, whether poor or not. (This is sometimes called a "basic income" scheme.) It would have a better incidence than an *ad valorem* subsidy tied to consumption of normal goods. Indeed, a poll transfer can actually be more cost effective in reducing poverty than even a well-targeted scheme with high administrative costs and other deadweight losses (such as income foregone or other costs in complying with the conditionalities imposed on a more sophisticated transfer scheme).[32] A basic income also preserves incentives to work. The administrative cost would probably be low, though certainly not zero given that in some low income countries, some form of personal registration system would be needed to avoid "double dipping" and to assure that larger households receive proportionately more. However, in poor countries that are severely affected by the crisis, a poll transfer could be very costly, depending on the benefit level.

The cost can probably be reduced by a sensible degree of targeting, though this requires careful consideration of the costs and benefits of each option in specific settings. There is now much experience to draw on. Readily measurable proxies for poverty are widely used for targeting. Geographic targeting has been common. Other indicators have also been used such as family size and housing conditions.[33] This can be thought of a "proxy means test" in which transfers are allocated on the basis of a score for each household that can be interpreted as predicted income or consumption, based on readily observed indicators. Depending on how it is

[32] On this point see Dominique van de Walle, "Targeting Revisited," *World Bank Research Observer*, 1998, 13(2): 231-48. For evidence on a specific program see Martin Ravallion and Gaurav Datt, 1995, "Is Targeting Through a Work Requirement Efficient? Some Evidence for Rural India," in Dominique van de Walle and Kimberly Nead (eds) *Public Spending and the Poor: Theory and Evidence*, Baltimore: Johns Hopkins University Press.
[33] For an overview of the methods found in practice, with derails on many examples, see Margaret Grosh, Carlo del Ninno, Emil Tesliuc and Azedine Ouerghi, *For Protection and Promotion: The Design and Implementation of Effective Safety Nets*, World Bank, Washington DC, 2008.

designed, this type of scheme can have better incentive effects than perfect means testing and have a higher impact on poverty for a given outlay than a poll transfer.

A recently popular version of this type of scheme requires the children of the recipient family to demonstrate adequate school attendance (and health care in some versions). These are called Conditional Cash Transfer (CCT) programs; the conditions are sometimes called "co-responsibilities." Early influential examples were the *Food-for-Education Program* in Bangladesh, Mexico's *PROGRESA* program (now called *Oportunidades*) and *Bolsa Escola* in Brazil. Clearly, if one was concerned solely with current income gains to participating households then one would not impose school attendance requirements, which entail a cost on poor families by incentivizing them to withdraw children or teenagers from the labor force, thus reducing the (net) income gain to the poor. Such programs are aiming to strike a balance between reducing current poverty and reducing future poverty. Given credit market failures, the incentive effect on labor supply of the program (often seen as an adverse outcome of transfers) is now judged to be a benefit—to the extent that a well-targeted transfer allows poor families to keep the kids in school, rather than sending them to work. Notice too that concerns about distribution <u>within</u> households underlie the motivation for such programs; the program's conditions entail that relatively more of the gains accrue to children.  While various economic rationales can be given for imposing conditions on transfers, possibly the main reason in practice is to do with political economy of safety nets: taxpayers and donors are often more supportive and generous when they know that recipients are compelled to do something to help themselves escape poverty in the future.

There is evidence from impact evaluations that these schemes bring non-negligible benefits to poor households, in terms of both current incomes and future incomes, through higher investments in child schooling and health case.[34] Expanding the coverage and increasing the benefit levels on CCTs has been one response to crises, particularly in Latin America.[35] For example, Mexico was able to help redress the adverse welfare impacts of the recent rise in food prices by implementing a one-time top up payment to *Oportunidades* participants.

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[34] On these programs see the forthcoming World Bank Policy Research Report, *Conditional Cash Transfers for Attacking Present and Future Poverty.* Also see the discussion in Jishnu Das, Quy-Toan Do and Berk Ozler, "A Welfare Analysis of Conditional Cash Transfer Schemes," *World Bank Research Observer*, 2004.
[35] See World Bank, *Conditional Cash Transfers for Attacking Present and Future Poverty,* Policy Research Report, Development Economics Research Group, The World Bank, forthcoming.

There has been some evaluative research on specific programs introduced during past crises. One example studied a CCT program in Indonesia, the *Jaring Pengamanan Sosial,* and found that it appreciably reduced school drop out rates amongst beneficiaries during the 1998 financial crisis; the program had greatest impact at the lower secondary school level where children are most susceptible to dropping out.[36] Another example studied Argentina's main social policy response, *Plan Jefes y Jefas,* to the severe economic crisis facing the country in 2002-3.[37] The program aimed to provide direct income support for families with dependents for whom the head had become unemployed due to the crisis. The program reduced aggregate unemployment, though it attracted as many people into the workforce from inactivity as it did people who would have been otherwise unemployed. While there was substantial leakage to formally ineligible families, and incomplete coverage of those eligible, the program did partially compensate many losers from the crisis and reduced extreme poverty. Another study examined the response of Russia's public safety net to the 1998 financial crisis. The response of the public safety net helped reduce the impact of that crisis. It was estimated that the incidence of income poverty would have been two percentage points higher without the changes in the safety net.[38]

A common drawback of targeted cash transfer schemes in practice is that they tend to be relatively unresponsive to changes in the need for assistance. A previously ineligible household that is hit by (say) unemployment of the main breadwinner may not find it easy to get help from such schemes. Efforts should be made to re-assess eligibility in the wake of a crisis.

One way to assure that the safety net provides effective insurance—a genuine "safety net"—is to build in design features that only encourage those in need of help to seek out the program <u>and</u> encourage them to drop out of it when help is no longer needed given better options in the rest of the economy. The beauty of this approach is that it elegantly solves the severe information problem of targeting in a crisis (or even in normal times).

Subsidies on the consumption of inferior goods (for which demand falls as incomes rise) are self-targeted to the poor. The problem is that not many goods are inferior, although there have been cases in which this was feasible. Tunisia was able to make its food subsidies more

[36] See Lisa Cameron, "Did Social Safety Net Scholarships Reduce Drop-Out Rates during the Indonesian Economic Crisis?" Policy Research Working Paper 2800, World Bank, 2002.
[37] See Emanuela Galasso and Martin Ravallion, "Social Protection in a Crisis: Argentina's *Plan Jefes y Jefas",* *World BankEconomic Review,* 2004, 18(3), pp: 367-399.
[38] See Lokshin and Ravallion op cit.

cost-effective in reducing poverty by switching to inferior food items, combined with quality differentiation through packaging.[39] Subsidizing inputs to production by traditional farmers in developing countries can also embody a degree of self-targeting, since farmers tend to be poorer than average, though the benefits may well be higher amongst the relatively better-off farmers.

The classic example of self-targeting is a "workfare" program (variously called "relief work" or "public works" programs; "food for work" programs also fall under this heading). Workfare has been widely used in crises and by countries at all stages of development. Famously, workfare programs were a key element of the New Deal introduced by US President Franklin D. Roosevelt in 1933 in response to the Great Depression. They were also a key element of the Famine Codes introduced in British India around 1880 and have continued to play an important role to this day in the sub-continent. Relief work programs have helped in responding to, and preventing, famines in Sub-Saharan Africa.[40] During the East Asian financial crisis of the late 1990s, both Indonesia and Korea introduced large workfare programs, as did Mexico in the 1995 "Peso crisis," Peru during its recession of 1998-2001 and Argentina in the 2002 financial crisis.[41]

Workfare programs can be responsive to differences in need—both between people at one date and over time for a given person—provided the program is designed and implemented well. Public spending on labor-intensive public works projects, such as building rural roads, can combine the benefits of an aggregate fiscal stimulus with those of income support for poor groups. The essential idea is that those seeking relief must work to obtain support, and the work is used to help affected areas rebuild after the disaster, or to develop badly needed public works.

A famous example is the *Employment Guarantee Scheme* (EGS) in Maharashtra, India, which started in the early 1970s.[42] This aims to assure income support in rural areas by providing unskilled manual labor at low wages to anyone who wants it. The scheme is financed domestically, largely from taxes on the relatively well-off segments of Maharashtra's urban

[39] See Harold Alderman and Kathy Lindert, "The Potential and Limitations of Self-Targeted Food Subsidies," *World Bank Research Observer*, 1998, 13(2) 213-29.
[40] On the India's Famine Codes see Jean Drèze, "Famine Prevention in India," in Jean Drèze and Amartya Sen, *The Political Economy of Hunger*, Oxford: Oxford University Press, 1990. On the role of the schemes in famine relief in Africa Joachim von Braun, , T. Teklu and Patrick Webb. *Famines in Africa: Causes, Mitigation Prevention.* Washington D.C.: International Food Policy Research Institute, 1994.
[41] See Grosh et al., op cit, Appendix B4 for a compendium of the programs found in these and other countries.
[42] See John Echeverri-Gent, "Guaranteed Employment in an India State," *Asian Survey* 1988, 28(12), pp. 1294-1310. Also see the discussion in Jean Drèze and Amartya Sen, *Hunger and Public Action*, Clarendon Press: Oxford.

populations. The employment guarantee is a novel feature of the EGS, which helps support the insurance function, and also helps empower poor people. In 2004, India introduced an ambitious national version of this scheme under the *National Rural Employment Guarantee Act* (NREGA).[43] This promises to provide up to 100 days of unskilled manual labor per family per year, at the statutory minimum wage rate for agricultural labor, to anyone who wants it in rural India. The scheme was rolled out in phases and now has national coverage.

Research on these programs has indicated that sizeable income gains to participants, net of their foregone incomes from any work they have to give up to join the program. One study of Maharashtra's EGS found that the foregone income was about one quarter of the wage rate; by re-allocating work within the household, poor rural families were able to come close to maximizing the net income gain.[44] Research on Argentina's *Trabajar* program suggested larger foregone income for participants, around half of their earnings.[45] Another study of the same program found that the income losses to those who left the program were sizable, representing about three-quarters of the gross wage on the program within the first six months, though falling to slightly less than one-half over 12 months.[46]

There is less evidence on the benefits to the poor from the assets created, and this can be important to whether or not they dominate cash transfer schemes in terms of their impact on poverty for a given budget outlay. An *ex ante* assessment of the scheme proposed under India's NREGA suggested that unless the assets created are of sufficient value to the poor the scheme would be unlikely to dominate even a poll transfer in terms of its poverty impact.[47] It appears likely that the schemes found in practice have given too little weight to asset creation.

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[43] Ministry of Rural Development, Government of India, *National Rural Employment Guarantee Act*, 2004.
[44] See Gaurav Datt and Martin Ravallion, "Transfer Benefits from Public Works Employment" *Economic Journal*, 104, November 1994, pp. 1346-1369.
[45] See Jyotsna Jalan and Martin Ravallion, "Estimating the Benefit Incidence of an Anti-Poverty Program by Propensity-Score Matching", *Journal of Business and Economic Statistics*, 2003, 21(1), pp. 19-30.
[46] See Martin Ravallion, Emanuela Galasso, Teodoro Lazo and Ernesto Philipp "What Can Ex-participants Reveal about a Program's Impact?", *Journal of Human Resources*, 2005, 40, pp. 208-230.
[47] See Rinku Murgai and Martin Ravallion, "Employment Guarantee in Rural India: What Would it Cost and How Much Would it Reduce Poverty?", *Economic and Political Weekly*, July 30, 2005, pp. 3450-3455.

## The ideal safety net

A comprehensive safety net will almost certainly require a combination of transfers (in cash or food) and relief work. The latter helps the working poor while a complementary set of transfers in cash or food can be targeted to specific groups who either cannot work (due to physical incapacity, including poor nutritional status) or should not be taken out of other activities (notably school) to join relief work. The experience of the (generally successful) CCT programs in developing countries points to some key design features, including a sensible degree of targeting and focusing the co-responsibilities of participating parents on the most critical points in their decision making about their children; for example, in many developing countries a critical point will be the decision to enter secondary school on graduating primary school.

Given its ability to respond rapidly to help those in greatest need of income support, a relief work program is likely to remain a key component of the crisis response. But here the design features are especially important. Drawing on the experience of some of the more successful workfare programs, some guidelines can be offered.

An ideal workfare scheme would guarantee low wage work on community-initiated projects.[48] The low wage rate assures that the scheme is "self-targeted" in that the non-poor will rarely want to participate. The federal or state government announces that it is willing to finance up to (say) 15 days a month of work on community projects for any adult at a wage rate no higher than the market wage rate for unskilled manual labor in a normal year. The work is available to any adult at any time, crisis or not. This would extend the coverage of the public works schemes often found in current relief efforts to include normal times at which demand would be much lower, but almost certainly not zero. It would also relax the eligibility restrictions often found on relief work. It would rely very little on administrative discretion in access to the program (either in turning it on and off, or determining who gets help.) As long as the guarantee is credible it will also help reduce the longer-term costs of risk facing the poor, as discussed above. Thus it can help in fighting chronic poverty as well as transient poverty in a crisis.

The work provided should only be on technically feasible projects, though the work may well be more labor-intensive in its production methods than is normal in the setting. This may

[48] For further discussion of the issues discussed here see Martin Ravallion, "Appraising Workfare," *World Bank Research Observer*, 1999, 14(1), pp. 31-48.

entail a tradeoff between the objectives of reducing current poverty versus future poverty. The right choice will de[end on the setting.[49]

The work should ideally be proposed by bona fide community groups in poor areas, to help assure that the relief effort is responsive to the needs of local communities and that the assets created are of value to the poor. The local community group would propose a specific project, documenting what exactly will be done, at what cost, and how many workers will be employed under the safety net program. The workers need not come from the same community (to allow flexibility, and help respond to idiosyncratic risk). The proposals would be sent to a central agency to assess if they qualify under the rules of the program, with full public disclosure. The center should only contribute to the non-wage costs if the community putting up the proposal is a designated poor area, as indicated by a credible "poverty map;"[50] non-poor areas should finance their own non-wage costs. The center should provide assistance to communities to both set up community groups and in designing projects. If the project is in a poor areas then the center can also help in securing any extra funding needed for non-wage costs beyond that available through the safety net program; this might come from other public programs or the private sector. The projects can include training in basic literacy and numeracy skills for adults, together with appropriate specialized knowledge, such as drought-avoidance lessons for farmers. The wage rate for training should be set somewhat lower than other work.

Argentina's *Trabajar* program illustrates the potential for a new wave of workfare programs that emphasize asset creation in poor communities. The program's design gave explicit incentives (through the *ex ante* project selection process) for targeting the work to poor areas, again compensating for the market failures that help create poor areas in the first place. There is typically much useful work to do in poor neighborhoods—work that would probably not get financed otherwise. Similarly to CCT programs, this type of program aims to combine an impact on current poverty consistent with longer-term poverty reduction through asset creation. Local community groups (non-governmental community councils) should maintain a shelf of useful projects in poor areas. With wide public knowledge of the existence of a federal employment guarantee on community work, and the permanent councils ready with a shelf of such projects,

[49] See Ravallion *ibid*.

[50] Such poverty maps are becoming common, or can be produced by the government's statistics office, with technical assistance if required.

the basis for a rapid response would be generated from the bottom up, rather than relying on administrative discretion from the top down.

Setting the wage rate is a key to success of all such schemes. A relatively low wage rate assures that the work reaches those in need, and as many as possible, and a low wage also protects incentives to take up regular work when available. Against these advantages, a low wage rate naturally means less of a gain to participants, many of whom may be in great need. Taking account of this tradeoff, a wage rate on a par with the going wge for unskilled agricultural labor is probably a good benchmark in most countries. This may well be lower than the statutory minimum wage rate, which is often set above market wage rates, and is thus not binding on the market, given weak enforcement.

When the crisis is over, the safety net will no longer be needed for the majority of workers and (provided the wage rate is not set too high) they will automatically return to regular work. However, when the wage rate for relief work is too high or the assets created are of too little value then a cash transfer program is probably a better option. There is evidence of considerable rationing of employment in Maharashtra’s EGS in the wake of a sizeable increase in the EGS wage rate, above market wage rates for agricultural labor.[51]

The budget allocation to such a scheme must be sufficient to assure that anyone who wants work at that wage rate and is signed up to a viable community works project will get the work. The attraction of a workfare program as insurance will be lost if the work must be rationed.

When the workfare scheme is well-designed, a rapid expansion of demand for relief work is a good signal that other transfers need to kick in as well, targeted to specific groups who either cannot work, or should not be taken out of other activities (notably school) to join relief work.

## After the crisis

The social protection response to a crisis should aim to compensate the poorest losers while promoting their longer-term recovery. Past evaluative research points to policy options worth considering—including policies that are feasible in poor countries.

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[51] See Martin Ravallion, Gaurav Datt and Shubham Chaudhuri, "Does Maharashtra's 'Employment Guarantee Scheme' Guarantee Employment? Effects of the 1988 Wage Increase" *Economic Development and Cultural Change*, 1993, 41, pp. 251-275.

However, even a highly successful effort to protect the living standards of the world's poorest from the global crisis will leave a reality in which poor people face multiple risks on a daily basis, well after this crisis. If the crisis does create the opportunity for building an effective safety net then it should become permanent, dealing simultaneously with crises and the more routine problems of transient poverty in normal years. It will be an integral part of the country's poverty-reduction strategy, recognizing that the impact of a shock is intimately connected to deeper problems of underdevelopment: credit and insurance market failures, underinvestment in local public goods, and weak institutions. The synergies between safety net interventions and longer-term poverty reduction can be reinforced by explicit deign features, such as incentives to encourage the children of poor families to stay in school or emphasis on building assets of value to poor communities.

The budgetary cost of such a permanent safety net need not be very high and it could well bring longer-term efficiency gains to the economy. The budgetary outlay could well be highly variable over time in risk-prone settings, entailing some fiscal stress. There will no doubt be relatively low frequency events, such as the current global financial crisis, for which extra external aid will be needed, and certainly justified on moral grounds when it was the rich countries of the world that were largely responsible for the crisis. However, the domestic resources should be sufficient to cover a normal sequence of shocks as well as modest demand in normal years.