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Social dimensions of macroeconomic policy

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Introduction

The social agenda is long-term in nature, in the sense that poverty alleviation along with a better distribution of income, wealth and opportunities are long-term goals. A sound macroeconomic policy, on the other hand, has to do largely with the consistent management of short-term policy instruments pursuing a sustainable and predictable pace for aggregate economic variables and major prices (wages, inflation, interest rates and exchange rates). In spite of the different arena and rationale in which they play, there are strong links between the two. First and most obvious, macroeconomic adjustment and structural reform are more likely to be sustainable when they are equitable. Second, social intervention —i.e., policies, programmes and reforms aimed at improving social performance in the long run—, needs stable funding which is not always available in view of macroeconomic constraints. Third, macroeconomic instability —especially episodes of recession or hyperinflation— increases poverty and inequality, while restoring macroeconomic equilibrium does not restore previous social balances. Finally, there is no unique macroeconomic policy mix to tackle a given situation, and the policy options may not be neutral from a social standpoint.

Monetary, fiscal and exchange rate policies, together with structural reform, have major consequences for the social wellbeing of societies, not only in terms of protection against shocks and crises but also in terms of equity. Many, if not all, of the necessary social policies are of a domestic nature. This report thus concentrates on domestic strategies aimed at maximizing the linkages between consistent macroeconomic policies and social progress. Pursuing them, however, depends to a considerable extent on the international enabling environment in which the global financial system, the unsettled debt crisis and increasing ODA flows play a significant role.[1]

Countries operate in a world economy where market players everywhere immediately scrutinize domestic monetary, financial or fiscal policy decisions and the performance of exchange rate regimes of individual countries. Under these conditions, the room for manoeuvre of policymakers has become considerably constrained. Consequently, it is becoming increasingly complex to incorporate the social dimensions into such policy decisions, to the extent that external analysts consider that authorities are sacrificing sound macroeconomic policies. The main message of the report is that the expediency of short-term economic efficiency as embedded in much of the advice on macroeconomic stability needs to be tempered by long-term development objectives.

The report starts with a short historical background which describes the ascendancy of macroeconomic policies over social development policies (chapter I). It continues with an evaluation of the relation between macroeconomic consistency and social effort (chapter II), and the importance of sustainable and stable growth for social progress (chapter III). The report then turns to the need for an equity-enhancing growth strategy (chapter IV) and an analysis of the priorities of social policies in an integrated approach to growth (chapter V). The final chapter adds some final institutional remarks.

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[1] This report does not specifically address this international enabling environment but rather takes its cue from the other EC-ESA reports referred to earlier.

I. Historical background

From the mid-1940s to the early 1970s, a period of considerable stability and rapid growth prevailed. This period was based on the new international economic order initiated in 1944, in Bretton Woods. A combination of fixed exchange rates and low levels of voluntary international financial flows generated a significant autonomy of national monetary and fiscal policies, which was widely used to pursue counter-cyclical macroeconomic policies in order to maintain full employment of labour and capital. Also, national institutions such as the "welfare State" in industrial countries and a "developmentalist State" in developing countries, became entrenched and attempted to assure social protection and shared growth.

The cumulative disequilibrium of some developed economies led to a rupture of this system in the early 1970s, triggered by the abandonment of fixed exchange rates by the major currencies. The new floating regime accelerated the development of an international private capital market, initially fueled by the surge of "eurodollars", and, soon thereafter by the recycling of "petrodollars". The transmission mechanisms of macroeconomic policy changed substantially since, as interest rate arbitrage became a dominant driving force for financial flows, the targeting of domestic interest rates became more difficult. The resulting shift in monetary policies coincided with a move towards a rising autonomy of the Central Banks with respect to Governments. Also, the change in the macroeconomic implications of fiscal policy allowed more expansionary policies, apparently with no short-term costs. In the United States, in particular, this process continued in the late 1970s with the simultaneous appearance of fiscal and current account deficits, along with the adoption of monetary targets in the design of monetary policies. The immediate outcome was a significant rise in interest rates and a strong appreciation of the dollar with respect to all other currencies. From a more structural standpoint, this profound change in the macroeconomic environment coincided with a shift in the role of the State *vis à vis* market structures in developed market economies.

The disciplining factors for macroeconomic policy design in developing economies of the previous era also exhibited a substantial change. Necessary adjustments in fiscal and external accounts could now be postponed more easily, as foreign financing was readily available. The counterpart, in many parts of the developing world, was a non-sustainable pace for foreign debt during the 1970s, with mounting fiscal and/or current account deficits. This process came to a halt when interest rate increases in the United States and the appreciation of the dollar restricted continued borrowing and triggered the debt crisis of the 1980s. In most cases the resulting recession was accompanied by extremely high and variable inflation.

The appearance of evident imbalances in industrialized countries, along with the highly unstable scenario of most of the developing world, increased the priority given to price stability as a main policy target. In the early 1980s it became widely accepted among government officials in the industrialized countries as well as among other members of the international financial community that the level of world demand would have to be held down by contractionary monetary and fiscal policies. The earlier policy objectives were set aside by the conviction that unless measures were taken to eliminate internal and external imbalances, severe unemployment would be unavoidable in any case. This being the assumption, a long period of “wringing inflation out of the system” was seen as the way of rebuilding a sound and growing economy and hence of restoring a high level of employment. The need for an aggressive anti-inflation effort was partly based on the premise that price instability was very costly to reverse. Even if maintaining low unemployment were valued more highly than maintaining low inflation, steps would still have to be taken to keep inflation from increasing today in order to avoid having to induce large recessions to bring the inflation rate down later on.

This view was based on the fairly broad consensus that the apparent trade-off between moderate inflation and employment in the short run is weaker in the longer run. This means that when the authority tries to take advantage of such a trade-off in the short-run, the most likely outcome is that inflation rises in a more persistent way, while gains in the rate of unemployment may not be sustained. To this extent, economists tend to agree that there is no systematic trade-off between moderate inflation and unemployment. Moreover, there may be long-term positive relationships between low inflation and growth as evidenced, first, in the fact that episodes of hyperinflation coincide with periods of economic and social distress, and, second, that moving to low inflation in a credible and sustained way, by extending the time horizon of economic agents, enhances investment and growth. Nonetheless, low inflation, important as it is, is far from being a complete measure of macroeconomic consistency. Many economies that experienced severe crisis during the 1990s showed, on the eve of their respective recessions, low and decreasing rates of inflation, while exhibiting other symptoms of overheating such as mounting current account deficits, exchange rate misalignments and an increasing dependency on net financial inflows. Also, although there may be no systematic trade-off between moderate inflation and unemployment, in the presence of unanticipated shocks such a trade-off does exist. When inflationary targets carry too much weight in the policy mix may concentrate the burden of volatility and unanticipated shocks on output and employment.

The move towards price stability required a strong fiscal policy adjustment, which could have been tackled either by cutting expenditures, by raising taxes, or by both. The political mood, however, was to adjust expenses and to reduce the size of the State. The concomitant budgetary cutbacks —including social services— occurred not only in the industrial world but also in many developing countries, in particular in Africa and Latin America, as part of the stabilization and adjustment measures to cope with the foreign debt crisis. These innovations in the macroeconomic policy mix were coupled with structural reforms, where privatization of public firms —and, to some extent, the administration of public goods— was prioritized along with stronger integration into the world economy. In some extreme cases of hyperinflation, new exchange rate arrangements were also introduced.

In dealing with these fiscal cutbacks, different concepts related to reforming social policy were introduced: (a) targeting of social programmes; (b) decentralization of the provision of social goods and services, and (c) the participation of the private sector in the administration and delivery of social programmes. These recommendations were based on the need to improve the management of social policy, and to reduce leakages that challenged the efficacy of social efforts. A recommendation favoring safety net programmes was also initiated during the 1980s, and re-emphasized during the 1990s. These were based mainly on two assumptions: first, that the problems to be dealt with were non-permanent, with a timing dependent on the macroeconomic adjustment and the structural transformation processes, and second, that safety nets would be needed to cover part of the transition costs.

It is difficult to question the validity of the arguments behind this view. In a context of economic adjustment, the scarcity of public funding is especially acute and improving the cost-effectiveness of social policy becomes particularly relevant. However, both the timing and the magnitude of these social efforts seem to have been inadequate when evaluating the actual outcome a decade later: in several developing countries, the per capita levels of social service funding still remain below the levels attained in the 1970s. Both quality and, to a lesser extent, coverage have not improved at the predicted pace, and, in some countries, the already inadequate social infrastructure in areas such as health and education has further deteriorated. A main conclusion for future efforts is that, notwithstanding the benefits of improving the efficiency of social policy, a higher political weight should be given to the consequences of reducing the financing of the social effort of government action.

II. Macroeconomic consistency is a component of social effort

Do these developments reflect a contradiction between pursuing macroeconomic consistency and improving social performance? There are a number of reasons for a strong negative response to that question.

First, for public policy —including social policy— to be effective and sustainable, comprehensive consistency among the different targets of authorities is needed. The absence of such consistency has precisely been a major cause for painful adjustments in policy design, as was the case in the 1980s.

Second, there is a consensus that macroeconomic instability is harmful for both growth and equity, and that a sound macroeconomic environment is a necessary condition for a successful social policy. In particular, episodes of instability disproportionately affect vulnerable groups in the short run, and, as mentioned before, economic recovery rarely brings back poverty and equity to their pre-adjustment levels. That is to say, instability generates a sort of hysteresis on poverty and equity. In addition, it also acts as a deterrent for the determinants of growth, since they affect the process of savings and investment and, thus, reduce long run growth and the potential for productive job creation.

Consistency and stability are necessary conditions for tackling structural goals, including improvements in the distribution of income and opportunities. Usually, when short-term economic stability is in place, the policy agenda is more likely to be long-term in nature.

Contrariwise, during episodes of recession, unemployment, accelerating inflation and/or domestic and external payments crises, the long-term agenda is wiped off, while regaining control of the economic situation becomes the sole and most urgent target for concentrating policy actions.

A context of stability and policy consistency increases the degree of predictability and expands the time horizon in decision-making for individuals, firms and authorities, in the same way as instability and inconsistency reduce the degrees of predictability and promote short-term speculative actions and short-sighted survival strategies. Given their structural nature, poverty reduction and equity enhancement require a context of macroeconomic consistency and stability.

These positive links between macroeconomic consistency and social performance must, nonetheless, be adequately interpreted. First and most important, stability and consistency are necessary but not sufficient conditions for better social performance. In general, they are necessary conditions for any set of structural goals, which may not necessarily have a straightforward social content. For example, it may be the case that the ultimate and prioritized structural target of the authority is purely and simply to reduce the size of the State and expand the scope of the private sector, even at the expense of sacrificing social policy efforts. Then, the rival of social policy is not macroeconomic stability and consistency, but the prioritization of long-run objectives.

Second, low inflation and balanced fiscal accounts are components of stability and consistency, but they are not synonymous. This is an important consideration, since most of the macroeconomic effort has concentrated on these two aspects. Among other examples, Mexico and the Southeast Asian economies, on the eve of their respective crises of the 1990s, exhibited fiscal balances or surpluses and low inflation rates, along with exchange rate misalignments and unsustainable current account deficits. In a few cases, also with inflation and fiscal policy under strict control, the main problem was the high weight of short-term liabilities in the term structure of the external debt. It is interesting to notice that in most of these cases fiscal surpluses coexisted with an excess of domestic expenditure, reflected in the current account imbalances, implying that significant private sector deficits were present. If the governments had used the slack provided by their public sector surpluses to fund additional social programmes, the overall macroeconomic imbalances would have been even worse. In this sense, there is a sort of crowding-out effect of excess of private expenditure on fiscal policy. In other words, in the absence of fiscal disequilibrium, mounting current account deficits are the counterpart of both private sector deficits and massive net capital inflows (allied, in some cases, with less than acceptable regulation of domestic financial markets). Under these conditions, the abrupt halt of external financing ignited painful adjustment processes, with negative consequences for most vulnerable groups. Thus, appropriate crisis prevention efforts must be introduced in the future, especially since the recent evidence shows that controlling inflation and fiscal imbalances is not sufficient to prevent crises.

A relevant implication is the need to strengthen domestic financial markets by proper prudential regulation and oversight, to benefit from sound and flexible financial intermediation. Such prudential regulation arises from the recognition of systemic risks that are not internalized by any specific private agent, and has become a key issue on the agenda of the new international financial architecture. Financial globalization is an irreversible process that provides additional sources of funding for development, but it has also shown that new components of systemic risks may arise. There are, however, no prudential regulation or crisis prevention safeguards related to international financial flows that are widely accepted by the international community. Or, put more straightforwardly, there are no conventional ways to keep international capital flows at manageable levels during periods of financial euphoria.

The volatile nature of external financing also has more subtle social consequences. External financing in emerging markets is usually available to larger and best risk-rated firms. During expansionary periods, this allows the domestic banking sector to expand other credits such as lending to medium- and small-scale firms, housing and consumption. As long as this process is prudent and well regulated, there are obvious welfare-improving effects. However, international crises cause large domestic firms to return to their national financial markets, crowding-out medium- and small-scale firms and households from the banking system through increased credit costs and widening of domestic interest spreads. This process can be especially painful for those small- and medium-scale firms that had expanded their liabilities in the previous phase, and that need to reconcile their debt services under prohibitive new conditions in a context of declining sales. Since this is a labour-intensive sector, the social consequences of financial volatility are evident.

It seems that the availability of external financing during boom periods relaxes the expenditure discipline of governments and the private sector. But, even if they adhere to Government discipline —including new institutional arrangements that provide larger degrees of accountability for a time span beyond a single fiscal year—, economic authorities do not have sufficient degrees of freedom to address the lack of private-sector expenditure discipline. Reducing fiscal expenditure could counteract the private spending boom, and it is advisable to do so until a prudent fiscal balance is attained. But should governments refrain from spending once a desirable fiscal balance is in place? That is not necessarily an optimal outcome, nor is it growth-enhancing. There are obvious welfare benefits in efficient government spending and, especially, government social investment can be as growth-enhancing as the accumulation of physical capital. To try to increase the domestic cost of credit to reduce private spending is partly self-defeating if there is interest arbitrage that allows agents to shift to external financing. To that extent, prudential safeguards aimed at limiting external financial flows during expansion periods should be considered.

Macroeconomics still owes the world a systematized and common view on how to prevent new sources of systemic risks that emerged with financial globalization.

The constraint that macroeconomic consistency does impose on social policies is that these need sustainable funding through time, and should operate in such a way that they do not deter savings and investment decisions or job creation. Thus, prudent management of scarce fiscal resources imposes an inevitable condition on the quality and efficacy of social policies. Every dollar of expenditure on public health or education that does not fulfill its purpose is a waste that negatively affects an otherwise desirable target. Also, the availability of fiscal resources places limits on the velocity at which new social programmes may be consistently implemented.

In another chapter we discuss the need to increase government efforts to finance social expenditure. However, no matter how intensive this effort, resources will always be scarce. To that extent, an important contribution that social policy can make to the task of the macroeconomic authorities is to be strict and disciplined in terms of the cost-benefit analysis of social programmes. This is valid both for the allocation of additional resources and for the continuous evaluation of existing programmes, which sometimes tend to survive beyond their optimal time span. In fact, improving the productivity of public expenditures is a task that goes far beyond social policies, and should also cover fields such as defence, public administration and any other public programme.

All in all, prioritizing social targets and equity enhancing is sustainable over time as long as there is no inconsistent behaviour that may trigger episodes of instability. Otherwise, a certain degree of voluntarism will sooner or later become painfully evident.

III. Sustained and stable growth is an important component of social success

Although sustained growth and equity are structural targets for policy design, both may be negatively affected by short-run policy mismanagement. Also, they share a need for macroeconomic consistency for both targets to be tackled successfully.

However, most of the determinants of growth and equity are long-term in nature, and in this arena they also have common elements. Labour income is the main source of revenue for the poor. To that extent, human capital accumulation, job creation and improvement of the quality of employment are key issues for sustainable poverty alleviation. All these ingredients are attainable in a context of dynamic economic growth. In fact, this was the general wisdom a decade ago, when structural reforms were recommended to resume growth after the deceleration of the 1980s in Africa and Latin America, and the transition to market economies was initiated in Eastern Europe.

The structural reforms were aimed mainly at enhancing growth, under the conviction that growth alone could provide the ingredients for social relief. In this sense, the main scope of the reforms were to strengthen market structures, to reduce government intervention and privatize public firms, and to dismantle protectionist practices by opening to international markets. These efforts had to be coupled with short-term macroeconomic efforts to ensure stability, which required major cutbacks in government expenditures in most of the developing world. As mentioned before, the main social effort prescribed by this process was the introduction of reforms aimed at targeting, decentralizing and promoting private sector participation in the administration of social policy, as well as the introduction of social safety nets during the transition period.

The outcome of this process has been mixed. With the notable exception of some Asian countries, growth rates have been disappointing in the developing world. In particular, growth rates in Africa, Eastern Europe, Latin America and the Middle East over the last decade were far below the post-war record up to the mid- or late 1970s. Moreover, several least developed countries and transition economies have per capita GDP levels that are sometimes substantially below those of decade or even two decades ago. In regions and countries experiencing slow growth, the reduction in poverty has been equally disappointing, and in several transition economies poverty levels are higher than they were a decade ago. Although the degree of income inequality varies greatly from region to region, it has increased in many countries, while the opposite trend has been quite uncommon. Inequality is greatest in Latin American and sub-Saharan Africa, but the increase is most striking in the transition economies.

From a different perspective, growth also became more volatile during the 1990s, imposing additional social costs. The Mexican crisis of 1994-1995 and the recent Asian crisis, with all their propagation mechanisms, revealed the presence of underestimated contagion effects and more subtle types of vulnerability. In this respect, macroeconomic policy efforts and structural reforms failed to anticipate and prevent the crisis, with unacceptable and unfair social effects.

Globalization and the wave of technological change —especially in electronics and communications— are posing interesting new challenges in almost all aspects of life. They have opened a world of opportunities to do new things, and to do the same things better. Distances, from an economic perspective, have shortened, and access to markets, though insufficient in “sensitive” sectors of strong interest to developing countries, has widened. In terms of economic growth, the advantages of these processes outweigh the associated costs.

The likely social consequences are not clear, however. The mix of creation and destruction inherent to growth becomes more evident and brutal when based on innovation and globalization, and there are distinct winners and losers. A context of pure economic “Darwinism”, where the strongest, the fittest and the best endowed agents displace the weakest ones may have disastrous social consequences. It may also have disruptive political consequences if the anguish of insecurity provoked by economic change promotes coalitions against globalization, as has been recently observed. On the other hand, rigid structures aimed at protecting against change may eventually discourage change, which would also be counterproductive.

It seems far more promising to take an integral view of this process. The main line of thought in this vein is that growth and equity, if correctly tackled, may reinforce each other. In fact, social efforts should concentrate mainly in supporting an **inclusive growth process**. The best social outcome is one in which all individuals share the benefits but also contribute to economic development. A social policy which seeks to strengthen the weakest, to fit the less adapted, to endow the poorer agents —especially with human capital— and to re-insert the losers as active economic citizens is one that not only contributes to equity, but also to growth. This is all the more true as growth and development is clearly a positive sum game. The attitude should be to see globalization and innovation as an opportunity to attain higher and more equitable levels of prosperity, rather than as a threat to them.

IV. The missing pillar: an equity-enhancing growth strategy

The unsatisfactory social performance of the 1980s and 1990s is the Achilles heel of these decades. Clearly, there is a need for a more integrated approach to economic and social policy, and for a bridging of the gulf which has opened up in recent decades between macroeconomic policy and the social dimension. Macroeconomic and social problems should be viewed in conjunction and economic policy-makers, without weakening the necessary consistency of their decisions, should also concern themselves with the social impact of their policies, especially on poverty. An ethical commitment by societies to generate welfare, reduce poverty, eliminate extreme poverty, and enhance equity and social integration requires persistent actions to reconcile economic growth, employment generation and an active social policy, within a consistent macroeconomic framework. It also requires a stronger commitment by all parties to uphold the norms and principles of human rights and to eliminate the causes of inequality and discrimination in economic and social policies and practices.

Economic development makes sense to the extent that it promotes welfare and social integration. Equity, economic growth and environmental protection should be elements of a single and integral development strategy. However, growth will not reduce poverty and enhance equity instantaneously, and the links are not automatic. The two-way links between growth and income distribution have been the subject of considerable attention over a long period of time. The recent literature has emphasized the positive economic and political links between these variables. Also, the response (elasticity) of poverty to growth depends on the concomitant income distribution. This implies that more equitable societies are characterized by stronger links between poverty reduction and economic growth. Given their central role in human capital formation, social investment policies are essential to reconcile growth and social development.

In the previous chapters we have revised macroeconomic issues related to stability and sustained growth. One of the first elements arising from the analysis is that low inflation and fiscal balance are necessary but not sufficient ingredients of stability. Emphasizing these two components during periods of expansion does not preclude exchange-rate misalignments, external vulnerability and unstable growth, nor does it prevent rising inequality and a deterioration in the quality of employment. During downswings, notwithstanding that necessary adjustments are appropriate and unavoidable, concentrating exclusively on inflation and fiscal balances may needlessly induce and aggravate recessions, with strong effects on labour market conditions —through varying combinations of deterioration in un- and underemployment, and real wages— and poverty.

We also observed that unstable growth has been the norm in most of the developing world in the 1990s, and that macroeconomics has failed to provide an acceptable framework to avoid economic volatility linked to swings in the direction of financial flows. In general, growth during the 1990s was more modest and more volatile than expected.

The evidence of the 1990s confirmed the view that growth, by itself, can reduce poverty, although at a speed that depends on the initial conditions and on the contribution of social policy. The evidence also shows that growth alone does not solve income inequality problems, and that growth-enhancing reforms aimed at improving market structures exhibited a bias towards concentration. Social safety nets, the targeting of social programmes and other innovations in social efforts, although useful, did not fully compensate for the social costs of these reforms.

In fact, the gloomy outcome in terms of equity may be explained by the fact that it has not been a priority in policy design. Or, more explicitly, that macroeconomic authorities, which have also headed structural reforms, have not been as accountable for the social effects of their decisions as they have been for other aspects. In the short run, macroeconomic authorities are accountable for the effects of their policies on economic stability. From a longer-term perspective, they are also accountable for their decisions on investment and growth and, naturally, they tend to focus their attention on those aspects of growth associated with the savings-investment process, especially those related to financial intermediation. As long as growth is necessary to tackle equity, a social agenda for macroeconomic policy should not weaken those concerns. However, growth also depends on the contribution of human capital and technology, among other factors affecting labour and productivity. In this area, there are obvious links between growth and equity in which economic policy has an important role to play. In this respect, the agenda should also consider the introduction of greater accountability for the effects of economic policy on the distribution of income and opportunities, especially when they are related to the accumulation of human capital and employment formation, which are as productive as physical capital.

Obviously, the idea is not to create confusion within the natural division of labour that should be maintained among public authorities. It is not a question of Ministries of Finance and Central Banks replacing or interfering with social ministries. The main point is that macroeconomic authorities are usually responsible for the overall coherence of the economic strategy. To the extent that equity concerns should be part of a coherent strategy, macroeconomic authorities should also be accountable for the social consequences of their decisions.

The original stabilization and structural adjustment programmes had few provisions for dealing with social consequences. Consequently, at the Social Summit a commitment was made to include social development goals in structural adjustment programmes. This commitment was partly based on the conviction that a stable economy cannot be built in an unstable society. To some extent this is what is problematic about a non-integrated structural adjustment strategy. It carries the seeds of its own failure if it creates the type of instability and unrest that are linked to unfairness. Thus, the social dimensions need to be brought explicitly into discussions on structural adjustment and macroeconomic policy design. What needs much more attention in the design of stabilization, reform, adjustment measures or packages is the safeguarding of social and long-term development objectives. Without the social underpinnings, it is difficult for economic development to be sustainable.

One reason for the continuation of poverty is the persistence of inequitable distribution of income and wealth; inequality is reinforcing and self-perpetuating. At the Social Summit three central goals were promulgated: poverty eradication, employment growth and social integration. A necessary condition for the creation of more just and harmonious societies is the strengthening of policies in support of greater economic and social equity. Equity should be understood as the broad-based access to resources, basic protections, voice (empowerment) and participation, based on principles of non-discrimination and universal, inalienable human rights and freedom. For this purpose, the principles of universality, solidarity and efficiency should guide the design of social policy. Deciding how these principles are put into practice is the joint responsibility of national institutions. In addition, the Social Summit brought about a shift toward recognizing the centrality of social development in the political priorities of governments and of organizations that embody the international community.

With these goals in mind, a number of international development targets have been established. The Millennium Declaration indicated, in particular, the decision to: (a) reduce by half in the proportion of people living in extreme poverty by 2015; (b) guarantee universal primary education in all countries by 2015 and the elimination of gender disparity in all levels of education; (c) reduce mortality rates for infants and children under age 5 by two thirds and maternal mortality by three fourths by the same date; (d) halt and reverse the spread of major diseases that afflict humanity, particularly HIV/AIDS and malaria; and (e) achieve by 2020 a significant improvement in the lives of at least 100 million slum dwellers.

The agenda is, undoubtedly, ambitious, and a major effort will be needed to increase ODA flows and international assistance in general, as well as government efficiency in developing countries. It may also be necessary in some cases to increase the overall magnitude of public expenditures and that, in turn, would require sustainable additional financing beyond the proceeds from economic growth. Obviously, as regards the optimal size of the State, a normative approach is impossible, except for extreme cases. Too small a public sector, with no resources to perform its duties efficiently, might reduce growth owing to suboptimal investment in human capital and might not maintain economic stability and social cooperation in a context of democracy and civil liberties. Too large a government, on the other hand, might crowd-out private initiative to the extent of suffocating growth.

Given the current and likely future fiscal situations in many countries, there may be limited scope for additional expenditures relative to the size of the economy. But there would seem to be considerable room for varying the form and content of both overall public expenditure and resource mobilization so as to give a greater weight to equity considerations within the framework of a policy of macroeconomic stability. The expenditure side of the budget offers, in fact, better opportunities than the tax side for redistributing income. Public investment in the human capital of the poor can be an efficient way to reduce income inequality over the long run, while social protection has short- as well as long-term effects on equity. Although increasing the progressivity of the tax structure should also be an objective, countries with extreme tax erosion and revenue inefficiency should rely on simple tax structures aimed at collecting revenues in a politically feasible way. Any regressive effect of such a simple tax system could and should be compensated by well-targeted expenditure programmes. That combination has a better potential for achieving redistributive goals than trying to enhance equity by means of a malfunctioning tax system, precisely because revenue inefficiency is a symptom of non-legislated horizontal and vertical inequity. At a second stage, once revenue efficiency has been achieved and taxpayer discipline enforced, government authorities could and should enhance equity by distributing the tax burden in a broadly progressive way. In the final analysis, what really matters is the net distributive effect of government expenditures and revenues.

V. Social policy priorities in an equity-enhancing growth strategy

Social policy should act on the structural determinants of income distribution and poverty: education, employment, nutrition, wealth distribution and demography, as well as on their associated gender and ethnic dimensions. These factors are the key to breaking the inter-generational transmission of inequality and poverty. Breaking these inter-generational links is the clue to equity. This effort should be carried out through an integrated policy to support the poor. The scope of social policy is multiple. Without detriment to other efforts on the social front, for an equity-enhancing growth strategy emphasis should be put on programmes and policies that affect human capital, employment and social protection.

A. Human capital

The accumulation of human capital is a key component of comprehensive development, since it has a simultaneous impact on equity, poverty reduction, growth and social and political integration. In particular, education in its broadest dimension represents the most important contribution of social policy to growth, and it deserves the highest priority in public policy design, given that it is both a human right in itself and an indispensable means of realizing all human rights. The likelihood of being poor is highest when basic education is incomplete. Education is thus the primary vehicle for lifting marginalized adults and children out of poverty, as well as for enabling them to obtain the means by which they can participate fully in their communities. In this regard, a number of targets should orient public decisions: universal access and coverage of basic education, continuity and permanence of students throughout the basic cycle, the continuous improvement of quality standards, and the promotion of democratic values and social tolerance, among other issues related to social cohesion.

Policy makers should seek to ensure the channeling of enough funding to promote human capital accumulation, especially in education. On average, developed economies channel larger amounts of public resources to education, both in absolute terms and as a proportion of GDP, than less developed economies. To the extent that there is a correlation between present educational disparities and future income disparities, both within and between countries, developing economies should make an effort to increase the contribution of public resources to education. Private spending is also useful and should be encouraged, but its distributive potential is more limited. Within the boundaries of a balanced fiscal budget, the structure of government expenditures is the best proxy of government priorities. The prioritization of education and human capital accumulation should be reflected in an increasing share of government expenditures in education in the budget, with a view to match OECD standards (almost 6% of GDP).

Increasing resources should be coupled with qualitative efforts to improve educational standards. It is essential to guarantee universal coverage for primary and, as much as possible, for pre-school and secondary education. Also, curricula should promote higher standards in formal knowledge —especially language and mathematics—, and should generate permanent learning capabilities that will be useful in an ever-changing environment, including team-work, learning to learn, foreign languages, and computer skills, among others. The emphasis on improving the coverage and quality of education is also a matter of priorities and should not be left aside by fiscal authorities when deciding to implement structural reforms.

A different but no less important dimension of human capital accumulation is that of training programmes. The need for competitiveness in a global economy, along with the rapid development of technological innovation, calls for quick and significant changes in manpower training. Therefore, a large-scale effort should be made to provide individuals with the up-to-date knowledge and skills they need in order to be competitive on the labour market. Again, a combination of social policies aimed at increasing labour productivity in labour-abundant economies seems appropriate to enhance both growth and equity. These training efforts should go beyond merely adapting to the production niches that appear in a context where innovation is the driving force for growth. In a successful and dynamic development context, growth is uneven between sectors and, in spite of good average records, there are activities that lag behind, usually those that are unable to increase their productivity at a suitable pace. These cases of "growing pains" need to be addressed through timely reconversion programmes, training and reinsertion of workers and, in extreme cases, by closing down firms as painlessly as possible. Recognition of the fact that human capital also depreciates, especially when skills are specific to declining sectors, introduces an important additional dimension for re-training programmes. The social component of this effort is evident, and well-designed programmes adopted in a timely way can help legitimize the introduction of greater degrees of flexibility at a minimum social cost.

Formal education and training are the most obvious forms of investment in human capital, but they are not the only ones. Nutrition —especially at the early stages of life, including pregnancy— and access to preventive and curative health are also important components of a strategy aimed at human capital accumulation. In the same vein, investing in water supplies and sanitation and, in general, improving the quality of life in rural and urban areas are other aspects of the integral development of human capital. All these measures are important elements of efforts to improve the prospects for substantial and equitable growth.

B. Employment

Given the crucial role it plays in the growth-distribution link and its ability to reduce poverty and generate social integration, employment deserves special attention. As mentioned before, to the extent that earned income is the main source of revenue for the poor, job creation, human capital accumulation and improvement in the quality of employment are key issues for sustainable poverty alleviation. In rapidly growing developing economies, where job creation is more rapid than population growth, the potential of social investment is higher. On the other hand, the less labour-intensive the growth pattern, the slimmer the chances of reconciling growth and equity in societies with a large labour endowment. A strong demand for labour is thus crucial for reducing poverty and improving income distribution.

Efforts to achieve adequate generation of quality employment so as to guarantee a strong effect of growth on poverty and to avoid adverse distributive effects seem to be one of the weakest links in the current environment. When employment generation is low and skill-biased, the likely outcome is a widening of income gaps between skilled and unskilled workers. Technology trends may be a driving force, but strong competition in traded goods and adverse trends in commodity prices may be associated to low employment generation in traded goods sectors, particularly in commodity-producing countries. Through ratchet effects on employment, instability in growth rates may be an additional complicating factor.

An inadequate generation of quality jobs will defeat efforts in the area of education. The central issue is the adaptability of labour to technical change and the business cycle. Some crucial contributing factors are: strong manpower training schemes; institutions that enhance cooperation, both at the national level (social dialogue) and within firms; adequate social protection, both permanent and for emergencies; and a prudent minimum wage policy. Institutions that facilitate the employment of women also have a significant impact on equity. Flexibility may be an ingredient, if accompanied by greater protection, but it may affect some of the factors mentioned and is certainly no substitute for adequate macroeconomic policies. Indeed, in an unstable macroeconomic environment, additional flexibility may lead to a rapid deterioration in the quality of employment.

The informal sector, which concentrates low levels of productivity, wages, stability and social protection, represents half of the labour force or more in most developing countries and has expanded in crisis-hit countries as the unemployed searched for alternative sources of survival. The switch to informal activities, however, is often made at considerable loss of income. This is partly due to the fact that earnings in the informal sector are usually lower and more volatile than in the modern sector, and partly to the fact that the informal sector is not sheltered by formal protection schemes. As aggregate demand contracts and links are interrupted, the income-generating potential of the informal sector is severely curtailed.

Stable and appropriately funded programmes should therefore be designed to provide informal workers with technical and managerial training and with access to formal financial sources and social protection. In all these issues, the informal sector shares with small and medium-sized firms the need to have access to the opportunities provided by market economies, which is not always spontaneous and automatic. Since the institutional structure may be different for the informal sector than for small-scale formal firms, parallel efforts should be made to integrate both of them to the opportunities provided by more modern activities. Historical examples of successful development of small firms are all based either on their complementarity with large-scale firms or on the alliance of smaller firms in clusters. This is a key area in which growth can be enhanced by increasing the productivity (and income) of otherwise underemployed workers.

In addressing these issues, the promotion of social dialogue is of great importance because the process of policy-making can be as influential as its substance in creating the conditions for the achievement of more and better employment. This entails strengthening procedures and institutions for social dialogue, including specific proposals for strengthening representative employer and worker organizations.

C. Social protection

Improved social security systems and safety nets are also key elements of an integrated approach to eradicating poverty and improving equity. These systems should provide for universal coverage and solidarity and should cover basic risks — particularly health, ageing and unemployment — in an integral way. In countries where the labour force is largely rural or informal, such schemes can only be developed gradually. Moreover, social security systems do not come without costs, as may be noted in many developed countries, particularly as the result of population ageing, changing family structures, increasingly expensive medical care, persistent unemployment and the abuses and disincentives they may generate.

To improve the efficiency of social security systems, a number of countries have embarked on reforms where the administration of these systems has been totally or partially privatized. The benefits in terms of transparency and of avoiding misuse of resources have been evident, but other problems have arisen. In the first place, in most cases administrative costs have been higher than expected. Market discipline does not necessarily work when the services provided by private operators are public or merit goods with compulsory contributions. Secondly, there is an obvious loss of the principle of solidarity which is characteristic of public and merit goods. Thus, the appropriate mix between public-sector and market solutions in the provision of public and merit goods and a sound and equitable system of regulation and subsidies is still on the agenda, and varies certainly from country to country.

The incipient and limited social security systems and social safety nets of crisis-affected countries can do little to shield people against a drastic deterioration of their living standards. Because of the lack of integration, much attention has been focused on providing safety nets in economic and financial crises. The development of affordable and appropriate social safety net institutions is indeed essential to reassure populations that the negative consequences of economic reforms and downswings in activity will not fall disproportionately on them. Such safety nets should be designed on a permanent institutional basis, so as to be able to respond quickly when a crisis strikes. They should not be viewed, however, as a substitute for basic social policy. Their financing during crises should thus not crowd-out spending on human capital or on more permanent schemes of social protection. Moreover, with time, they should evolve into elements of a more permanent social security system.

Nonetheless, the usual way in which the notion of safety nets is applied falls very much in the category of "add-ons" to macroeconomic policies. Thus, social safety nets and targeted transfer programmes are seen as important means of softening the adverse short-term effects of crises and ensuring political support for reforms designed to achieve macroeconomic stability and remove impediments to long-term growth. Such views of social policy as an appendix to macroeconomic policy are inconsistent with the integrated policy framework that should be the basis for well-designed social and economic strategies.

Transfers to the poor that are linked to human capital accumulation (e.g., to school attendance or training) or to increased access to production, as well as emergency employment or labour-intensive public works programmes, are particularly promising. Again, such temporary schemes should not be confused with, nor should they replace long-term programmes to fight structural poverty.

VI. Final remarks

Given the crucial links that exist between economic and social development, an integrated policy framework should be developed. Such a framework should take these links into account, as well as the links between social policies (e.g., the mutually supporting effect of different social policies, through integrated poverty programmes, in particular) and between economic policies (e.g., macro-meso linkages, particularly to facilitate the development of a dynamic small-enterprise sector). One of the main weaknesses in this regard is the lack of appropriate institutions for integrated policy frameworks. Such institutions should include: participation of social actors to speak for the poor, systems to allow for the definition of explicit social targets of public sector policies, effective systems to ensure coordination between economic and social authorities, and rules to enhance the "visibility" of the social effects of economic policy.

With rising inequality, the Social Summit commitment of promoting social integration will become more elusive. Social cohesion and solidarity is a fundamental condition of development and social progress, and efforts to develop and reinforce institutions and mechanisms encouraging social integration must be sustained. A well-educated, healthy, suitably-employed, socially-protected citizenry contributes to the social cohesion of a country and imparts dynamism to all aspects of life and culture. By promoting inclusion and reducing deprivation, social development strengthens democratic institutions and processes, makes social and economic relations more harmonious, and provides a firm foundation for achieving long-term development and prosperity.

There is no single way to implement these efforts, and diversity of national and regional institutional arrangements may not only be inevitable, but desirable, as they adapt to different social structures and feasible political agreements.

Finally, tackling the agenda of the Social Summit requires efforts not only at a national level but also an explicit commitment of the international community, in terms of accepting, promoting and demanding that priority be given to more effective social investment efforts to promote solidarity and equity. In the case of the richest countries, such commitment should also be reflected in the channeling of aid, in accordance with the internationally-agreed target of 0.7% of GDP, and in the opening up of markets to products from developing countries.

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