MDG-Based PRSPs Need More Ambitious Economic Policies

Terry McKinley
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Abstract

This paper identifies implications for economic policies of basing Poverty Reduction Strategies on the ambitious, long-term framework of the Millennium Development Goals. One of its main objectives is to open up the dialogue on the policy content of Poverty Reduction Strategies and promote greater policy choice for national policymakers. With regard to fiscal policies, it argues for an increased emphasis on raising domestic revenue—along with a renewed stress on achieving vertical equity—and financing extensive public investment programmes, which, contrary to obstructing private investment, are essential to raise its productivity. The paper also counters the view that a large influx of Official Development Assistance will necessarily appreciate a country's exchange rate and make its exports less competitive. If countries lack the 'absorptive capacity' to effectively disburse development assistance, the paper claims that resources should be directed, early on, towards developing such public sector capacity. Also, the paper contends that monetary policies should accommodate expansionary, investment-focused fiscal policies and thus be targeted to real variables, such as economic growth, not just inflation. With regard to financial policies, the paper maintains that because of the failures of unfettered liberalization to stimulate growth or reduce poverty, the public sector should provide support to specialized institutions, such as rural banks and development banks, which can promote long-term investment and provide equitable access to financial services. In addition, the paper contends that although privatization has been given unqualified donor support, it has a mixed record, and is particularly unsuccessful in providing equitable and affordable access to essential public services. The paper concludes that if 'Second-Generation' Poverty Reduction Strategies are based on MDGs, they should have economic policies that are less fixated on macroeconomic stabilization and more geared to accelerating growth with equity and promoting long-term human development.

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Introduction

Recent efforts to strategically link PRSPs to MDGs are beginning to dramatically alter international assessments of poverty reduction strategies and pro-poor economic policies. By calling for big increases in external and domestic resources to meet the MDGs, the U.N. Millennium Project has contributed to this re-assessment. It has helped stimulate a new global debate, in particular, on the need for more expansionary public-investment led economic policies (www.unmillenniumproject.org). Meanwhile, a broad range of UNDP regional initiatives in Asia-Pacific and the Arab States and country studies in the Caucasus/Central Asia and Africa are confirming the need for more pro-growth and pro-poor economic policies (www.asiapropoor.net; www.undp.org/poverty/propoor.htm; McKinley 2003).

There is no alternative to ambitious MDG plans: many developing countries desperately need a quantum leap in resources, sustained consistently over a decade or two. Yet PRSP economic policies remain short sighted, obsessed with price stability. Inflation jitters constantly trump policies for growth and development. To reach the MDGs, economic policies have to be bolder and more expansionary. Fiscal policies should be focused on substantially scaling up public investment, financial policies geared to channelling considerably more lending to productive private investment and monetary policies reshaped to target, not just inflation, but also real economic variables, such as increases in incomes and jobs and big reductions in poverty (McKinley 2004a,b,c,d).

Based on comprehensive national assessments of meeting basic human needs, the Millennium Project has called for substantially larger ODA contributions to many developing countries, especially in Africa (Sachs 2004). This necessarily involves making PRSP objectives much more ambitious. Such an injection of funds should rapidly scale up public investment in physical and social infrastructure. But a sizeable share should be targeted, upfront, to enlarging 'absorptive capacity'—i.e., each country's ability to effectively disburse these monies for development purposes (Nebie 2004). Otherwise, national ownership of poverty reduction strategies will be sacrificed in the process. Thus, central to this campaign is a major agenda of national capacity development.

To avoid long-term aid dependence, governments also need to mobilize more domestic resources: boosting revenue or borrowing domestically, if necessary, for public investment. This aspect is too often neglected. Another big priority: reform domestic banks to mobilize more savings (which is in short supply in many countries) and motivate them, through various means, to direct lending to long-term private investment and poverty reduction (Chandrasekhar 2004). Boosting savings and investment is a centrally important long-term development objective (overriding the undue importance attached to keeping inflation low and re-allocating available resources more efficiently).

With more revenue, governments should mount a large-scale public investment programme to spark growth and meet basic MDG-related human needs. The prevailing deficit phobia needs clinical treatment. As long as current revenue covers current expenditures, governments can usefully borrow to finance such investment. This is standard practice for private corporations. Why not for governments? Fiscal deficits should remain sustainable as ensuing growth boosts revenue collection (Weeks and Roy 2004).

The resultant growth of productive capacities will keep inflation moderate—namely, within a 15 per cent rate per year. MDG-compatible monetary policies should avoid afflicting the human pain—big drops in income, jobs and essential public services—required to squeeze inflation, unnecessarily, below five per cent (Epstein 2003 and Chowdhury 2004). Along with more pragmatic inflation targets, Central Banks should adopt real targets consistent with the MDGs, such as halving income poverty and hunger. To do this, Central Banks should support fiscal policies that accelerate real GDP growth and job creation, instead of being obsessed with macroeconomic stabilization.

Blaming a Lack of National Absorptive Capacity: A Lame Excuse for Holding Back Needed Foreign Aid

The U.N. Millennium Project, led by Jeffrey Sachs, has begun "needs assessments" of low-income countries in order to determine the increases in investible resources that they require to reach the Millennium Development Goals (Sachs et al. 2004). The Project has done very rough estimates of the costs involved for Africa, the continent where recent progress has been slowest. For this continent, the sums are not large compared to what the United States spends on military and reconstruction efforts in Afghanistan and Iraq. The rough estimate is $100 per person per year (Sachs 2004). While such an estimate can provide only a rough order of magnitude, it does suggest the scope of the additional effort that is required.

The Millennium Project estimates that mobilizing domestic resources will contribute $40 per person. So external resources have to contribute the other $60 per person. Since ODA already contributes $10 per person in Africa, the remaining requirement is $50 per person. This is a quintupling of present ODA levels.

Other estimates call for smaller increases in ODA (UN 2001, Devarajan et al. 2002). Nevertheless, the magnitude of the costs remains substantial. In stark contrast, the resource demands made by Poverty Reduction Strategies, which are supposed to be the chief vehicle to achieve the MDGs in low-income countries, are much more modest and short-sighted. They plan usually for only three years and end up requesting only for ODA levels that donors are currently willing to provide.

If donors regard PRSP requests for funding as too ambitious, they make sure that these requests quickly become more 'realistic'. But in this case, realism is defined by what the donors are willing to contribute, not by a country's genuine needs for assistance. Focused more on macroeconomic stabilization than growth and development, PRSPs often call for "'belt tightening' for people who cannot afford belts" (Sachs 2004, p. 4).

One of the most common excuses that donors give for not substantially increasing their assistance is that countries lack the "absorptive capacity" to disburse such large new sums of money. In some cases, this is certainly not true: adequate capacities do exist. In many countries, donors contribute to the problem by over-burdening national capacities. Aid management systems are geared to donor requirements, not national priorities and are often run parallel to government structures. As a result, government capacities are weakened, not strengthened. In addition, donors often place multiple, diverse and uncoordinated demands on governments—even when they co-finance the same project. Governments often have difficulty in complying with complicated donor procedures, which, to make matters worse, frequently change, along with donor staff and policies (Nebie 2004).

In those cases where national mechanisms are, in fact, lacking to disburse development funds, the priority for donors should be to rectify this condition, instead of lamely using such a problem as an excuse to hold back funding. Building up absorptive capacity involves increased expenditures, particularly during the early stages, on personnel and governance institutions and increased investments in a foundation of social and physical infrastructure.

Another common donor excuse for holding back aid is that its substantial increase will cause a "Dutch Disease", i.e., an appreciation of a country's exchange rate and a consequent loss of international competitiveness. But the short-run effects of increased aid inflows on a country's exchange rate ignore their potential longer-run effects on expanding an economy's productive capacity.

Donors contribute to macroeconomic problems if their aid is short-term and unpredictable (DfID 2002). This causes volatility in prices and the exchange rate. In the short term, large inflows of aid will tend to appreciate the exchange rate and raise prices, principally by raising demand for non-tradable services and goods. The appreciation of the exchange rate signifies that the prices of non-tradables (e.g., food crops, construction work and public services) rise relative to the prices of tradables (e.g., items that are customarily exported, such as cash crops, and imported, such as machinery). The competitiveness of a country's export sectors might suffer as the costs of their non-tradable inputs rise faster than the prices of their outputs on the world market.

Over the medium term, the effect of aid can be much more positive provided that it is used productively—and the higher level of aid is sustained (DfID 2002). If it is sustained, governments can then afford, in the short term, to 'sterilize' the increased aid inflow by selling some of the additional foreign exchange to the private sector or issuing domestic debt. Both of these measures decrease the money supply (by drawing domestic currency out of the private sector) and thereby relieve upward pressure on prices. However, governments that insist on maintaining inordinately low prices will tend to 'over-sterilize' (draw too much money out of the private sector) and undercut the potential for using aid to finance increased public investment and stimulate more private investment. This is a clear and present danger for those governments wedded to strict 'inflation targeting'.

In the short term, governments should not allow the appreciation of the exchange rate to destabilize the economy. This is likely to happen if the exchange rate is left to 'freely float', namely, left completely subject to market forces. Instead, governments should use the exchange rate as a short-run policy instrument. They should adopt a 'managed float' approach, intervening in the market through the buying and selling of domestic currency in order to provide some measure of short-run stability. This will allow the potentially more positive medium-term effects of ODA to take effect.

Governments could use increases in ODA to lower domestic taxes or domestic debt but neither of these options is likely to have a powerful impact on increasing domestic investment and productivity. Moreover, many low-income countries need to generate much more tax revenue, not less. They also need to build up more effective financial institutions. Even if interest rates were lowered as a result of lowered public debt, the private sector is unlikely to borrow more funds for investment if the supply of credit remains low, or is geared mostly to short-term lending (such as for working capital).

The best use of ODA is to finance public investment, such in physical and social infrastructure or in the restructuring of institutions, such as the banking system, that can galvanize private investment. In economies with under-utilized capacities—a characteristic of most low-income countries—such investment is unlikely to cause more than a moderate increase in inflation. At the same time, a positive supply response is likely to be rapid (because new capacities do not have to be immediately created).

This is likely to be the case for both the non-tradable and tradable sectors. Increased public investment can improve the production of non-tradables, such as providing rural roads to increase food crops in rural areas. This could have a powerful direct impact on poverty. Such investment could also have a longer-term impact on the non-tradable sector through financing education and health. Public investment can also boost the production of exportables, such as through providing a more efficient energy infrastructure for urban manufactures. This could boost export competitiveness and revenues (Adam and Bevan 2003).

While appreciation of the exchange rate might dampen exports in the short term, the productivity effects of public investment can augment exports over the medium and long term. These potential effects imply that if ODA is used for public investment that is targeted to increasing the productivity of labor and capital, the net effect on incomes and human well-being will be notably positive and likely remain so for the long term.

MDG-Based Poverty Reduction Strategies: Home Grown Rather Than Imported

Poverty Reduction Strategy Papers are supposed to be the main vehicle in low-income countries to attain the MDGs. They are also supposed to be 'home-grown', 'nationally owned' strategies. But their economic policies, which are the foundation of poverty-reducing growth, have to be based on conditionalities agreed with the International Monetary Fund and the World Bank. Hence, there is widespread scepticism that these policies are genuinely 'home-grown'. This 'tension' between externally imposed conditionalities and 'national ownership' of PRSPs has been recognized by recent IMF and World Bank evaluations (World Bank 2004a, IMF 2003 and 2004).

Unfortunately, national 'ownership' of such strategies is a donor preoccupation rather than a government objective. Governments are being urged, in effect, to adopt, "as their own," policies introduced by outside agencies—without real policy autonomy in designing home-grown strategies. If there is reluctance to do so, or a lack of enthusiasm in the process, donors should not be surprised.

PRSPs still have to be approved by the Executive Boards of both the IMF and the World Bank. Yet the position of these two institutions and many international donors continues to be—in apparent contradiction—that PRSPs should be nationally driven strategies. Furthermore, the donor community has agreed to align and harmonize its operations with the PRSPs—based on the dubious assumption that they are, indeed, nationally owned.

National empowerment and lender conditionalities are inherently at loggerheads. Part of the problem is that the conditions imposed by international development lending institutions on national policymaking have proliferated (Buira 2003). Conditionalities have spread to cover all important economic decisions and many structural policies, social measures, governance reforms and, last but not least, anti-poverty strategies themselves. Despite recent efforts by the Bretton Woods Institutions to reduce or 'streamline' conditionalities, their predominance still hampers the development of national autonomy.

If PRSPs were genuinely home-grown, they should reflect a diversity of national approaches. However, they are remarkably uniform (Stewart and Wang 2003 and Oxfam 2004). This uniformity is most evident in their macroeconomic policies, which are rarely subject to national dialogue or debate during the period of PRSP formulation (Vos 2004).

The IMF's Poverty Reduction and Growth Facility, which sets most macroeconomic policies for borrowing countries, should be based on the PRSPs. But the reverse is usually the case. Because most PRGFs have been negotiated before PRSPs, they have not benefited from national dialogue and debate, in which various policy options could be evaluated. The PRGF macroeconomic framework has been imported virtually without change into many PRSPs. And national policy autonomy has suffered as a consequence.

Since governments have tailored their policies to satisfy external priorities, it is no wonder that PRSPs exhibit little variation. In recognition of this problem, the World Bank's Operations Evaluation Department has recently recommended that the World Bank should "reduce or eliminate uniform requirements and foster better customisation" of PRSPs to country circumstances (World Bank 2004a, p. xiii). It has also noted the problem of lack of national ownership, maintaining that the World Bank Executive Board's "review of the PRSP appears redundant, as well as attenuating ownership in the eyes of most stakeholders" (World Bank 2004a, p. xvii).

For the same reasons, the IMF evaluation recommends that emphasis be shifted from "the production of documents to the development of sound domestic policy formulation and implementation processes" (IMF 2004, p. 15). Governments have produced standardized documents because they have shared the same motivation, namely, to obtain concessional financing and debt relief. Thus, it is better to strengthen national policymaking capacity than directly tie financing to the approval of documents.

In light of this problem, the international donor community should focus greater efforts on fostering national empowerment in formulating poverty reduction strategies, especially Poverty Reduction Strategy Papers (PRSPs). As impartial, grant-based institutions with close relations to governments and expertise in capacity development, U.N. agencies, particularly UNDP, are well placed to promote national policy autonomy. In campaigning for the MDGs, they promote globally accepted goals. They do not impose prescriptions on how to achieve them.

In fostering participatory discussion and debate on the MDGs and how to 'upscale' PRSPs to reach the 2015 targets, it is important, in particular, to foster national policy choice. This is a critical enabling condition for national policy autonomy. The recent World Bank and IMF evaluations both make this point. The World Bank evaluation states, for example, that the Bank should "encourage PRSPs to explore a wider range of policy options, including those aimed at enhancing growth" (World Bank 2004, p. xiii). The IMF Independent Evaluation Office is more forceful in its assessment: "the PRS process has had limited impact in generating meaningful discussions, outside the narrow official circle, of alternative policy options with respect to the macroeconomic framework and macro-relevant structural reforms" (IMF 2004, p. 7).

Regrettably, the PRSP evaluations of both the World Bank and IMF give little attention to linking PRSPs to MDGs. The current debate on the nature of the PRSPs should clearly centre on how to align their policies with the MDGs. This implies that the PRSPs have to graduate from focusing on short-term stabilization policies to promoting long-term development options based on a dramatic upscaling and deployment of resources, both domestic and external.

Both the World Bank and IMF are beginning to recognize the need to help revamp the nature of PRSPs but they still concentrate unduly on trying to reconcile national concerns about larger and more predictable aid flows with donor concerns about the effective use of such increased aid (i.e., 'absorptive capacity'). But the IMF evaluation does note that "the present 'architecture' of the PRS approach does not provide a clear framework for helping countries and donors decide what is an appropriate medium term resource envelope in which macroeconomic strategy should be derived" (IMF 2004, p. 21). This acknowledgement opens up space for a potentially productive dialogue on the scale of ODA—and domestic resources—necessary to convert the PRSPs into effective strategic vehicles for reaching the Millennium Development Goals. It also opens up the debate on the nature of MDG-consistent macroeconomic strategies.

Low, Unfair Taxes: A Major Roadblock to MDG Progress

Many governments in developing countries will have difficulty in reaching the MDGs because of a lack of revenue to invest in growth and reduce poverty. Strikingly, their central strategies, the PRSPs, remain modestly resourced. Even debt relief has provided, so far, only a modicum of financial relief.

Small government and low taxes are not the answer for reaching the MDGs: governments need to raise more domestic revenue as well as allocate it more effectively. Having the rich pay their fair share of taxes is part of this campaign. Tax systems should be more equitable as well as more efficient. They often put the burden, however, on low-income households and let the rich off the hook with a host of loopholes, exemptions and deductions. The poor should not pay proportionately more taxes than the rich nor should they receive proportionately fewer public benefits. As long as inequitable systems of public finance continue, can PRSPs be successful in uprooting poverty? The answer: only marginally, at best.

The domestic revenue base of most developing countries is too small, not too big. The main problem is the lack of tax revenue. For all developing countries, tax revenue, as a ratio to gross domestic product (GDP), is less than half the level of industrial countries (i.e., 18 per cent versus 38 per cent) (Tanzi and Zee 2001). In poor countries, such as Bangladesh, Guinea, Madagascar, Nepal and Yemen, total tax revenue is only 10-11 per cent of GDP, or less. See Table 1 for data on a few selected countries that illustrate this point.

Table 1. Tax Revenue as a Percentage of GDP

Country	**Tax Revenue as % Of GDP 2002**	**Country**	**Tax Revenue as % Of GDP 2002**
Bangladesh	7.0*	India	9.9
Chad	7.2	Madagascar	11.3
Congo, Rep.	10.5	Nepal	9.6
El Salvador	10.0	Sudan	6.6*
Georgia	10.4	Uganda	10.8
Guinea	11.2*	Yemen	9.3*

Source: *World Development Indicators* 2003, 2004b. Table 5.6. Note: '*' signifies 2001.

A pervasive 'small-government ideology' hides the reality that governments are starved of resources, unable to adequately finance many essential public services. Poor households end up as the main losers. While directing more money to pro-poor expenditures is part of the answer, raising more funds is also critical—but frequently neglected.

Standard tax reforms do not provide the answer. Trade liberalization has significantly reduced trade taxes—a big source of revenue for many poor countries. Their replacement, the Value-Added Tax (VAT) on consumption of goods and services, has failed in many cases to recoup the losses (Weeks and Roy 2004). Part of the reason is the demands that such a tax places on administrative capacity. Also, such a tax is often regressive because the poor consume more of their income than the rich. Hence, even if the tax rate were the same for all, it would deal a heavier blow, relatively, on the consumption of the poor.

If tax reformers place such an emphasis on the VAT, they should put a priority on making it more progressive. At least food or the other essential consumption items that dominate the spending of poor households should be exempted. And higher rates should be imposed on luxury items consumed by the rich. High excise taxes on items such as automobiles and consumer durables could complement the VAT and contribute to a more equitable system. Yet it is difficult to design consumption taxes that are both progressive and effective.

Because of their bigger impact on richer households, direct taxes tend to be more progressive than indirect taxes. However, tax reform remains riveted on indirect consumption taxes and pays little attention to direct taxes. Vertical equity—namely, obliging those with greater ability to pay tax to contribute a larger share of their income or wealth—has become, unfortunately, an archaic principle of taxation. There are obvious political economy reasons for abandoning vertical equity as a guiding principle of taxation. The rich have the political power to push for tax systems that are more favorable to their interests.

One reason that the income and wealth of the rich are under-taxed is the many loopholes that they enjoy. Another is the poor enforcement of tax laws. The IMF Independent Evaluation Office has recently recognized these problems: "stronger and parallel efforts [to the VAT] should be made at improving collections, curtailing discretionary exemptions, and reducing tax evasion—particularly [for] direct taxes (personal and corporate)…" In the same context, it also noted that "efforts by the IMF in this area have not been forceful enough…, particularly if they affect powerful vested interests" (IMF 2003, p. 10).

Another reason for under-taxation of income and wealth is the systematic weakening of vertical equity as an essential component of tax systems. The tax rates for richer households are being significantly lowered relative to those for poorer households—all in the name of being more efficient in generating revenue. Vertical equity is being redefined, perversely, to mean that tax systems should concentrate on *not* making the poor poorer. Making the rich poorer is regarded as an ill-advised, and ultimately futile, exercise (Thirsk 1997). Tax systems have left the rich off the hook because conventional wisdom now regards taxes as an inefficient means to redistribute income. But this opinion is based on the assumption that tax systems should not concentrate on making the rich pay their fair share of taxes—even the share that tax systems mandate that they should pay. Frequently, the main problem is a lack of enforcement.

For the same reasons, taxes on corporate income are in marked decline in many parts of the developing world, despite the fact that they have contributed, on average, more revenue than personal income taxes. In Latin America, for example, corporate income taxes as a share of total tax revenue dropped from 15.1 per cent in 1990-1994 to 12.2 per cent in 1995-1999 (Stotsky and Wolde Mariam 2002).

One indication of the trend towards less vertical equity is the lack of taxation of wealth. In many countries, taxes on property, an immobile and often easily identifiable form of wealth, are a relatively untapped source of revenue, particularly at the level of local government. This is certainly the case for residential and commercial real estate. But little effort is undertaken to register and properly value such property.

The upshot of these trends in taxation is that tax systems are becoming less progressive, not more progressive. This direction undermines progress on the MDGs since rendering tax systems less equitable will nullify the effort to achieve a more equitable, poverty-focused allocation of public expenditures.

A big priority for progressive tax reform is to re-assert vertical equity as a basic principle of taxation. This would involve tilting the composition of taxes away from regressive consumption taxes and towards progressive income and wealth taxes. In industrial countries, the ratio of income to consumption taxes is more than double that of developing countries (Tanzi and Zee 2001). This ratio should be used as a long-term benchmark for reforming tax systems in developing countries.

Up-Scaling Public Investment Will Drive MDG Progress

Public investment is a crucial means to stimulate growth and focus resources on the poor. Such investment is not the enemy of private investment but its prerequisite. Since it is essential for building basic social and physical infrastructure, it is fundamental to achieving substantial progress on the MDGs. When well-designed public investment boosts the productivity of labor and capital, it stimulates more private investment instead of 'crowding it out', as is often mistakenly claimed.

Many developing countries are stuck in slow-growth doldrums. To stimulate growth, they need to implement more expansionary fiscal policies. Increased public investment is crucial, not only because it injects more demand into a stagnant economy but also because it expands an economy's productive capacity.

Private-sector development will stall without public investment. When growth is stagnant, so are profits; and when profits languish, so does private investment—domestic or foreign. But current policies still artificially pit public investment against private investment. The result: a general slowdown in investment.

In all developing countries, the average annual rate of growth of gross capital formation (which includes both public and private investment) slowed from 2.1 per cent during 1980-90 to 1.7 per cent during 1990-2002. In low-income countries, where investment growth is critical to reaching the MDGs, the growth rate slowed from 4.7 per cent to 4.2 per cent. In lower middle-income countries, the rate dropped precipitously from 3.4 per cent to 0.3 per cent (World Bank 2004b).

In developing countries as a whole, private household consumption has been spurring growth. While growth of investment was slowing during 1990-2002, the rate of growth of household consumption was accelerating from 2.9 per cent to 3.7 per cent. But consumption-based growth cannot sustain itself over the long term. Consumption is not an independent factor: it depends on increases in income or borrowing. Inevitably, growth will have to slow. In the meantime, economies remain particularly vulnerable to shocks and setbacks.

Many economists argue against expansionary fiscal policies in developing countries despite their desperate need for public investment. But the same economists do not object when huge tax breaks are lavished on the rich in some developed countries. Unfortunately, the multiplier impact of a tax cut on an economy is, on average, half as powerful as that of an equivalent increase in public expenditure (Henning, Kell and Mahfouz 2002). If the rich get the benefits, the impact is even weaker because of slower growth in aggregate demand. A better alternative: increase public investment and make sure that much of it benefits the poor.

Expansionary fiscal policy can take various forms. It can be consumption-led or investment-led. It can also be public led or private-sector led (Pollin 1998). Governments could use tax reductions to immediately increase private consumption—at least among formal sector workers who pay taxes. However, part of the multiplier impact of this increase can leak out of the economy if the consumption is focused on imports. Certainly, if the rich receive the tax breaks, they are more likely to consume imported luxury items. Also, a consumption-led expansion is more likely to be associated with rising inflation since the supply capacities of the economy are not be expanded in tandem with the expansion of aggregate demand.

Governments could also emphasize stimulating private investment as the primary expansionary factor. However, the policy tools that government can employ to stimulate private investment are relatively weak (Pollin 1998). Monetary authorities can seek to lower short-term interest rates, with the hope that these will bring down the long-term interests rates that influence investment decisions. However, there is little guarantee that long-term rates will be reduced and that even if they were, they would spark private investment. The effects on private investment of tax breaks, such as tax credits or capital gains tax cuts, are also uncertain.

The advantages of using public investment to spur economic expansions outweigh those for using private investment or consumption. The import content of public investment can be influenced. Also, public investment serves to expand the supply capacities of an economy. Furthermore, public investment can be used to focus resources on regions of the country or sectors of the economy where the poor are concentrated. Thus, it can directly serve poverty reduction purposes.

For the above reasons, expanding public investment is preferable to expanding public consumption, even though the latter can also have a multiplier impact on the economy. Public consumption, such as social welfare programmes, can also be directed towards the poor. However, the medium-term multiplier impact of public investment on the economy is stronger than that of public consumption, and is less likely to increase inflation.

Despite the pressing need for more public investment, it remains low where it should be high, namely, in low-income countries with under-supplied public goods. As a percentage of GDP, public investment should be above 5 per cent in most developing countries, but many of them fall short of this threshold. In Peru, this ratio is 2.6 per cent, in Pakistan, it is 2.5 per cent; in India, 1.6; in Cameroon, 1.1 per cent; and in Georgia, a mere 0.4 per cent (World Bank 2000 and 2001). Also, the output elasticity of public capital is likely to be high in many low-income countries, where the stock of capital—such as roads, electrical grids and irrigation works—is low. Such capital is also likely to have a persistent impact on growth through a cumulative effect on raising productivity and sustaining employment.

Although it should be increasing, public investment is declining in many countries. In the South Asia region, for example, capital expenditures were, on average, only nine per cent of total public expenditures in 2002—down from 12 per cent in 1990 (World Bank 2004). In Europe and the CIS, the share of capital expenditures in 2002 had dropped dramatically, also to only nine per cent.

In many countries, there has been a secular decline of public investment since 1980. Table 2 contains data for selected countries on the ratio of public capital expenditures to GDP for 1980, 1990 and 1998. In Indonesia, for example, public capital expenditures as a ratio to GDP dropped from 10.4 per cent in 1980 to 5.7 per cent in 1998. During this same period, this ratio dropped from 12.1 per cent to 5.7 per cent in Jordan and from 16.6 per cent to 6.3 per cent in Sri Lanka.

One recent study of public investment trends in Sub-Saharan Africa (using consistent time series data for 15 countries) indicates that it has been in secular decline since the early 1970s. While public investment as a percentage of GDP ranged between five and six per cent in the 1970s, it had dropped to three to four per cent in 1990-2001 (Weeks 2004). Taking capital depreciation into account would highlight the predicament of many African countries: they are unable to even maintain their infrastructure, much less expand it and use it to stimulate growth.

Table 2. Public Capital Expenditures as a Ratio to GDP (%)

Countries	1980	1990	1998
Burundi	10.9	11.8	3.7
Cameroon	5.2	5.5	1.1*
Guatemala	5.1	--	2.3*
Indonesia	10.4	8.0	5.7
India	1.4	1.8	1.6
Jordan	12.1	5.8	5.7
Kenya	5.9	5.5	3.4
Pakistan	3.1	2.6	2.5
Peru	4.4	1.3	2.6
Philippines	3.4	3.1	2.2
Sri Lanka	16.6	6.1	5.3
Zimbabwe	1.4	2.8	2.1

Sources: *World Development Reports* 1999/2000 and 2000/2001, Table 14. Note: '*' signifies 1997.

The quantity of public investment is not, of course, the only important issue. Its quality is also critical. Large public investment programmes are not, by definition, a productive use of public resources. Rent-seeking is one major problem that affects their efficiency. There are also important design features. If such programmes use capital-intensive methods of production, rely on large contractors or depend heavily on imported materials, then their benefits could be marginal (Griffin 2001). For efficiency as well as equity purposes, public investment projects that are employment-intensive, hire small and medium-sized contractors and use local suppliers of materials could often utilize public resources more optimally. The quality of public investment also includes its impact on poverty. As already indicated, public investment can be critical for focusing resources directly on the poor. China's Great Western Development Strategy is a good recent example of focusing public investment on poor regions.

Also, public investment needs to be more diversified. It is critical not just for basic education and health—on which everyone now agrees—but also for such essential infrastructure as rural roads, energy and irrigation. In most countries, increasing growth cannot benefit the poor without more rural and agricultural development, especially in more remote or backward areas. This is precisely where public investment on critical economic infrastructure is most needed, and most often lacking.

Tight Inflation Targets Hold Back MDG Progress

National policymakers should aim for income stability as well as price stability—employment targeting as well as inflation targeting. Slow growth and low employment hurt the poor more than anyone else. Inflation is certainly not their only problem. Moderate inflation can, in fact, be compatible with growth. But low inflation can be as harmful as high inflation. When low-inflation policies keep the economy mired in stagnation or drive it into recession, the poor lose out, often for years thereafter, as their meager stocks of wealth are wiped out or their human capabilities seriously impaired.

Money is too important to be left to central bankers (as Milton Friedman once stated) (Chowdhury 2004). Without jobs and income, people cannot benefit from price stability. Inflation targets cannot be set independently by technocrats but must be determined through government-wide, democratic decision-making, weighing the importance of price stability vis-à-vis other objectives such as output and employment stability (Epstein 2003). The monetary technocrats can then be left to craft the means to achieve the agreed public objectives.

Most developing countries have been advised to reduce annual inflation to a 3-5 per cent range—a usual requirement for external loans. Also, many national central banks have been given the independence to achieve this monetary goal, despite any adverse consequences for growth, employment and poverty. Apparently, some economic policies are too important to be subject to democratic decision-making.

But there should be more open debate and decision-making about policies of such significance. However, central bank independence—for determining goals as well as methods—is staunchly defended by neoliberal orthodoxy. In fact, one indicator that is used to gauge such independence is the number of times that central bank governors are replaced. According to this perspective, the fewer times that they are replaced, the better (Rogoff 2003). However, this can hardly be considered a hallmark of democratic governance.

In recent years, inflation has declined to its lowest level since the 1960s (Kumar et al. 2003; Rogoff 2003). Over just ten years, global CPI inflation dropped from about 30 per cent to almost four per cent (Table 3). During 2000-2003, yearly CPI inflation was 2.0 per cent in industrial countries and 5.7 per cent in developing countries. In Asia, it had sunk as low as 2.3 per cent. (See Table 4 for further data on individual countries).

Table 3. Global Trends in CPI Inflation (% per year)

Category	1980-84	1985-89	1990-1994	1995-1999	2000-03
World	14.1	15.5	30.4	8.4	4.1
Industrial Countries	8.7	3.9	3.8	2.0	2.0
Developing Countries	31.4	48.0	53.2	13.1	5.7

Source: Rogoff 2003, Table 1.

Until recently, the main problem for one fourth of all countries, especially in Asia, was not inflation but deflation—a sustained drop in the general price level. A major cause has been their slow economic growth, which has driven down prices by dampening the demand for goods and services. By contrast, some orthodox economists laud conservative anti-inflation central banks for contributing decisively to such dramatic disinflation. They also cite globalization and rapid liberalization, which have supposedly helped eliminate domestic monopoly pricing, as additional important factors (Rogoff 2003).

There is no evidence, however, that very low inflation is good for growth. Many studies confirm that moderate inflation—ranging between 5 and 15 per cent annually, if not higher—correlates well with growth (Chowdhury 2004; Bruno and Easterly 1998). The new 'politically correct' justification for minimizing inflation is that it hurts the poor. However, this misreads the facts: very high, destabilizing inflation (above 40 per cent) definitely hurts the poor; and very low inflation (below 5 per cent) can also harm their interests when it impedes growth and employment.

When central banks try to squelch inflation, the economy is often driven into a 'stabilization trap'. Looming on the horizon is deflation, a self-reinforcing downward spiral of prices, profits, output and employment. When deflation sets in, expansionary fiscal policy is definitely the best response because it can have a powerful immediate impact on aggregate demand. It is also the best option for avoiding deflation in the first place.

Table 4. Inflation Rates in Selected Countries
(CPI Yearly Inflation Rate, 2000-2003)

Country	Inflation Rate	Country	Inflation Rate
Algeria	2.5	Maldives	1.0
Armenia	1.4	Morocco	1.8
Azerbaijan	2.2	Niger	2.5
Bolivia	2.4	Oman	-0.1
Burkina Faso	2.6	Panama	0.9
Cambodia	1.6	Peru	2.1
China	0.1	Senegal	2.0
Congo, Rep. Of	1.6	Sierra Leone	0.6
Egypt	2.7	Singapore	0.7
Ethiopia	-1.4	Taiwan Province	0.3
Gabon	1.2	Thailand	1.4
Jordan	1.7	Tunisia	2.8
Lebanon	0.8	Uganda	2.4
Malaysia	1.8	Vietnam	1.4

Source: Rogoff 2003, Table A.1

Many countries have now adopted 'inflation targeting' as their chief macroeconomic policy. This means setting both monetary and fiscal policies to maintain price inflation rates within a target range (often 3-5 per cent per year). According to this perspective, inflation is caused by excessive aggregate demand, not by cost factors. Inflation can also be caused, secondarily, by expectations about its future rate. Hence, by publicly announcing an inflation target, monetary authorities hope to control such expectations. Monetary policy is regarded as the main instrument to control inflation and interest rates (not the money supply) as the main tool of monetary policy.

Even Central Banks that do not exclusively adopt inflation targeting still tend to neglect changes in real variables, such as output and employment. The main reason is that Central Banks are evaluated primarily on their ability to control inflation, not on their ability to maintain output stability or stimulate economic growth (Arestis and Sawyer 2003). The rationale given for such a bias is that politicians tend to favor the growth of employment and income so central bankers should counter-act this tendency by focusing on maintaining low inflation.

Unfortunately, an inflation-targeting approach subordinates fiscal policy to monetary policy. Monetary policy leads and fiscal policy is forced to align itself with the monetary stance, particularly by avoiding fiscal deficits. Monetary policy (i.e., interest rate policy) is postulated to affect only inflation, not any real variables. However, the interest rate can have an effect on investment decisions, particularly if the real rate is very high. Hence, monetary policy can, indeed, affect real variables, such as the capital stock, and thus the long-term rate of growth of an economy. Money is not 'neutral' with respect to the real economy, as the inflation-targeting approach often claims.

Moreover, because this approach constrains the use of fiscal policy, policymakers have little ability to maintain output stability. When inflation is exacerbated by cost factors, such as the rising price of imported oil, inflation-targeting central bankers have only one option: dramatically increase real rates of interest and plunge the economy into a recession.

But drastic disinflation, which is intended to drive down nominal wages and thereby eventually restore employment, usually has the opposite effect (Palley 2004). The fall of output prices caused by a recession amplifies the problem of unemployment as firms, now unable to recover their production costs, cut output even further. This causes wages to fall. Widespread structural reforms that have increased wage flexibility exacerbate this tendency. With unions and labor legislation weakened, workers have little protection from wage losses (and reap smaller benefits from any recovery).

Falling wages also exacerbate the debt burden of workers. Because debtors tend to have lower incomes than creditors, they have a higher propensity to consume. Thus, their loss of income contributes an additional factor that lowers aggregate demand. Increased price and wage flexibility only worsen the downward spiral of aggregate demand. At this point, strong counter-cyclical fiscal policies are necessary to spark a recovery. Even the IMF has begun to recognize the need for counter-cyclical fiscal policies in situations—not uncommon now—in which their fiscal adjustment programmes have proven incapable of stimulating private investment demand (IMF 2003, p. 3).

Linking PRSPs to MDGs has implications not only for macroeconomic policies and public finance but also for structural economic reforms. This paper concludes with sections on two such structural reforms, financial liberalization and privatization. It begins with financial liberalization.

Financial Deregulation Impairs Investment and Poverty Reduction

Unfettered financial deregulation has dampened investment and adversely affected the poor. Contrary to the widespread liberalization mania, the evidence points to the need for greater regulation of the financial sector, including foreign short-term borrowing, in order to promote greater economic stability and more equitable access to financial services

(Chandrasekhar 2004). The IMF now acknowledges that capital account liberalization has exacerbated economic volatility (Prasad et al. 2003). But the record of domestic financial liberalization has also been poor.

Liberalization, both domestic and external, has caused huge setbacks to MDG progress. The financial sector is crucial to mobilizing domestic resources and channeling them to productive investment. If ill-advised economic reforms impair this function, growth will stall and poverty reduction will slow. Instead of addressing problems affecting the entire financial sector, the international donor community has allowed itself to be diverted into focusing on a small segment of it, namely, microfinance.

While the poor still lack systematic access to credit, microfinance alone cannot solve this problem. While poor workers need jobs, the businesses that could employ them cannot get the loans they need to start-up or expand their operations. In addition to backing micro-finance, international donors should encourage public-sector support to rural banking systems and financial institutions serving small and medium-sized enterprises (SMEs). If SMEs in urban centres and rural areas cannot obtain access to credit, the decent-paying jobs needed to reduce poverty will be lacking.

The record of financial liberalization has been, in fact, neither pro-growth nor pro-poor. It has been one of the most disastrous components of the neoliberal reform agenda. One central barometer of its failure has been that in many countries, real interest rates have risen and the spread between the deposit and lending rates has widened. Table 5 provides relevant data on interest rates for selected countries.

Because of rising interest rates, borrowing by firms for productive investment has been seriously impeded. Banks have concentrated their activities in a few urban areas, depriving the rural population of access to financial services. Although aggregate financial 'deepening' looks like it might have improved, access to credit has become more—not less—inequitable. The ill-advised dismantling of development banks, a major source of finance for long-term investment in many developing countries, has likely contributed to these problems.

While national policymakers have been encouraged to focus on microfinance (as the main weapon to combat poverty), they should seek to address more directly the fundamental problems created by unregulated financial institutions. Without state support, for example, rural banking systems often collapse under liberalization. Farmers and non-farm enterprises are denied access to the credit that is crucial to reducing poverty.

Long-term investment is constrained as commercial banks focus more on short-term lending, such as for consumer durables or working capital. The inflow of speculative capital only exacerbates the short-term horizon of investors. Without stronger regulation and support to specialized financial institutions, growth will be neither sustainable nor equitable.

Table 5. Interest Rate Differential and Real Interest Rate

Country	Deposit Rate of Interest 2002	Lending Rate of Interest 2002	Real Interest Rate 2002
Armenia	9.6	21.1	18.5
Bangladesh	8.2	16.0	12.4
Bolivia	9.6	20.6	17.5
Cambodia	2.5	16.2	12.8
Cameroon	5.0	18.0	17.2
CAR	5.0	18.0	16.3
Gabon	5.0	18.0	11.4
Honduras	13.7	22.7	15.5
Kyrgyz Republic	5.9	24.8	22.0
Lao PDR	6.0	29.3	18.4
Mongolia	13.2	28.4	21.1
Nicaragua	7.3	23.2	17.0
Tanzania	3.3	16.4	11.8
Uganda	5.6	19.1	23.1
Zambia	23.3	45.2	21.1

Source: *World Development Indicators* 2004b. Table 5.7

Under liberalization, banks and corporations have resorted more to short-term external borrowing, making the country more vulnerable to short-term capital flight and the havoc that it can wreak in times of crisis. When the economy is booming, 'hot money' rushes in to make a quick profit, but this sows the seeds of financial instability. When the crisis hits, it can rock economies to their foundations. Recent financial crises have caused unprecedented losses for countries. For example, during the Asia Financial Crisis, the cumulative GDP difference between a country's previous trend rate of growth and its actual lower rate during 1999-2002 was huge in several countries. The cumulative GDP shortfall from trend was 27 per cent for the Republic of Korea, 57 per cent for Thailand and 82 per cent for Indonesia (Arestis 2003). Despite these disasters, unfettered financial liberalization continues as a standard conditionality of structural adjustment programmes.

Privatizing Public Services: The Adverse MDG Effects

Privatizing public services runs the danger of undercutting progress towards the MDGs. The mixed development record of privatization casts serious doubts on its choice as the invariably best option for promoting the public interest. However, lender conditionalities invariably promote it, lauding it as though it were a goal of development (Bayliss 2002). Instead, national policymakers should have the latitude to examine a range of policy options, including restructured public-sector provision and public-led partnerships with the private sector, as well as full-scale privatization.

Success in privatizing public-sector enterprises is often due more to a competitive environment and public regulatory capacity than changes in forms of ownership. In key instances, maintaining public ownership and restructuring the public provision of services might be, indeed. the best option. The ultimate test in judging each modality is whether it is the most effective in promoting development goals. The contribution of such structural reforms to advancing progress towards the MDGs is the key litmus test.

The justification for privatizing state-owned enterprises (SOEs) and public services often assumes that private firms are more efficient, provide better-quality services to more people and charge more competitive prices. The evidence on improved efficiency—often cited as the strongest claim for privatization—is mixed, especially if private firms are compared, as they should be, to restructured public firms (Dagdeviren and Fine 2004).

The argument that privatization contributes to better access and quality is even weaker, particularly with regard to the provision of essential public services. In Africa, for example, privatization of public utilities has a sorry record in some cases (Barthelemy et al. 2003). The privatization of water and power, for example, has led to higher, not lower tariffs because of the need for firms to cover large sunk costs. Without proper regulation, these privatized utilities have kept investments low and deprived rural communities and the urban poor of access to electric power and water supply—all in order to maximize their monopoly profits.

This indicates that privatized firms do not necessarily charge competitive prices. The scramble for special government favors ('rent-seeking') still characterizes many privatized enterprises, particularly if they enjoy a monopoly position. 'Corruption' can be just as much a problem (if not more so) in private firms as in public.

One of the main justifications for privatization is that governments will save public money, which they can then supposedly use to promote the public good, particularly poverty reduction. This is a curious, roundabout way of justifying privatization. Part of the reason might be the unstated recognition that privatized firms are not very concerned with providing coverage to the poor.

But even this justification should be viewed critically. The fiscal payoff to privatization may well be exaggerated. The process itself is complex and expensive. The costs (including administrative costs and compensation to employees) often outweigh the benefits (the proceeds from fire-sale prices of public wealth).

While a significant proportion of state-owned enterprises are profit-making, they also often happen to be the first to be sold, with the consequent loss of yearly profit income for the state. Moreover, little is known about the amount of tax revenue that these privatized firms contribute to the state. At the same time, the continuing costs of regulating them can be substantial. Ironically, states supposedly too weak to run effective SOEs are assumed strong enough to regulate these firms when, being privatized, they are more difficult to influence (Kessler 2003). The state continues to bear a much heavier fiscal burden for privatization than initially imagined by neoliberal reformers.

Most importantly, the poor are likely to pay a disproportionately high cost for rapid and poorly designed liberalization. Little research has been conducted on the distributional impact of privatization, particularly on poverty. Privatizing essential public services could, in fact, slow MDG progress unless private firms are heavily subsidized to maintain services for poor customers (see Nixson and Walters 2003 on Mongolia). And if big state subsidies are necessary, what was the point of privatization? Cross subsidies (from rich customers to poor) are standard practice for public firms providing essential services.

Also, SOEs often account for a significant share of formal-sector employment, where decent labor standards prevail. Privatization can lead to both a big drop in formal-sector employment and a weakening of the trade unions that set the national pattern for job protection and pay. In sum, privatization's advantages are likely to have been inflated while its disadvantages have been conveniently under-estimated.

Conclusion

This paper has drawn out the implications for economic policies of basing Poverty Reduction Strategies on the MDG strategic framework. It recognizes some of the weaknesses inherent in an ODA-driven development process but seeks to correct them through a heightened emphasis on domestic resource mobilization and a concerted effort to develop state capacities. In order to advance 'national ownership' of the development agenda, the paper also seeks to spark a broader policy dialogue—based on creating wider policy choice—on the macroeconomic and adjustment policies that govern Poverty Reduction Strategies.

With regard to fiscal policies, it addresses two major themes: 1) the need to significantly augment public revenue in order to finance public services and infrastructure that are essential to underpin progress towards the MDGs and 2) based on increasing both domestic and external financing, the need to dramatically scale up comprehensive public investment programmes.

In arguing for mobilizing more public revenue, the paper emphasizes doing it more equitably—namely, re-asserting vertical equity as a core guiding principle of tax systems. And in stressing the importance of public investment, the paper counters the neoliberal view that such expenditure will 'crowd out' private investment. It argues, on the contrary, that by enhancing the productivity of labour and capital, public investment can stimulate private investment. Moreover, even when a large inflow of ODA finances such public investment, it is possible, the paper contends, to counter-act the tendency of the exchange rate to appreciate and thereby undercut the competitiveness of exports. The solution comes from the expansion of the productive capacities of the economy, especially in the sectors producing tradable goods.

With regard to monetary policies, the paper maintains that in many countries, unnecessarily restrictive inflation targets are hampering growth and employment generation. It argues that any targets for macroeconomic stabilization, such as inflation rates, should be supplemented with targets for real variables, such as real growth in income, increased employment or greater reduction in income poverty. Monetary policies should not dominate national economic policymaking; instead, they should accommodate expansionary, investment-focused fiscal policies.

With regard to financial policies, the paper maintains that rampant deregulation has hindered investment and directly hurt the poor. It claims that real rates of interest have risen in the wake of financial liberalization and dampened lending for productive investment. Since commercial banks have withdrawn from what they regard as unprofitable lending in rural areas, the access to credit has become more inequitable. In order to overcome these adverse developments, the paper maintains that national policymakers should prioritize public-sector support to rural banking systems, specialized financial institutions for SMEs and development banking services for long-term investment.

With regard to privatization, the paper argues that it has had, a best, a mixed development record—one that is, indeed, incommensurate with the unqualified donor support that it has received. The paper claims that privatization does not necessarily have a better track record than public-sector provision in promoting efficiency, quality services, lower prices or broader access. It is not even clear, the paper contends, that the public sector has gained much net income from selling state owned enterprises. The dangers of privatizing public services are particularly pronounced, since universal, affordable access to such services is critical to reaching many of the MDGs.

In sum, the paper contends that the economic policies under-girding 'Second-Generation' PRSPs—namely, PRSPs firmly anchored in an MDG framework—should be less fixated on macroeconomic stabilization and more geared to stimulating rapid growth and long-term human development. Unless economic policies are revamped along these lines, and fully backed up with ample development resources, the prospects for reaching the MDGs will remain remote. And PRSPs will remain short-term, tactical instruments designed primarily to legitimize stabilization measures and set up social safety nets in order to mitigate the inevitable adverse consequences for poverty.

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