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Where to from Here? Generating Capabilities and Creating Opportunities for the Poor

by

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Introduction[1]

Poverty is present in all modern societies. Even in the richest countries in the world, few would disagree that some individuals have unacceptably low living standards.[2] How to address this problem, however, is still unclear. Recently, an old debate has been revived: is the solution to achieve economic growth, or should governments actively pursue poverty reduction policies? There are basically two opposing views. One states that the income of the poor grows one for one with economic growth; therefore, policies that guarantee growth implicitly contribute to poverty reduction, and the justification for additional social policies is unclear.[3] The other view is that the incomes of the poor grow less than one for one with average income.[4] The poor might in fact benefit from growth, but since the effect is rather small, growth alone will take too long to solve the problem? if it does so at all. According to this view, in addition to growth-enhancing policies, the State should actively pursue policies aimed at improving the well-being of the least favored members of society.

Attanasio and Székely (2001) argue that growth alone does not guarantee a solution to the poverty problem, at least in Latin America. Consider the following two examples. Between 1996 and 1998, GDP per capita increased in Mexico by 9.7 percent in real terms, which is a spectacular gain as judged by the country's macroeconomic performance during the previous 16 years. However, poverty hardly declined. In fact, the incomes of the poorest 30 percent of the population contracted during this period. The huge increase in mean income was due entirely to income gains among the richest 30 percent? particularly the richest 10 percent? of the population.[5]

The second example is Chile, which has been characterized as one of the most successful economic growth stories in Latin America for the past decade. Between 1992

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[2] If one uses a definition of poverty of 2-dollars-a-day, the proportion of poor in most developed countries turns out to be very small (around 2% of the total population). But this type of definition, which might be appropriate for developing countries, is meaningless in the context of rich countries. In the developed world, the poverty line is usually relative to the standard of living of each population. These definitions always yield poverty rates well over the absolute poverty levels.

[3] Some examples are Dollar and Kraay (2000), Gallup *et al.* (1999), and Roemer and Gugerty (1997).

[4] See for instance, Bourguignon (2001), Birdsall and De la Torre (2001) and Foster and Székely (2001).

and 1996, Chilean GDP per capita expanded by more than 30 percent in real terms. During the same period, moderate poverty registered a substantial decline from 20 to 16 percent? a reduction of 20 percent in the head count ratio. But income inequality also increased during the period (the Gini index rose by 7 percent). In fact, had the income distribution remained the same as in 1992, the proportion of poor would have actually declined to 10 percent, rather than 16 percent? that is, the poverty rate would have been cut by one half, instead of by 20 percent.[6]

These two examples show that growth by itself does not necessarily guarantee a solution to the poverty problem, and that growth alone may result in much lower poverty reduction, especially if its benefits are concentrated among the better-off sectors of the population. They suggest that growth-enhancing policies should be given high priority, but additionally that poverty reduction should be actively pursued through a wider set of policies.

The objective of Attanasio and Székely (2001), the product of a project sponsored by the Inter-American Development Bank, is to outline a framework for thinking about which policies can lead to substantial poverty reduction. The introductory chapter and the country case studies generate evidence supporting the idea that income is just “the tip of the iceberg.” Once one goes beyond income and looks into what is behind the process of income generation (the asset-based approach), a whole new range of possibilities arises. The purpose of this paper is to discusses the policy implications of the asset-based approach in greater detail.

Before delving into the policy discussion, it is helpful to briefly review the evolution of social policy approaches in Latin America over the past decades. This helps put the asset-based approach into a historical perspective.

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[5] See Székely and Hilgert (2001).

[6] This result is obtained by using the CASEN household survey for 1992, and multiplying all incomes by 1.3 to simulate the growth rate registered between 1992 and 1996. The poverty rate computed after this adjustment can be interpreted as the poverty that would have been observed had the distribution remained unchanged between the two years. Obviously, this is only a simulation for illustration purposes, since there is no guarantee that growth would have been the same under a static distribution.

Evolution of Social Development Strategies in Latin America and the Caribbean

Although the experience with social policy has varied widely from country to country, Latin America's social strategy can be broadly classified into four phases:[7] (i) Import substitution, (ii) the debt crisis of the 1980s, (iii) the structural adjustment packages of the mid to late 1980s, and (iv) the incipient recovery of the 1990s.

The first phase covers the period between the Second World War and the late 1970s. These were the "golden years" of Latin America in terms of economic growth. The industrial sector in most countries was growing vigorously, fueled by the import substitution development strategy that prevailed in those decades. During these years, the urban middle classes were expanding.[8] All kinds of subsidies were granted for industrial production under the belief that industrialization was the best engine for growth.

This first generation of social policies was characterized by the widespread provision of subsidies to goods and services open to the whole population. Its main beneficiaries were the expanding middle classes. Some of these subsidies? like those to food consumption? were justified as an indirect subsidy to industrial sector wages. Since high growth rates financed these widespread subsidies to consumption, there was a virtuous circle: on the one hand, the middle classes contributed to economic growth by joining the industrial sector and migrating from rural areas. On the other, the policies that were introduced to facilitate the import substitution process contributed to improving the standard of living of vast sectors of the population by guaranteeing low prices for basic goods and by supplying subsidized services.

In essence, the social strategy and the wider development strategy were one and the same. And the same was true for the rural sector. In the spirit of the import substitution strategy, rural areas played the key role of providing primary goods and natural resources for industrial production at low prices, as well as low-cost goods for the consumption of the expanding middle class. This implied in many cases subsidizing rural production. But it also implied land redistribution, since high priority was given to

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[7] Obviously, all countries did not follow the same strategy, nor were they exactly synchronized. This characterization is made for purposes of simplifying the discussion.

[8] See, for instance, Székely (1998) for a description of the case of Mexico.

minimizing idle resources and the underutilization of land. Again, social policy was seen as a fundamental part of the overall development strategy.

In spite of the large declines in poverty and inequality that accompanied this development strategy, at some point it proved unsustainable.[9] During the late 1970s and early 1980s, declining international oil prices triggered the debt crisis that pulled Latin America into a deep recession. Thus began the second phase of social development policies.

Under the new macroeconomic constraints of the early 1980s, widespread subsidies to goods and services were simply prohibitive. Governments had to cut all expenditures? especially in social areas, which were not a priority at the time? in order to reduce public deficits. With escalating inflation rates, devaluation, and GDP declines, the policy priority was to stabilize the economy at all costs. It was hoped that once the macroeconomic situation was under control, growth would resume, and with it the expansion of the middle classes and the social development of past decades. People would have to endure some sacrifices in order to return to the "glory days," perhaps at the cost of substantial declines in living standards. The sacrifice, however, would only be temporary and would not discriminate by each person's position in the social ladder. Everybody would have to pay for the "excesses of the good old days."

Consequently, the second phase began by dismantling the previous social development strategy. It coincided with an identity crisis of the State, where it was unclear whether the government's role should go beyond "setting the rules of the game," and perhaps intervening only when markets failed. In this context, widespread subsidies and social policies in general became an obstacle to growth, rather than a powerful engine of development as in the past.

Growth, however, did not resume immediately. Latin America went through a period of economic reform, intense volatility and stagnation that lasted for nearly the entire decade, and this prolonged the population's sacrifice well beyond initial expectations. The previous social strategy of providing widespread subsidies open to the population at large proved to be financially unsustainable. However, signs were

[9] See Londoño and Székely (2000) for evidence on poverty and inequality trends for Latin America during the 1970s.

appearing that the shift to the opposite extreme of dismantling the previous system and minimizing the role of the State could also be unsustainable from the social point of view. Toward the end of the decade there was increasing evidence of growing inequality, and most worrying, of substantial increases in poverty.[10] This marks the end of the second generation of social policies, and the start of the third.

The third phase began with the acknowledgement that structural adjustment programs and economic reform could impose greater burdens on the poor. It was recognized that the poor generally have fewer means of protecting their incomes from unexpected shocks, or from the erosion of liquid assets entailed by high inflation. They were also the most disadvantaged in terms of their chances of engaging in the sectors of activity with higher productivity and higher probability of surviving external competition.

The policy solution was the introduction of compensatory policies through the implementation of *safety nets*. In a set of influential papers, Ravi Kanbur (1985, 1987a, 1987b) started the development of what became the feasible alternative for introducing a safety net: targeting resources to the poor.

The concept of targeting is quite simple. It suggests that when budgets are limited in times of economic hardship, the policy problem is how to allocate scarce means in order to obtain the largest possible poverty reduction per *peso* spent. Since there are administrative costs of finding the people who are most in need, the population is generally classified into subgroups according to some characteristic (geographic location, gender, schooling, etc.). To target specific subgroups it is necessary to have the guidance of poverty maps or poverty profiles, which identify the population with the highest poverty rates and that which is most sensitive (in terms of poverty reduction) to fund allocations. If one finds the subgroups that will generate higher poverty declines per unit of the budget spent, then one should allocate the funds to these units until there are others where the marginal *peso* would produce greater poverty reduction.

This third generation of policies has two important features. The first is that they entail a totally different way of distributing resources. In fact, they entail new "costs," since to find the poor, one has to look for them. So, there has to be a balance between the

[10] One of the documents that best articulate the worries that adjustment programs were causing excessive social distress, is the book by Cornia, Jolly and Stewart (1987).

administrative costs that need to be incurred to find the target population, and the benefits of finding the poor. Under this framework, the policies of the first generation were inducing high "leakage," since many of the non-poor or the not-so-poor were benefiting from resources that should have perhaps been allocated only to the poorest of the poor. Most of the gains from targeting originate precisely in reducing leakage. However, this comes at a cost. Since finding all the poor would be too costly, almost inevitably, some of the poor will be "missed." Thus, the main challenge is to find a balance between administrative costs, leakage, and under-coverage.

The second, and perhaps most important feature, is that there is a deep change in the spirit of social policy. Under the targeting generation, policies aimed at increasing the standard of living of the poor or at protecting them against the unfavorable macroeconomic environment are compensatory, and they have to be small, specific and tightly focused. The development strategy of countries in terms of growth might well be totally disconnected from these social policies. More often than not, social and macro-economic goals in the third generation of social policies were *not* part of an integrated strategy, and they were regarded as having opposite objectives. Perhaps due to the profound scars of the lost decade of the 1980s, the main objective of governments was to keep tight budgetary controls; thus, social programs, although perhaps necessary, were a potential threat to public deficits and to macroeconomic stability. Social policies and a country's growth strategy became two separate things; they were opponents challenging each other for public resources.

The early 1990s mark a shift in the macroeconomic environment in Latin America. On the one hand, the first years of the decade witnessed the recovery of positive economic growth in most countries in the region. Economic performance was far from spectacular—with the sole exception of Chile—but in general governments could afford to start looking beyond the objective of macroeconomic stability. On the other hand, the worldwide trend towards globalization became apparent during the middle of the decade. The economic reforms implemented in the 1980s implied opening up Latin American economies and exposing them to world markets; during the 1990s this was combined with similar trends in other regions of the world. Globalization made it clear that to survive in today's world it is necessary to be competitive.

This change in the economic environment had crucial consequences for social policy, mainly because it implied that if a country wants to be competitive, having large sectors of the population living in poverty could be a strong disadvantage. This is so because those at the end of the social ladder are not usually endowed with means for being "productive" in the terms of the new economic order. For instance, if poor families have limited means to finance the education of their children and large sectors of the population live in poverty, then the country will have limited human capital endowments and may not be able to attract investment in order to finance development. To be competitive, countries must have some natural resources, or human, physical, or other factor endowments that enable them to produce goods and/or services at relatively low cost. Having an army of unskilled workers with low wages does not necessarily do the trick. First of all, workers need to have at least some minimum skills (such as the ability to read or write) and must be physically able to engage in economic activity. Secondly, the awareness of human rights triggered by the access to information in the new economy imposes some restrictions on the use of labor, such as minimum standards in working hours and wages.

These developments were accompanied by a fourth generation of social policies. Programs such as *Progresa* in Mexico, *Bolsa Escola* in Brazil, or *Chile Joven* in Chile[11]? all of which are a centerpiece in the social development strategy of their respective countries? have shifted away from the concept of only having temporary safety nets to compensate the poor. These programs, which are being replicated across the region, have one important element in common: they provide assistance to the poor, but by including strong incentives to the accumulation of human capital. The spirit of

[11] *Progresa* is the Spanish acronym for the Programa de Educacion, Salud y Alimentacion (Education, Health and Nutrition Program). The program provides cash transfers and a nutritional supplement to families in extreme poverty in rural areas. Cash transfers are conditioned on children's school attendance rates of at least 85%, and regular attendance at health clinics for checkups and follow-ups. The cash transfer is given to the mother, who also has to attend a series of talks and courses on health practices. *Bolsa Escola* is a similar program that provides scholarships for disadvantaged children. Part of the cash transfer is held in a special account, which the beneficiary can access after completing a schooling cycle. Chile Joven is also a program of cash transfers, but in this case they are provided to young adults as a training incentive. A detailed description and evaluation of the *Progresa* program can be found at www.ifpri.org/country/mexico.htm. A description of the *Bolsa Escola* program can be found at http://www.mec.gov.br/home/bolsaesc/default.shtm.

these programs is that they help the poor, but they do so by equipping them with the tools that will allow them to help themselves in the new economic environment.

The fourth generation of social policy continues to use targeting mechanisms to allocate resources, but it has two key features that distinguish it from the previous generation. The first is that in some way it aims at attacking the causes of poverty, and not only its consequences (low incomes). If one of the reasons why the poor are poor is because they have scarce human capital, then helping them to improve their human capital endowments by supporting investments in schooling or health (as in the case of Progresa) may improve their situation well beyond the operation of the program. Even if these programs are discontinued in the future, they might improve the standard of living of their beneficiaries for a long time because they improve income-earning capacities permanently.

The second key feature is that these types of programs are not totally disconnected from the overall development strategy, as is the case of traditional targeted safety nets. These new policies can even be viewed as actions that contribute to some extent to economic growth in the long run. For instance, it is normally agreed that education is an important requirement for faster GDP growth, and if these programs contribute to increasing education levels, then in some sense they may be fueling the economic system with resources that are useful for expanding production and competitiveness.[12]

But still, the fourth generation policies are normally viewed as a separate set of programs aimed at specific subgroups of the population that need assistance from the State and that are a cost to the economic system. These programs still have to compete fiercely for public resources and have not been institutionalized in any country so far. In many ways they are still viewed as a necessary cost that society has to pay for compensating the disadvantaged.

Besides, these types of programs also entail some risks. Perhaps the main danger is confusing the implementation of a program of this type with the full social policy strategy of a country. These programs definitely have the capacity to improve the well-being of the poor, but they cannot be regarded as a solution to the poverty problem. For

[12] See Birdsall, Pinckney and Sabot (1998).

instance, they may contribute to improving schooling levels among poor children, but if there are no opportunities to put human capital to work, they might not have the expected impact on the income-earning capacity of individuals. Relying on these programs as the full social strategy of a country is like throwing the poor a lifesaver that may keep them temporarily afloat but doing nothing about the storm that is drowning them.

Where To from Here?

The main limitation of the fourth generation of social policies described above is that programs such as *Progresa* or *Bolsa Escola* do not change the economic environment or the underlying elements in the structure of the economy that are causing poverty. Having low human capital endowments is certainly one of the reasons why the poor have low incomes, but this is not the whole story. The factors generating poverty are "in the system" since they are deeply rooted in the functioning of the economy. If the forces that are generating poverty are not dealt with, these policies will always be swimming against the tide, or will have a much smaller impact than expected.

In the case of Latin America, it seems that poverty is due not so much due to the insufficiency of resources to satisfy each individual's basic needs as to inequalities in the distribution of such resources. Londoño and Székely (2000), for example, estimate that if Latin America had the same income as it actually does, but with the income distribution of any other region of the world, poverty would be cut by at least one half. If Latin America had its same income but with the distribution of Asian countries instead of the Latin American distribution, the poverty rate would be around 10 percent of what it actually is.[13]

If poverty is to a large extent the consequence of high inequality, the natural question to ask is why is there so much inequality. Part of the reason is that individuals are different in many dimensions: schooling, age, gender, regional location, occupation,

[13] Of course, this does not apply to the same extent to all countries. There are cases where GDP per capita is low, and income redistributions would have a lesser impact. In any case, since the average income in all Latin American countries is well above international and country-specific poverty lines, it could be argued that poverty is to a large extent a problem of inequality, and not one of insufficiency of resources. This exercise is only performed for the sake of illustration, since there is no guarantee that if the distribution of resources were to be modified, the level of income would remain the same.

sector of activity, etc. But these characteristics typically explain only about one third of income differentials.[14]

Furthermore, in countries with high inequality, inequalities are reproduced at all levels. Table 1 illustrates this. The table includes the Gini inequality index for household per capita incomes for 19 countries? 17 from Latin America, plus Thailand and Taiwan. The first column presents the index at the national level, while the second column shows the average Gini coefficient obtained from estimating inequality within each of the smallest geographic areas that can be identified in the corresponding household survey. In Argentina, for example, the overall Gini is .493. The average Gini coefficient from all 28 states is .467. The third column presents the standard deviation of the Gini coefficient for each state. The fifth column indicates the smallest geographic area that can be identified in each country, while the last presents the number of geographic units identified.

Table 1.

Inequality in Latin America and East Asia by Geographic Area

Country	Year	Gini Total Population	Average Gini of all Geographic Areas	Std. Dev. Gini of all Geographic Areas	Std. Dev. as a % of Average for Geographic Areas	Geographic Identifyer	Number of Geographic Identifyer
Argentina	1998	0.493	0.467	0.029	6.1	State	28
Bolivia	1999	0.601	0.586	0.049	8.3	State	9
Brazil	1997	0.585	0.569	0.032	5.7	State	27
Chile	1998	0.559	0.536	0.033	6.1	Region	13
Colombia	1999	0.555	0.530	0.032	6.0	State	25
Costa Rica	1998	0.461	0.437	0.022	5.1	Region	7
Ecuador	1998	0.557	0.564	0.015	2.6	Region	3
Guatemala	1998	0.562	0.494	0.076	15.4	Region	8
Honduras	1998	0.585	0.555	0.055	9.9	Region	18
Mexico	1998	0.538	0.488	0.045	9.3	State	33
Nicaragua	1998	0.602	0.546	0.061	11.2	State	17
Panama	1999	0.563	0.533	0.034	6.4	Province	9
Peru	2000	0.569	0.410	0.021	5.1	State	7
Paraguay	1998	0.493	0.508	0.071	14.0	State	16
El Salvador	1998	0.559	0.543	0.045	8.3	Región	5
Uruguay	1998	0.439	0.409	0.026	6.2	State	19
Venezuela	1999	0.467	0.444	0.030	6.7	State	23
Taiwan	1996	0.285	0.262	0.021	7.9	City	45
Thailand	1998	0.516	0.463	0.018	3.8	State	5
Average		0.526	0.492	0.038	7.6		

Source: Author's calculations using household survey data.

[14] See, for instance, Chapter 1 in Attanasio and Székely (2001). The chapter reports a set of Mincer regressions for several countries, which were used to estimate the returns to schooling. In none of the cases reported did the R-square in the regression exceed 27 percent. See also IDB (1998) for comparisons across countries.

There are two interesting features from the table. The first is that there is a very high correlation of .97 between the overall Gini index and the average Gini of the geographic areas within each country. The second is that, on average, the standard deviation of the Gini within each country is only 7.6 percent of the average Gini. The highest standard deviation is for Guatemala, with 15.4 percent, and it is lower than 10 percent in 16 out of 19 countries. This means that in countries with high inequality at the aggregate level, large inequalities are also found in each region, state, municipality or city. In countries such as Brazil, which are among the most unequal in the world, the inequality is reproduced in each of the 27 areas into which the country can be disaggregated. The standard deviation of the Gini by state is not even 6 percent in this country. In contrast, in countries such as Taiwan, which have much lower inequality, low inequalities are also found in each city in the country.

To some extent these inequalities reflect differences in personal characteristics, but typically, around two-thirds remain unexplained after accounting for them. The other two-thirds reflect aspects of the economic environment where individuals live—aspects that are deeply entrenched in the system and reproduced at all levels. The reason why Brazil, Chile, Mexico or Colombia is so unequal is not due to regional differences. In each region or state, very high inequalities are also found. Similarly, the main reason why Taiwan or Uruguay has the lowest inequalities among the countries in the table is *not* that there are low regional differences. Even in each city or state within the country, there are low inequalities.

If inequality, and therefore poverty, in Latin America is deeply entrenched in the economic system, as Table 1 suggests, it is highly unlikely that the poverty problem will be solved unless some fundamental elements of the system are not modified. Again, specific programs such as *Progresa* or *Bolsa Escola* can certainly do much good, but the forces generating inequality will limit their impact.

The Asset-Based Approach: A Fifth Generation of Social Policies?

The main policy implication of the asset-based approach to poverty reduction is that the solution to the poverty problem must go well beyond income. It is necessary to look into the determinants of income to be able to identify those that are prone to change through policy action.[15]

Chapter 1 of Attanasio and Székely (2001) suggests a way to organize the discussion. It states that the income of each individual in society is the product of five elements. First of all it depends on the income-earning assets owned by each household member. Broadly speaking, assets are classified into human, physical, and social capital. Second, it depends on the rate of use of the assets, since assets only generate income when they are put to work in the market. Third, on the production side of the economy, income-earning assets are viewed as factors of production. The extent to which they generate income depends not only on the ownership and the rate of use of the asset, but also on the price paid for factors of production. Depending on the extent to which factors are demanded and supplied, prices can be high or low, and depending on the degree of trade openness of each country, the prices will be set by internal forces or by international markets. The fourth element is the income received independently of income-earning assets. It includes transfers (public or private), gifts, etc. that individuals receive not because they are putting an asset to work, but because of other factors. The safety nets of the third generation of policies would enter into this category. Finally, each person's income depends on the size of the household where the individual lives and on the way in which resources are shared within the household. For simplification purposes it is assumed that household resources are added up and that each individual's access to resources is the same.

From the policy point of view, there is scope for public action on all five fronts, and several examples are given in the chapter. The emphasis here is that the main implication of the asset-based approach is that it leads to a different policy strategy, and to a different way of thinking about social policy than the second, third and fourth generation policies. It means that social policies are not separate from the overall development strategy; on the contrary, they are at the heart of it. On the one hand, their main objective is to improve the standard of living of the poor, but on the other, they can

[15] Poverty is a multi-dimensional concept that includes aspects of culture, freedom, democracy, empowerment and others. To make the concept tractable from a policy point of view, the analysis is restricted to income poverty. As will be seen later, this scheme can be easily adapted to more comprehensive definitions of poverty.

do so in a way that contributes to growth, to increasing the productivity of factors of production, and to improving factor allocation in the economic system.

To simplify the discussion, the items listed above can be reframed into two broad policy categories: (a) the *capabilities* that individuals have to obtain resources (all income-earning assets), and (b) the *opportunities* available for putting income-earning assets to work (including the rate of use and prices). In this scheme, the role of social policy is to generate income-earning *capabilities* and to create *opportunities* for using them productively.[16]

There are four types of capabilities that are clearly prone to policy action: education (formal schooling as a proxy for human capital), health, investment capacity, and housing and basic services.[17] Education can be thought of as a measure of the human capital or skills that an individual can offer in the labor market, or which can be used to create his or her own employment. Health refers to the mental and physical capacity to perform economic activity. Investment capabilities are the own possibilities that individuals have for creating their economic activities through means other than their labor. Housing and basic services are measures of the availability of basic infrastructure to operate in society.

In terms of opportunity, the two clear areas of intervention are employment opportunities and investment opportunities. Employment opportunities refer to the conditions, costs and incentives in the labor market that influence the prices paid for different kinds of labor and the demand for skills. Investment opportunity is given basically by the existence of an efficient financial market that gives access to credit. Credit can be used to create economic activity and to take advantage of the economic environment to generate income.

[16] The concept of capabilities employed here is not exactly the same as that pioneered by Amartya Sen (1985, 1987, 1989). Sen defines capabilities as the ability to achieve. This concept includes what are here called capabilities (income-earning assets in the present scheme), but it also includes the opportunities to put them to work. For the present purpose, the concept of capabilities (income-earning assets) is separated from opportunities to simplify the policy discussion. In Sen's framework, capabilities are a means to attain functioning, or living conditions. In the present scheme, income plays the role of functioning because the definition of poverty is restricted to income poverty.

[17] Social capital is not included here because it is a more elusive concept.

Creating Capabilities

(i) Policies for Human Capital Accumulation

In the case of education, there are at least two clear ways in which public policy can support the accumulation of skills by individuals. On the one hand, to be able to invest in the education of its members, a household has to be able to afford the private costs of schooling. Even when access to public schools is available, households need to finance private costs such as books, clothing, nutrition, and perhaps most importantly for poor households, the opportunity cost of sending their children to school instead of sending them to work. If households lack the means to finance even these basic investments, it is most likely that they will under-invest in human capital. Programs such as *Progresa* or *Bolsa Escola*, which provide direct financial support to households conditioned on investing in the education of their members, are perhaps one of the best policy options on hand to enhance human capital accumulation by the poor. But even these could be complemented with school supplies, meals, and transportation services for students to make the effect stronger.[18]

But on the other hand, to make investment in schooling an attractive option for a household, services of a certain quality have to be available. As discussed in IDB (1996 and 1998), resource allocation in the schooling systems of most Latin American countries is shaped by payment commitments to large bureaucracies, and not by the level and quality of educational results. Higher income families may have the chance to escape to private schools where competition and standards for quality are in effect, but the poor are basically stuck with the public system, and when it is of low quality, differences in human capital are intensified. The government can play a decisive role if it devotes at least part of its efforts to generating information, setting quality standards and assuring that schools receive funds from public resources based on the quality and quantity of the education they provide, instead of focusing only on bureaucratic and budgetary controls.[19]

[18] In the case of the Progresa program, a key issue is that by definition, some of the poorest of the poor do not have access to its benefits because they live in isolated and remote areas where no school or health clinic exists. If the program were accompanied by supply-side efforts, or by support for temporary reallocation (during the school year) or subsidies to transport costs, it could perhaps reach these sectors of society.

[19] This will be even more of a challenge than before for Latin America in the future, as a result of demographic factors. Chapter 1 of Attanasio and Székely (2001) shows that the main bottleneck for the poor appears to be in their low chances of enrolling and going beyond secondary schooling, and IDB

There is also scope for introducing new ways of teaching for the disadvantaged. Education by television is the prime example of an innovative way to reach the poor in remote areas, and it has not yet been exploited to its full potential.[20]

An additional problem is that many of the poor are already beyond school age and will not benefit from improvements in the standard schooling system. They are the ones who dropped out early because their families could not finance the investment any longer, or those who never went through more than a couple of years of schooling due to low quality of public schools and pressing household financial needs. For these individuals training policies may be one of the only ways to reverse the disadvantage they face in the labor market. But here too there are problems of investment capacity, and there are problems of supply of training services since it is normally more costly to train individuals the lower their schooling level. From the investment side, one option could be to create *Progresa*-type programs for training. If one of the reasons why the poor that are beyond school age do not continue their schooling is due to pressure to make ends meet at home, direct incentives in the form of cash transfers conditioned on training might be a feasible option.

On the supply side, the problem is that in Latin America technical education and training programs, and especially those targeted to the poor, became obsolete decades ago (see IDB, 2000). Some countries are beginning to experiment with different organizational approaches to introduce incentives to improve their operation. There are some recent experiences where the private sector has created its own training centers paid by payroll taxes, but the quality of this option is not always good, and these facilities are difficult to monitor. Perhaps the scope for action is in redefining the role of the government as regulator of the system rather than focusing on providing the service. If this is combined with income-support programs, there might be better chances for the poor to acquire the training they would need to increase their income-earning power for the rest of their working life.

(2000) estimates that to meet the demographic challenge of a changing age structure over the next 10 years, the number of teachers in secondary schools will have to increase from 1.8 million to 2.6 million just to keep pace with higher demand.

(ii) Policies for Improving Health

As with schooling, there are two main reasons why the poor usually have more precarious health capabilities than the rich.[21] The first is that they have fewer means for investing in health to at least maintain their income-earning capacity. The second is that they normally lack appropriate health insurance and therefore end up having access only to lower quality public services open to the whole population.

In this case, too, there are two ways of thinking about which public policy could improve the situation. First of all, governments can provide families with direct income support to finance health services. The *Progresa* program is a good example, but even actions of this type fall short of the needs of the poor because they do not normally include support for medication or preventive services for infants. Expanding income support to include these items may have a strong impact on improving, or at least maintaining the precarious income-earning potential of the poor.

On the supply side, governments have usually ignored private health insurance markets by seeking instead to support the poor by building and financing hospitals to provide high-cost treatment directly. The problem is similar to that of public education in the sense that efficiency is low, and in the end it is not clear whether the objective is providing health services or supporting the huge bureaucracies that have grown up around them. As in the case of schooling, perhaps the main challenge is to find ways of creating effective regulatory frameworks that guarantee access of the poor to basic health services. IDB (1996) discusses this thoroughly by acknowledging that resources for spending in the health sector are limited, and that potential improvements could be achieved by enhancing efficiency. To do so, it proposes a set of measures to change the organization of public health services. These include increasing the autonomy of local providers, building mechanisms of accountability through information, empowering consumers through choice, and allocating resources on the basis of outcomes instead of on the basis of budgetary needs. These are deep changes, but they have the potential to benefit the poor, or at least to improve their access to health services.

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[20] As discussed by IDB (2000) there are already several examples of success in the region. The program *Telecurso* in Brazil and *Telesecundaria* in Mexico are among the most notable.

[21] These are reflected in higher infant mortality, lower life expectancy and being more prone to disease. For some examples, see IDB-RES (2000), which illustrates this clearly for the case of Mexico.

(iii) Investment Capabilities

In the absence of formal credit markets, one can finance economic activity either by saving, or by having access to informal credit markets. But if incomes are too low and access to banks to place saving deposits does not exist, it is difficult, if not impossible, to create savings for own investment. In these cases savings must be done in a non-monetary form (building materials, livestock, etc.) or by holding cash. But both of these strategies are risky. They tend to have a lower return and incur high transaction costs in many instances, such as converting illiquid assets into cash. The problem is worse in a context of economic uncertainty where savings can only be used as a buffer-stock to face unexpected shocks, and where savings cannot be used in long-term ventures with at least medium-term maturity periods. Moreover, if the poor are not able to save they will be more exposed to fluctuations in the economic system and, worst of all, they will be unable to accumulate the income-earning assets that could lift them out of poverty.

With respect to access to informal sources of credit, the family or other networks may be a good source of resources, but for the poor these resources are limited due to the poverty of the people in their networks. When these resources are restricted, people have to turn to informal credit markets that charge huge prices for credit. This reduces the profitability of investment or makes it prohibitive altogether.

There are at least two areas for policy action in terms of creating savings capabilities. The first and perhaps most obvious is promoting the existence of small-scale financial institutions that provide the poor with safe ways to save through liquid savings accounts, and which yield some return even when the investment is low. These can be promoted by setting the rules of the game in ways in which some regulation and supervision is introduced, at the time that guarantees to investors are provided. The second is by creating insurance mechanisms such as unemployment insurance or own-insurance through social security accounts, which reduce the risk of abrupt income declines. Schemes of this type could allow the poor to invest with longer-term objectives ? such as accumulating income-earning assets? and have access to investments with higher yields, which would make their savings and investment more profitable. A stable macroeconomic environment could also be thought of as an important contribution to reducing risk for the poor.

(iv) Housing and Basic Services

Housing, basic infrastructure, and services such as electricity, potable water, and drainage are necessary for functioning in modern societies. Without them the human capital and health of individuals are severely undermined. Moreover, the chances of creating economic activity are crippled. This is especially so in the case of women. Latin American women have traditionally been responsible for domestic chores, and with inadequate electricity, water, etc., they end up spending a huge amount of time and effort in these activities.

Although the poor, especially in urban areas, may have some access to housing and public services, most of the poor rarely have them in adequate quality and quantity. In part this is because the priority for governments has been to keep prices and tariffs low in the hope that this will provide widespread access (see IDB, 1998). The result is that the wealthy and middle classes, which consume the most, have received subsidized services while the poor in rural and marginal urban areas have very limited access, if any.

Since electricity, potable water, drainage and basic infrastructure are usually publicly provided, there is a clear role for the State in covering the deficits accumulated in the past by the poor. But in the case of housing there is also scope for helping to create both financial markets and a regulatory framework that is suitable for the poor. One example of the limitations of current regulatory frameworks is that in most countries, public or private mortgage options are only available for "finished" housing, defined as units that have been completely built and that have access to basic services. One of the reasons is that the house itself is normally the collateral, so it has to have some minimum value to make it worthwhile for banks or other creditors to engage in the deal. The problem is that the poorest of the poor either do not have access to these mechanisms, because they are employed in the informal sector, or they do not meet the minimum requirements to qualify for a loan for the full price of a house. Either a regulatory framework promoting the financing of "unfinished" units, or the creation of a market for "unfinished" housing could improve the chances of the poor to acquire housing of acceptable quality as well as access to services.

Generating Opportunities

(v) Employment Opportunities

Opportunities, as defined here, are about prices and about the chances for using assets to generate income flows. From the point of view of the rate of use of assets such as human capital, Chapter 1 of Attanasio and Székely (2001) shows that the main difference between rich and poor is found in the labor force participation of women. Practically all males in prime age, regardless of their social position, work and are income-earners, while in the case of women, the participation rate among those who have better opportunities due to their education is much higher than among those who have less schooling.

One reason for this outcome is that traditional mechanisms for protecting labor in Latin America were designed by men, for men. Their objective was to generate formal employment with benefits, and with guarantees of stable jobs. But this implicitly induces discrimination against women, on the one hand because these mechanisms impose higher implicit costs for hiring women (due to maternity leave and allowances), and on the other because, by restricting employment to full time and limiting flexibility in hours, these restrictions makes employment a prohibitive venture for some women. These efforts at protection result in reality in much lower participation rates among poor uneducated women.

There are at least four ways in which public policy can contribute to reducing restrictions to female participation. The first is through providing access to basic infrastructure and services that lower the cost of household chores and free some time for women (see discussion of housing and services). The second is through enhancing child care services and preventive health services that create a network of support for females who wish to engage in the labor market, but who do not do so because of the restrictions imposed by household tasks. These services could either be subsidized by the State or promoted through appropriate tax incentives, or other schemes, for private firms. A fourth way is by socializing maternity costs. If rather than charging these costs to employers they are financed through fiscal revenue, the incentives to hire women would improve, and with it, their opportunities.

The fourth way is through labor legislation. As argued by IDB (1998), labor protection laws and regulations end up favoring individuals who are able to participate in the formal sector? who are normally those that are endowed with some schooling and health? while leaving the rest uncovered. There are at least two types of actions that could contribute to improving labor market opportunities for poor women. The first is introducing greater flexibility into contracting conditions in order to allow for part-time or temporary workers who have to deal with household tasks as well as labor market activities. But this must be accompanied by the corresponding (proportional) benefits enjoyed by full-time workers. The second action is unemployment protection to stabilize workers' income if they temporarily lose their jobs or are transiting between jobs. Many countries have already established individual savings accounts that can be used as personal unemployment insurance, but the main limitation is that this is restricted to the formal sector of the economy. For those in informal employment, it could be possible to establish collectively financed social safety nets that could play the role of social insurance. Individual savings accounts could possibly be expanded to cover these groups.

But apart from the differences in labor force participation between rich and poor individuals, the poor also face the strong disadvantage of receiving lower remuneration to the precarious human capital that they own. As illustrated in Chapter 1 of Attanasio and Székely (2001), in Latin America the returns to primary and secondary schooling are relatively low, while the returns to higher education are huge. Perhaps the most straightforward option would be to influence the level of the minimum wage in the hope that by increasing it, the returns to the assets of the poor would increase. The problem is that high minimum wages often result in even more discrimination against women with low education, and unskilled workers in general, so in the end they do not serve their purpose of redistributing income.

In an era of globalization it is difficult to think of policies that promote higher wages and employment for the poor without referring to trade policy. Since most Latin American countries are now open to international trade, their wages are set not only by the internal supply and demand for labor, but also by the scarcity or abundance of different types of labor in world markets. Therefore, minimum wages have an even more limited role than before. Perhaps the best example of this situation is the entry of China and India into world markets. These are the two most populated countries in the world, and when they started opening up to trade more than a decade ago, the availability of unskilled labor in the world increased substantially. Latin America is not an unskilled-labor abundant region any longer, at least by world standards, and thus, it is not clear that it has the comparative advantages that attract investment and generate demand for local labor.

This means that to improve the wages of the poor it is necessary to have a trade policy that promotes the use of the human capital owned by them. According to the IDB (1998), one way of dealing with this is to advocate flat and moderate tariff structures that protect all sectors alike and that do not privilege imports of capital in industrial activities that are normally complementary to skilled labor. Tariff structures that favor intermediate inputs or factors of production that are complementary to relatively unskilled labor (by Latin American standards) would have better chances of increasing the demand for the labor of the poor.

(vi) Investment Opportunities

It has been known for a long time that efficient financial markets are one of the main vehicles for social mobility. Financial markets provide the institutional framework with which savings are mobilized to finance investment ventures. For individuals with low savings capacity they often are the only way of accessing resources to create economic opportunities. But unfortunately, it is well known that Latin American countries have inefficient and small financial systems that result in credit scarcity. This considerably inhibits the opportunities of the poor and reduces their capacity to put their meager income-assets to work. Therefore, reform to create or to improve the functioning of financial markets in Latin America could be one way of enhancing the income-earning capacity of the poor.

One way to do this is to promote lending institutions that make micro loans.[22] The role of the State in this case might be to create the regulatory framework for them to flourish. This requires setting clear rules of the game, imposing restrictions on the use of financial resources by banks for investing in certain instruments, monitoring the operation of banks, and creating guarantees that reduce the risk of their investment.

But the problem is that micro lending institutions are so far only a minuscule part of the financial sector in Latin America. Altogether, they do not account for even 1 percent of the credits provided by commercial banks to the whole economy. This points to the need for policies that generate widespread access to credit for the population. The option of creating and managing state-owned banks that provide subsidized credit is not the solution, at least as judged by their low rate of success and high inefficiency in the region. To know where there is scope for intervention, it is first necessary to identify the obstacles that impede the credit relationship.

According to IDB (1998), "the fundamental problem lies in the first step in a credit relationship: the creditor must give the borrower money based on a promise of repayment." The credit relationship therefore depends on the ability to repay loans and the willingness to repay. The question is what can policy do to ensure ability and willingness to pay. Apart from introducing appropriate regulation and supervision of banking institutions, there are at least four mechanisms that governments can use to create or expand competitive and efficient financial systems that reach the poor: punishment, collateral, reputation and relationships.

Punishment is basically about the effectiveness of the legal system in enforcing the law. While enforcing the law does not necessarily benefit creditors on a case-by-case basis, it does provide incentives to debtors to repay if they possibly can. For financial systems that serve smaller borrowers, there need to be additional ways of ensuring willingness to pay. Areas for improvement include operational restrictions of banks (in terms of flexibility of times and forms of operation), simplification of documentation requirements, and lowering capital requirements on loans.

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[22] There are many examples of this in Latin America. Perhaps the most successful are the Banco Sol and Caja los Andes in Bolivia and the Banco del Pacífico in Ecuador. The Grameen Bank in Bangladesh is perhaps the best known case in the world of successful micro lending for the poor.

Collateral is one of the key mechanisms that make financial systems work because they imply some guarantee of repayment. The problem in the context of poverty reduction is that the poor normally lack collateral. One option is the introduction of new financial products such as leasing and factoring, or at least creating the regulatory framework so that they can exist. These types of instruments are closer in spirit to the concept of “renting” capital, rather than selling it. For instance, in leasing the lending institution normally retains ownership of the equipment or other form of capital, while the debtor pays a monthly rent (which includes interest and amortization) for its use and eventually becomes an owner. One way in which public action can promote these types of arrangements is by facilitating the parties to repossess the leased equipment at rapid and low cost in case of default. Tax schemes tailored to the needs of these schemes, and the elimination of regulatory barriers, are also areas where public policy can intervene to facilitate the creation and expansion of formal credit in the economy.

Reputation can be an effective mechanism for lowering the costs of monitoring ability and willingness to repay loans. One of the strongest advantages of reputation in the context of poverty reduction is that anybody can develop a good reputation, regardless of his or her socioeconomic condition. One feasible policy for introducing reputation mechanisms into the financial system is the creation of credit bureaus. These information-sharing mechanisms concentrate credit histories that are made available to creditors. By sharing information with creditors they impose high risks from default by limiting future access to credit to those with a bad history. Credit bureaus are a rare commodity in Latin America. Interestingly, among the few places they are found are where small banks providing micro loans operate. In these types of institutions, credit is provided progressively in larger loans to an individual or group, with default resulting in loss to access. Rates of repayment of micro loans are usually very high, to a large extent due to this set of arrangements. Creating public credit bureaus on a larger scale could be one of the policy alternatives for providing incentives to create and expand credit markets in the region.

Promoting *relationships* is another important way to promote the creation of financial institutions. For instance, one common credit mechanism is group lending, where default by one member of the group results in loss of access to credit for the entire group. These schemes take advantage of the relationship that borrowers have with each other by introducing self-monitoring mechanisms that dramatically reduce the cost of monitoring lending. One way in which public policy can promote the use of group lending is through fiscal incentives to entities or groups that provide these types of loans. Additionally, there is scope for policy intervention in setting the regulatory framework, or even creating insurance mechanisms that reduce the risk of default.

Social and Development Policy: One and the Same

It is time to start thinking about new ways of designing social policies in Latin America. We need policies that support the poor in a way that by doing so they contribute to growth and are themselves engines of growth and development. This can only be done if social policy is at the heart of the development strategy of a country, rather than an opponent constantly competing for public resources that may undermine macroeconomic stability. Therefore, the solution is not compensatory measures, but policies that promote efficiency in the economic system and that improve the productivity of the poor.

If we go beyond income, and ask what determines the income of each individual, it is possible to outline some of the elements of such a strategy. This discussion has been framed in terms of policies that generate capabilities and create opportunities. The idea is that by creating capabilities and opportunities for the poor, their incomes will be higher and this will give them access to a better standard of living.

But when we start thinking about what is needed to improve capabilities and opportunities, we end up talking about cash transfer programs such as Progresa or Bolsa Escola, health policy, incentives for saving, housing and basic services, labor market regulations, trade policy, the introduction of credit bureaus to expand access to credit, and even about the promotion of alternative financial instruments such as leasing to avoid the restrictions imposed by lack of collateral by the poor. We end up talking about the economic environment as a whole. And what is most interesting is that many of these items are rarely conceived of as part of social policy. They are normally viewed as part of the overall development strategy of countries.

The purpose of this paper has been to outline a scheme where the various public policies can be viewed as part of this integrated strategy. By framing it in this way, it is obvious that programs such as *Progresa* are an important part of the strategy, but they cannot be regarded as *the* strategy for poverty reduction. If other elements of the economic environment are not modified, these types of government intervention will always be swimming against the tide. But, on the contrary, if they are complemented by a wide set of policies that generate capabilities and create opportunities for the poor, their chances of contributing to solving the poverty puzzle may be multiplied.

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