Economic Shocks, Inequality and Poverty: the Need for Safety Nets[1]

Nora Lustig

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Empirical evidence suggests that macroeconomic shocks can result in substantial increases in inequality and poverty. Latin America has experienced two major crises in the last 15 years. In the 1980s, Mexico's debt crisis spread throughout Latin America on the back of trade shocks and weak public finances. In 1995, Mexico's liquidity crisis, spread only to Argentina.

How did poverty and income distribution change when countries had to endure stagnant or negative growth? In Brazil, Guatemala, Mexico, Panama and Venezuela poverty and inequality increased during the 1980s, and so did poverty and inequality in the urban areas of Argentina, Bolivia, Chile, Honduras and Peru. Similarly, urban poverty and inequality in Argentina rose sharply during the 1995 crisis. (Data for Mexico has not yet been released by the authorities). Although the poorest quintile of the population was not always hurt disproportionately, their average income fell. Clearly, income downturns can have a more devastating impact on those living close to subsistence. Furthermore, in country after country hit by the crisis, the income share of the top 10 percent increased, sometimes substantially.[2]

Although social indicators such as infant mortality rates and average years of schooling, continued to improve in Latin America during the 1980s, they did so at a slower pace. This was the result of the fact that some finer indicators of health and education worsened. For example, in Mexico infant and preschool mortality caused by nutritional deficiency rose in the 1980s, reversing the 1970s trend. In Chile the data on low birthweight infants and undernourished children follow the

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[1] Lustig, Nora, Arianna Legovini and Cesar Bouillon, AEconomic Shocks, Inequality and Poverty: the Need for Safety Nets,@ to be presented at the Conference on Social Protection and the Poor, Washington, D.C., February 1999.

[2] Lustig, Nora (editor) Coping with Austerity. Poverty and Inequality in Latin America, The Brookings Institution, Washington, D.C., 1995, Introduction, pp. 4-5.

trends in economic conditions, after a systematic improvement in both indicators in the 1970s. In Venezuela the literacy rate for people aged 15 to 19 fell in the 1980s. In Mexico the proportion of children of the relevant cohort entering first grade shrank and so did that of students moving to hich school after completing junior high.[3] These trends also imply that investment in human capital probably became more skewed making the observed increase in inequality more entrenched.

The fact that adverse shocks have more devastating effects on the poor and that the richer echelons tend to have access to income-protecting mechanisms (including capital flight) is not circumscribed to macroeconomic slumps. Natural disasters or sudden changes in the terms of trade can have similar effects. For example, in Ecuador it is estimated that more than fifty percent of the population in areas affected by El Niño is poor. The sharp fall in coffee prices following the dismantling of the International Coffee Agreement led to a sharp rise in poverty in coffee-producing states in Mexico in the early 1990s.

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[3] Lustig, Nora (editor) Coping with Austerity. Poverty and Inequality in Latin America, The Brookings Institution, Washington, D.C., 1995, Introduction, pp. 5, 11 and 12.

In the 1980s Latin American governments responded to the social costs of the economic crises in many ways. Measures ranged from food assistance programs, unemployment insurance, social funds, extension of health care coverage to the unemployed, scholarships for children, training and retraining programs and workfare programs. However, with the partial exception of Chile, the overall response was too little, too late. What are the lessons?[4]

First, tackling social issues means putting them at the top of the agenda. Too often in the Latin American crises, policymakers' energy is only devoted to restoring macroeconomic stability and implementing structural reform. Second, the design of the response is crucial. Even in the case of the Social Emergency Funds which were designed to cushion the social costs of economic adjustment measures, success was at best mixed because beneficiaries were not necessarily those most affected by the crises. In Mexico and elsewhere, general subsidies were cut without the introduction of effectively targeted alternatives. Of greatest importance is the need to maintain support for core education and health services to avoid irreversible losses in human investment; this was done poorly in Latin America in the 1980s as evidenced by the slower progress in health and education indicators mentioned above. In the 1990s, Argentina waited until 1997 to introduce an emergency employment program despite the sharp rise in unemployment during the last previous years and despite the fact that the existing severance payment and small-scale unemployment insurance schemes were no safety nets for the unemployed poor. Third, evidence suggests that programs put in place and operating before crises hit (albeit on a smaller scale) are better equipped to protect the target population than ad hoc emergency measures.

At present, most Latin American and Caribbean countries still do not have adequate mechanisms to mitigate the impact of adverse shocks on the poor and temper the unequalizing character of economic crises. While there is widespread perception that social funds were put in place for precisely that purpose, a closer examination reveals that most Social Investment Funds were more effective at building small-scale social infrastructure than they were in creating employment opportunities for those hurt by the emergency. In fact, most countries in the region lack effective private or public insurance markets for consumption-smoothing safety nets which could serve to protect the poor from output, employment and price risks associated to systemic adverse shocks. A recurrent problem is that because the institutional mechanisms to protect the poor from the brunt of the shocks are not in place beforehand, responses have to rely frequently on

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[4] Lustig, Nora and Michael Walton AEast Asia can learn from Latin America=s Travails@, International Herald Tribune, May 29, 1998.

improvisation, or programs that were designed for purposes and beneficiaries other than those affected by the crisis. Emergency responses to emergency situations often lack the time for adequate technical analyses, both for clarifying the socio-economic profile of groups most vulnerable to the adverse shocks, and for evaluating the cost-effectiveness of different social protection options.

There are examples of good practices inside and outside the region of safety nets that work well. For example, in the 1980s, Chile implemented a large-scale public works program that provided employment for a large portion of the work force self-target to the most needy via below market wage rates. Furthermore, there is no reason why social funds cannot be adapted to function as safety nets when the need arises. Because many governments lack the resources to put social safety nets in place, the alternative of setting up social funds proved useful both to mobilize external resources and to respond rapidly to pressing needs.[5] Whatever their form, implementing efficient and cost-effective safety nets to cope with emergencies can be of great value in the quest for greater social equity in the region.

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[5] See AThe Use of Social Investment Funds as an Instrument for Compating Poverty. A Bank Strategy Paper,@ SDS/POV, Inter-American Development Bank, 1998.