Public Finance for Poverty Reduction: An Overview

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CHAPTER 1

Public Finance for Poverty Reduction

An Overview

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Governments in low-income countries have the difficult task of making wide-ranging decisions about public spending, taxation, and borrowing with the aim of helping their countries maintain long-term debt sustainability, achieve higher economic growth, and ultimately reduce poverty. Making such decisions is difficult because it involves considering multiple trade-offs. There are at least four reasons why designing and implementing fiscal policies that contribute to growth and poverty reduction are particularly challenging tasks in developing countries. First, private-market failures are widespread and often unpredictable. Second, government and institutional failures also limit the effectiveness of public interventions. Third, raising public revenues is difficult in a context of macroeconomic and growth instability, high debt ratios, weak tax administration, and large informal sectors. Finally, many developing countries lack the data necessary to conduct a thorough analysis of the effect of government policies on the poor segments of the population.

Despite those challenges, however, the budget remains one of the most important instruments (together with laws and regulations) that governments have at their disposal to foster poverty reduction. Policy makers in both developing and developed countries, as well as nongovernmental organizations and providers of aid, can benefit from a deeper understanding of how internally or externally financed public funds channeled through the budget can be used more successfully to benefit the poor in a realistic manner.

To set the stage for the chapters that follow—chapters that address public financing and poverty reduction—we start here with a brief discussion of the rationale behind the role of the government in public finance. Then we discuss some of the limitations faced by governments in developing countries. We follow those discussions with an overview of the nature and structure of the material presented in this book and with our thoughts on germane topics yet to be addressed adequately.

Rationale for the Role of Government

Before analyzing the appropriate levels of public spending, taxation, and debt in a particular country context, it is worth asking why it is even pertinent for governments to play a role that promotes growth and poverty reduction.

Believing that competition and the profit motive would lead individuals pursuing their private initiatives to serve the public interest, many economists have argued for the government to play a limited role in this regard. According to their view, its role should be constrained to correcting market failures and providing basic public goods, including law and order, national defense, and basic physical infrastructure.[1] Other economists, however, have advocated much wider government interventions—among them, promoting income equality. It is widely accepted that well-designed government institutions are necessary for country development; but the task of defining the most suitable size and type of government, and the right mix of markets and government activities, remains difficult.

A starting point in this discussion is recognizing that there are at least three reasons for government involvement in a market economy: (1) to establish the preconditions for markets to operate efficiently, (2) to correct market failures, and (3) to improve social welfare and promote equity.

First, governments need to set up the preconditions for markets to operate efficiently by creating the necessary institutions, laws, and regulations that will facilitate their functioning. Where government intervention in areas such as property rights and competition laws is lacking, some market activities may not develop at all, or they may develop in an inefficient manner with impossibly high entry costs or administrative and legal barriers.

A second reason for governments to intervene is to correct market failures. In a general sense, these failures refer to a set of conditions under which a market economy does not allocate resources efficiently. Correcting such a situation requires that the government assist the "invisible hand"[2] to approximate what the market would have done in the absence of market failure. There are various types of market failures, each requiring different forms of government intervention (World Bank 1997). In the case of public goods, for example, the market usually fails to define the charge that individual consumers should pay for their use. Here the function of the government to overcome that failure would be revealing the citizens' preferences for public goods—preferences often expressed and channeled through the political process.

Closely related to public goods is the concept of externality—the recognition that consumption or production of some goods may generate positive or negative external effects for the society that are not reflected in their price. This argument has often been used to justify a government's role on the grounds that, without such intervention, the market would overproduce or underproduce those goods, depending on whether the externalities were positive or negative. In addition, market failures often are associated with incomplete markets and imperfect or asymmetric information among consumers and suppliers. Markets may not provide goods or services whose costs are less than what consumers are willing to pay.[3] Similarly, imperfect and asymmetric information may lead to an erroneous valuation of goods and services, and therefore to inadequate supply or demand. Finally, market failures are related to problems of adverse selection and moral hazard when buyers or sellers act exclusively on the basis of their own benefit and to the detriment of the general interest.[4]

The third and equally important rationale justifying government intervention refers to the concern for distributive justice or equity. Even if markets could function efficiently, by their nature they would not ensure that growth and income are distributed in a fair or just manner. Government thus should play a role in income distribution, without compromising the efficiency of the markets to allocate resources. Welfare economics considers the function of the government as going beyond the provision of public goods and focusing on the distribution of income.

Although the concern for equity is typically associated with the role of government, this does not mean that only the government should or could contribute to reducing poverty. If one thinks of poverty as resulting from a lack of opportunities, empowerment, and social protection, it is clear that the government is not solely responsible for filling that lack.[5] In fact, the private sector does play an active role in creating economic opportunities (employment, credit), promoting inclusion of all members of the civil society (associations of private sector producers, workers, parents of students, and the like), and protecting citizens (education, health care, and social protection, with or without public sector involvement in financing or delivery), thus contributing to reducing poverty either through its independent actions or by association and partnership with government activities.

The three reasons for government intervention described above suggest that there is substantial scope for government action, particularly in countries where poverty is widespread and only some segments of the population benefit from growth and development. There is a growing awareness and global consensus about the need to increase efforts to combat poverty more vigorously by providing opportunities and assets for people who are less well-off on equity grounds. In addition, empirical results generally suggest that improvements in income distribution may contribute to greater economic growth, faster development, and less poverty. Inequality often produces insecurity and crime, which are negative externalities with detrimental economic and social effects both nationally and globally.

Limits to Government Intervention in Developing Countries

Several features distinguish the government from the private sector. Governments have both strengths and weaknesses that must be understood in an effort to decide what functions they should perform. On the positive side, in democratic countries the people who run public institutions are elected or are appointed by an elected official. This makes them legitimate in the eyes of the population. In addition, the democratic government is endowed with certain rights that private institutions do not have —such as imposing taxes on citizens; seizing private properties for public use; and prohibiting, punishing, and requiring participation. These capacities can be exercised because government institutions have two unique features: cohesion and universality (Stiglitz 1995; Tanzi 1998). In some circumstances, governments may be able to curb negative externalities when the private sector, acting alone, cannot.

On the negative side, however, the government also faces limitations that differ from those of the private sector. First, the political process itself imposes restrictions because the mandate of the government often is vague and subject to political pressure from interest groups. Even the existence of externalities would not justify public action if externalities were politicized to justify inappropriately large government interventions. Second, other restrictions are associated with the difficulty in predicting changes in the external environment and, more particularly, in the private sector reaction to a changing world, as well as in gathering information reflecting the results of private or public actions. Third, the rules governing public institutions often are more rigid than those of the private sector because of the fiduciary responsibilities the government bears to the population and the complexity and interaction of the many objectives being pursued in the name of public interest. All such limitations may reduce the efficacy of government interventions.

Thus, if there is agreement to say that markets are fully efficient only under fairly restrictive assumptions (many of them nonexistent in developing countries), there is also recognition that government failures limit the effectiveness of a government in correcting market inefficiencies. For that reason, many economists argue that the government should focus on areas where market failures are most significant and where the conditions ensure that it can make a difference. In addition to government failures and difficulties in adjusting to a changing environment, there are institutional failures related to the gap between government goals and the availability of existing policy tools to pursue those goals. That gap leads policy makers to use public policy instruments whose efficiency is less than ideal. Moreover, for the government to perform its essential tasks, public institutions must be guided by the appropriate incentives. If public institutions are used by individuals for their own ends and to the detriment of the general interest, the government becomes an impediment to economic activity, progress, and development.

When assessing the role of government, we must divide its functions into two broad categories: the government as a provider and the government as a promoter/facilitator/partner. Regarding its provider function, there is now evidence and widespread acceptance that ownership of regular production processes is not a sensible function for the government. The private sector obtains better results than does the government, even in areas that previously were considered natural monopolies[6] (energy, telecommunications), mainly as a result of technological changes. The government, however, is better placed to provide such public goods as macroeconomic stability, justice, external defense, a clean environment, and dispute resolution. Also, the government often is better positioned to provide protection from poverty or destitution and to defend individual rights and social stability (Drèze and Sen 1991). Now, not all these functions require the government to be a provider of goods or services because many can be facilitated simply by regulations and the creation of an appropriate framework.

Regarding the role of the government as a promoter/facilitator/partner, the nature of regulation is a key ingredient. Regulations can become beneficial or harmful, depending on how they are used. Necessary regulations are those that enable activities to operate more efficiently and protect individuals from risk and losses. Necessary regulations include air and road traffic regulations, and drug and food safety norms. Regulations also can be used in lieu of taxes to mitigate negative externalities, as in the case of environmental regulations. However, regulations may constitute an inferior public policy instrument. For example, regulation of harmful emissions may be inferior to using tradable pollution vouchers. By creating a private market for the right to pollute, the government may be able to channel the pursuit of self-interest to achieve a given reduction in pollution at minimum costs—an outcome that regulations may not be able to achieve.

Damaging regulations are those that allow individuals to enter an economic activity on favorable terms (by granting special concessions) to seek their own benefit to the detriment of the general interest, or to pursue objectives that are questionable from a social point of view; and those that are inefficient in the way they achieve well-justified social objectives.

Regulations do not always represent an alternative to public spending. Pension reform is the clearest area in which government regulations that encourage individuals to allocate part of their income to pensions translate into lower government spending. However, in other areas, such as unemployment, sickness, or protection from other risks, regulations may have the opposite effect.

In developing countries, governments face especially significant difficulties when, acting as providers or mere facilitators, they strive to establish the preconditions for markets to operate efficiently, correct for market failures, and improve social welfare. These difficulties are the result of many factors, including an uneven income distribution and a high percentage of the population affected by severe poverty; a high degree of vulnerability to external shocks of all kinds (for example, natural disasters, world prices, and aid dependency); numerous, pervasive, and unpredictable market failures resulting from imperfect information, prevalence of monopolistic practices, and different kinds of negative externalities; a lack of appropriate incentives for the private sector to operate in terms of competition policy, regulatory framework, and the judiciary system; and government and institutional failures resulting from weak capacity and rigidities, as well as problems of credibility and governance.

In this context, one could conclude that there is a greater need for government intervention in developing countries. However, a greater role for the government does not necessarily mean the need for higher expenditures and the revenues required to finance them. It is important to distinguish between the size of the government measured quantitatively (perhaps as a share of gross domestic product [GDP]) and the positive role that government can have as assessed qualitatively. In practice, although developed countries show relatively higher ratios of public revenue and expenditure to GDP than do developing countries, presumptively this does not say much about the effectiveness of those governments. There is evidence that the share of public expenditures in GDP in developed countries has been increasing over the last decades. This indicator does not reflect the "economic" role of the government because most of its functions associated with legislation, the judiciary system, and macroeconomic and foreign trade policies typically represent only about 2–3 percent of GDP. It is significant from the social point of view, however, because the composition of those expenditures often reveals an increase in social safety nets. This result may be attributed to a number of factors, such as the importance of labor in the industrialization process, changes in the number and age structure of the population, and attempts to promote education and reduce income inequalities.

The results of those large expenditures in developed countries in terms of improvements in income inequality and other social and economic indicators are not necessarily clear. In other words, there is no obvious evidence that larger governments, if measured by public spending as the percentage of GDP, have generated better social outcomes. In some cases, an increase in expenditures combined with a general public aversion to paying taxes have generated higher public deficits and larger debt-to-GDP ratios in the developed world—something that typically must be avoided in developing countries, given the limited ability of these countries to repay their debt. Furthermore, developing countries generally face greater difficulties in raising fiscal revenues to finance increasing public expenditures than do developed countries. These difficulties often translate into macroeconomic deficiencies—such as inflationary monetary financing, quasi-fiscal activities, high levels of debt, and deterioration of the government's net worth—not always appropriately reflected in conventional measures of fiscal deficits.

Structure of the Book

The objective of this volume is to introduce its readers to key themes and simple analysis techniques related to public finance and poverty. It is based on a Public Finance for Poverty Reduction program prepared at the World Bank Institute, in cooperation with the Poverty Reduction and Economic Management Network at the World Bank. The program was designed for policy makers and researchers in both Latin America and sub-Saharan Africa.[7] Case studies were prepared as part of the operational work of the World Bank in both regions, primarily as background research for poverty assessment or public expenditure reviews.

The book first provides a set of four conceptual chapters addressing debt, taxation, public expenditure tracking surveys, and benefit incidence analysis. These chapters are followed by case studies on each theme, first from Latin America and then from sub-Saharan Africa. The idea behind combining conceptual chapters and case studies is twofold: to provide some theory and background on key themes that are important in analyzing links between public budgets and poverty reduction, and to show concretely how simple tools developed by economists can be used to shed light on the issues confronted by policy makers. The book provides only an introduction to the themes reviewed, given the very extensive and complex literature on the topics covered. An effort was made here to present in simple ways the core principles and techniques as well as the empirical results from the case studies so as to make the book accessible to a wider audience beyond economists.

Thus, in this book we provide a discussion of some key techniques that can be used to produce public policies that improve the lives of poor people. The techniques are related to the analysis of debt, taxation, and public expenditure (in the last case, with an emphasis on both tracking surveys and benefit incidence analysis). The objectives are not only to define and explain concepts (in the first part of the book), but also to illustrate how those concepts are being used in practice (in the second and third parts devoted to case studies in Latin America and sub-Saharan Africa).

What follows here is a brief overview of the discussions to come in the rest of this volume.

Debt Sustainability

In poor countries, the need to balance short-term fiscal policies with long-term development goals (such as those expressed in the Millennium Development Goals) typically is associated with the government's commitment to implementing a poverty reduction strategy. Particularly in sub-Saharan Africa, this commitment takes place within the context of the debt relief provided under the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative and more recently under the Multilateral Debt Relief Initiative (MDRI). Given this context, the first theme covered in this book is debt sustainability. Along with taxation, monetary financing, internal borrowing, and quasi-fiscal activities, foreign debt historically has been one of the most important ways through which governments raise the resources needed to implement their development policies. In some cases, however, this has been a double-edged sword, given the need to repay the loans obtained from donors and other creditors. Reliance on external debt was not always determined by how much debt could be serviced and repaid, taking into account real growth and international interest rates, and the use of the loans received did not necessarily provide poor people the greatest benefit.

One can refer to debt sustainability as the requirement that indebtedness (or debt service) be kept in line with capacity to repay. But a country's capacity is not easy to define. Various approaches have been used in the literature to define debt sustainability, including external, fiscal, and solvency approaches. Chapter 2 discusses these approaches and shows how they have been made operational through the HIPC Initiative. In recent years, beyond the capacity of countries to repay, a greater emphasis has been placed on the negative impact of high levels of debt (through the concept of debt overhang), as well as on the "human development" dimensions of debt sustainability. Alternative approaches to analyzing debt sustainability have been instrumental in bringing about additional debt relief to poor countries through the MDRI.

The basic concepts of debt sustainability are discussed and illustrated in the cases of Paraguay for Latin America (chapter 6) and of Guinea, Rwanda, and Senegal for sub-Saharan Africa (chapter 10). The case studies rely essentially on the traditional concepts of external and fiscal sustainability rather than on other alternative approaches discussed in chapter 2. Emphasis is placed on using simple examples to show how debt sustainability depends critically on various growth and taxation-spending scenarios. A simple debt simulation tool is used to perform complex simulations easily. The tool can be used by analysts to help the government and other actors identify some simple trade-offs between debt sustainability and key macroeconomic variables involved in the debt dynamics—variables such as growth, interest rates, inflation rates, exchange rate changes, as well as fiscal and current account deficits and their impact on spending to alleviate poverty.

Taxation

Taxation is the second topic discussed in the book. Taxes are needed to fund public expenditure, and they have direct distributional effects. The existing evidence, however, shows that, unless personal income taxes play a greater redistribution role in developing countries, contributing to equity via taxation will be difficult. Even when the personal income tax base is developed, income tax competition from other countries and tax administration limitations may constrain the government's ability to use the tax system to redistribute income and wealth. Nonetheless, the design of specific tax instruments should take poverty concerns into account—for example, by exempting basic foodstuffs from such indirect taxes as the value-added tax. A pro-poor exemption of that type could be offset through higher indirect tax rates on luxury products. Similarly, policies to mitigate the antilabor bias of corporate income tax in small and open economies can make tax policy more pro-poor. In addition, broad-based tax systems, with few deductions and exemptions (apart from a personal income tax exemption not larger than per capita income, and low or zero tax rates on purchases of basic goods) and with relatively low tax rates (albeit proportional or moderately progressive in the case of the personal income tax), compatible with administrative capabilities, are more likely to provide a sound basis for economic growth.

The conceptual issues related to taxation are discussed in chapter 3, which considers the following questions: What is the role of the tax system? What criteria can policy makers use in evaluating tax systems in general and specific tax instruments in particular? What factors should policy makers consider in determining the aggregate level of taxes? What factors should be considered in determining the relative use of different tax instruments? How effective are different tax instruments in redistributing wealth or income in a society? and When designing different tax instruments, how effective are particular tax provisions in reducing the tax burden on poor people? Although there are no definitive answers for all these questions, the discussion in chapter 3 offers some guidance.

The case study of Latin American taxation presented in chapter 7 is devoted to Mexico. The study offers a wide-ranging evaluation of the performance of Mexico's tax system over the 1980s and 1990s in several important areas, including revenue adequacy, structure, temporal elasticity, stability and behavior over the business cycle, efficiency, and equity. This evaluation includes a discussion of various hypotheses that may explain why the system has not performed as well as possible.

The taxation case study for sub-Saharan Africa (chapter 11) is devoted to Niger and is limited in scope. Its main objective is to demonstrate how, even with limited available data, simple techniques can be used to analyze the potential effect of indirect tax reforms on poor people. Specifically, chapter 11 provides first a review of medium-term targets for generating public revenues in Niger (together with a description of the current structure of tax revenues); then it uses household survey data to assess the potential distributional incidence of selected reforms under consideration in the country in the first few months of 2005; and, finally, it shows briefly how the overall impact of any tax reform depends in part on how larger tax revenues are spent.

Public Expenditure Tracking Surveys

There is broad agreement that the revenue side of fiscal policy can affect growth and poverty reduction positively, mostly by providing funds to finance public spending, particularly in physical (basic infrastructure) and human (education and health care) capital to benefit poor people. But in the desire to avoid excessive interference from the state in the productive sectors and to minimize distortions in the economy, there also is broad consensus that public expenditure is a more potent instrument to reduce poverty than is taxation itself. Despite constraints on the absorptive capacity of countries that lack institutional strength, there is ample room to improve the allocation of public expenditure to reduce poverty in most developing countries.

The focus in this book is on public expenditure tracking surveys (PETSs) and the associated quantitative service delivery surveys (QSDSs). As noted in chapter 4, studies suggest no close link between public spending and outcomes, with higher spending not necessarily leading to enhanced services because leakage prevents funds from reaching schools and health clinics, and because waste and corruption often distort public spending impact. The PETS is useful in ascertaining the extent to which public spending actually reaches households—and especially the poor. Implementing a PETS and publicly disclosing the results have been shown to improve the allocation and use of funds in several developing countries. Better monitoring and tracking of funds have reduced leakage. These surveys demonstrate that data collection and analysis, and the subsequent dissemination of results, can be potent means of increasing transparency in the use of government funds and can give a stronger voice to poor people.

Chapters 8 and 12 are devoted to surveys carried out in Peru and Rwanda, respectively. Poor targeting, deficient financial management, and leakage all were found to varying degrees in Peru. The targeting of public spending varied greatly from one social program to another. The financial management issues there included the volatility of central government funding, insufficient transparency, and a lack of auditing and supervision in municipalities' use of funds. The PETS was used specifically to examine leakage in the Vaso de Leche (Glass of Milk) program. The greatest leaks were found not between the central government and municipalities, but at the local level.

In Rwanda, the survey was used to analyze the health care and education sectors. The study found delays in the transfer of public resources from the central administration to primary beneficiaries, and leaks at the regional and district-level health and education offices—again with weak accountability, bookkeeping, internal financial controls, and auditing. In both primary education and health care, allocations from the central government only paid the salaries of teachers and health workers, so facilities relied on household contributions, fees, and sporadic contributions from donors and nongovernmental organizations to fund their needs and activities. That reliance led to affordability issues and to a lack of such inputs as student textbooks.

Benefit Incidence Analysis

The final topic covered in the book is benefit incidence analysis, which can be used for both taxes and public expenditure. This analysis combines administrative data (on taxes and/or spending, often at a disaggregated level, such as primary rather than secondary and tertiary education) and household survey data to measure how revenue and expenditure policies affect different groups of households. The tool also can be used for other purposes, such as assessing the distribution of user charges in various sectors (such as education and health care, and basic infrastructure services).

As is noted in chapter 5, establishing the incidence of taxes and expenditure is important because those people who actually pay the taxes are not necessarily those who bear the burden of the taxes. Similarly, public expenditures that, in principle, are intended to benefit the poor may be badly targeted and thereby benefit better-off households. Subsidies for the lower brackets of the tariff structure of electricity and water consumption provide a classic example: the subsidies are supposed to make services affordable for the poor, but because the poor tend to have very low rates of connection to the electricity and water networks, the subsidies often end up benefiting the middle class instead. These are the situations that benefit incidence analysis is meant to identify. Although such exercise is important, it is not necessarily easy to implement. It is not a simple matter to shift from a positive analysis of who benefits from public expenditure or who pays taxes to a normative judgment of the policy changes that should be adopted to improve the system.

Chapters 9 and 13 offer case studies on benefit incidence analysis in Uruguay and Cape Verde, respectively. The Uruguay chapter discusses a range of social assistance programs that use various targeting schemes with quite different outcomes. The chapter first organizes the programs according to their risk management role and then examines their performance, using indicators of costs, incidence, and targeting. The discussion points to examples of good practice and to missed opportunities in program design. Chapter 13 analyzes the targeting performance of public transfers in Cape Verde—a small West African economy following a social-democratic model that heavily subsidizes the social sectors but that, at the time of the study, faced tighter budget constraints. Beyond the basic analysis of the incidence of public spending, the chapter provides a framework for analyzing the determinants of targeting performance. The framework uses both access and subsidy-design factors that affect performance. Finally, the chapter explores the potential for better targeting under a proxy means-testing system or geographic targeting.

The Way Forward: Topics for Future Study

There are many topics of importance in public finance not covered in this book. A key dimension is the political economy of the design and execution of public spending programs. Because of the need to attract middle-class support for social programs, countries face limits in their ability to target benefits strictly to the poor. Given this political constraint, improving targeting performance may not always serve the poor if it undermines public support for the programs.

A second important topic for future consideration is budgetary planning in response to macroeconomic stability goals and longer-term development objectives. The role of medium-term expenditure frameworks in enforcing a multiyear fiscal constraint, enhancing budget discipline and sustainable expenditure policy, and improving government performance cannot be underestimated. But even well-prioritized budgets designed under a medium-term framework can be undermined by shortcomings in actual spending when large differences between approved and executed budgets appear in countries with limited monitoring and control systems.

Finally, we have not addressed the cyclicality of public spending, whereby public expenditures in many countries are cut during recessions because of a lack of resources, thereby hurting the poor at the moment they most need support.

The ultimate impact of public finance decisions on poor people depends as much on the interaction among various fiscal dimensions as on particular interventions within any given areas. In particular, the redistributive effect of tax policy depends not only on tax design and compliance, but more essentially on how their beneficiaries use the funds raised by those taxes. Although the public spending program clearly remains the most direct instrument by which governments provide opportunities, empowerment, and protection to the poor, clearly it also is essential that the revenue side of the budget be considered, given its implications for efficiency and equity in the economy and its impact on the dynamics of debt and growth. Thus, to make the best decisions about the allocation and execution of public budgets, governments should consider both public spending and the revenues raised to finance them.

Despite the range of topics beyond the scope of this volume, we hope the chapters provide a good introduction to some of the critical issues faced by policy makers when trying to assess the impact on poverty of the decisions they make in the area of public finance.

Conclusion

In concluding this introduction, it is important to say that the goals of the government should be established in such a way that they are consistent with its ability to operate efficiently, while they promote an improved role for markets. The great need for government intervention in developing countries to deal with market imperfections and inequalities essentially calls for reducing government and institutional failures, improving public sector performance so that the main functions of the government can be ensured, and promoting effective public-private partnerships. Ultimately, it is essential that the fiscal policy instruments used by the government contribute to eliminating—not exacerbating—market distortions, and to improving—not worsening—income distribution.

Notes

1. A "public good" is a commodity for which the cost of extending the service to an additional person is zero (the commodity is said to be *nonrival*), and for which it is impossible to exclude other individuals from enjoying it (the commodity is *nonexcludable*). Because private provision of public goods generally is insufficient to meet the public need, government must step in to encourage the production of such goods. National defense provides a perfect example of a public good: when a nation protects its freedom, it does so for every individual and can exclude no one from enjoying that freedom.
2. This refers to Adam Smith's definition.
3. In some cases, private markets may not function well at all. In the case of private unemployment insurance, for example, demand and potential supply ex-

ist, but the inability of private firms to monitor and verify private behavior prevents the creation of a well-functioning market for unemployment insurance.

4. *Adverse selection* results when differences in information (or information asymmetry) between two parties lead to an unequal or inefficient exchange on the market. *Moral hazard* occurs in situations where agents maximize their own utility to the detriment of others because they do not bear the full consequences (or reap the full benefits) of their actions as a result of uncertainty, incomplete information, or the nature of the particular contract in force. Moral hazard behavior implies that economic agents take on more risk than they would take on normally in the expectation that some of their potential liabilities will be covered by others.
5. *Opportunities* essentially refer to jobs, regular income, and assets. *Empowerment* is associated with inclusion and capabilities to influence the decision-making process. *Protection* is a need emerging from the basic needs of the poor (education, health care, basic infrastructure, and so forth) and their vulnerability to external shocks. For more information, see World Bank (2000).
6. A *natural monopoly* is one that does not arise from government intervention in the marketplace to protect a favored firm from competition, but rather develops from special characteristics of the production process in the industry under the existing status of technology. Theoretically, a natural monopoly arises when there are very large economies of scale relative to the existing demand for the industry's product, so that the larger the quantity of the good a single factory produces, the cheaper the average costs per unit—right up to production at a level more than sufficient to supply the entire demand in the relevant market area. Natural monopolies typically are utilities, such as water, electricity, and natural gas.
7. The program and the preparation of this book benefited from the support of Belgium's Directorate-General for Development Cooperation.

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