Abstract

Understanding the relationship between macroeconomic policies and poverty still remains a key policy challenge. This paper develops a framework to link key macroeconomic variables with poverty and tests the effect of policies, namely the government-led channel of development spending and financing that directly influence poverty after accounting for the effect of sectoral output and price ratios, using data from India spanning over the last five decades. First, the policy-driven model emphasises the sectoral income distribution and intersectoral terms of trade as a mechanism in determining the level of poverty. Second, the paper considers key components of fiscal spending and monetary or financial policy via availability of credit, rather than the cost channel, to show that a strategy of government-led development spending and financing is a precondition for growth with poverty alleviation. The relative price of agriculture increases poverty by eroding the purchasing power of the poor as any demand pressure arising from higher income effect is not sufficient to offset the rise in food prices that comprise a large part of the consumption basket of most poor who are largely agricultural labourers or tenants. More irrigated area on the back of higher government capital spending on the other hand offsets the adverse impact, along with the extension of bank credit to agriculture, contributing significantly to poverty reduction.

Keywords: macroeconomic policy, India, China, development spending, development finance, poverty reduction

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