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The New Reform Agenda

Edited by
Boris Pleskovic and
Nicholas Stern

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About this Book

The Annual World Bank Conference on Development Economics is a forum for discussion and debate of important policy issues facing developing countries. The conferences emphasize the contribution that empirical and basic economic research can make to understanding development processes and to formulating sound development policies. Conference papers are written by researchers in and outside the World Bank. The conference series was started in 1989. Conference papers are reviewed by the editors and are also subject to internal and external peer review. Some papers were revised after the conference, sometimes to reflect the comments by discussants or from the floor. Most discussants' comments were not revised. As a result, discussants' comments may refer to elements of the paper that no longer exist in their original form. Participants' affiliations identified in this volume are as of the time of the conference, April 29-30, 2002.

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Keynote Address

New Policies for Economic Development

JOHN B. TAYLOR

Thank you for inviting me to speak here today. I'd like to use this opportunity to talk about the Bush administration's economic development agenda. It is a big agenda designed to help people around the world exit from extreme poverty. It stresses new quantitative methods to achieve good economic policy and good economic results. It includes substantial increases in development funding for the first time in many years. And it applies new ideas in economic development—including many of the ideas coming out of this conference series.

Before describing some of the specific policies, I want to define the problem we are trying to solve. Then I want to discuss in simple, straightforward terms the economic principles that logically and empirically lead to the specific policies. In doing so I will draw on economic development research completed in the last dozen years.

The Problem

The problem that we are all trying to deal with, of course, is that many people and many countries around the world are still very poor. Despite remarkable economic progress in many parts of the world, more than 1.3 billion people live on less than US$1 a day, and half the world's population lives on less than US$2 a day. As the color-coded maps on the World Bank Web site illustrate, many of the poorest countries are in Sub-Saharan Africa, Central Asia, and Central America.

The Goal of Productivity Growth

The first question is why are these countries so poor? Low productivity is the proximate answer. Productivity is the amount of goods and services that a worker pro-

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duces per unit of time with the skills and tools available. If there are many high-productivity jobs in a country, then the country is rich. If there are only a few high-productivity jobs in a country, then the country is poor. If you want to reduce the number of poor countries—to make all the colors on those World Banks maps the same color as the United States and Europe—then you have no choice but to increase productivity in poor countries. And the higher the rate of productivity growth, the faster those colors will change. Simply put, the ticket out of poverty is higher productivity jobs.

This is why U.S. Treasury Secretary Paul O'Neill has argued that program and loan decisions by the World Bank and the other multilateral development banks should focus on raising productivity. It is important to note that when the International Development Association (IDA) was first proposed by the Eisenhower administration in 1959, higher productivity was the key goal. In the words of the very first article of IDA's Articles of Agreement, "The purposes of the Association are to promote economic development, increase productivity and thus raise standards of living in the less-developed areas of the world. . . . The Association shall be guided in all its decisions by the provisions of this Article." It is unfortunate that I've seen too few examples in which increasing productivity has been the key goal for IDA decisions in recent years. Let's follow the provisions of the IDA articles or amend them.

Let me say a few more words about goals. The Millennium Development Goals are a very useful set of objectives. But there is something missing from these goals as stated: the goal of higher productivity growth. What might such a goal look like? As I'll discuss in a few minutes, we should expect that countries with lower productivity than the United States should have a productivity growth rate higher than that of the United States. But we could be more specific, stating that the greater the productivity gap between a country and the United States, the greater should be the productivity growth rate in that country. In fact, we could be even more specific by stating numerical goals for productivity growth. For example, empirical studies indicate that a reasonable annual productivity growth rate goal for a country with productivity one-fifth that of the United States is 3 percentage points greater than the productivity growth rate of the United States. For a country with one-tenth the productivity of the United States, a reasonable goal would be 5 percentage points greater productivity growth than the United States. And extrapolating, for a country with one one-hundredth of U.S. productivity, perhaps a goal of 9 percentage points greater growth than the United States could be set.

These are ambitious goals. But seriously addressing global poverty demands nothing less. And make no mistake—raising productivity growth is the only way to achieve substantial and sustained reductions in poverty. Empirical studies confirm this. Higher growth increases the income per capita of the lowest quintile by about the same amount as the other quintiles.

Impediments to Catching Up

If low productivity is the proximate cause of poverty, then we need to answer another question: why is productivity so low in so many areas of the world? According to basic economic growth theory, productivity depends on two things: capital per worker and the level of technology. If there are no impediments to the flow and accumulation of capital and technology, then countries or areas that are behind in productivity should have a higher productivity growth rate. Capital will flow to where it is in short supply relative to labor and, with more capital, higher productivity jobs can be created. Similarly, technology can spread through education and training—perhaps through on-the-job training via foreign investment, or education via the Internet. For these reasons, poor areas or countries should be catching up to rich areas or countries.

There is evidence for such catch-up when there are few impediments to the use and accumulation of capital (including human capital) and technology. For example, an examination of the productivity growth rates in states in the United States shows that states that were relatively poor in the late 19th century, such as Texas and Florida, grew more rapidly in the 20th century than did richer states, such as New York or California. Similar evidence of catch-up exists in the countries of the Organisation for Economic Co-operation and Development (OECD). Among the countries that were founding members of the OECD in the 1960s, lower productivity countries have grown more rapidly than have higher productivity countries.

It is unfortunate that there is little evidence of such catch-up in the world as a whole. Although some countries that were very poor in the 1960s have grown more rapidly than have the rich countries, many other poor countries have grown more slowly. Why has there not been more catch-up? Is economic growth theory wrong? Many answers have been given to these difficult questions—indeed, the questions have been on the minds of development economists for years. More and more evidence, however, has been accumulating that the laws of economics have not been repealed, but rather that significant impediments—in the broadest sense—to investment and the adoption of technology are holding back countries and people.

One can group these impediments into three areas. First, *poor governance*—the lack of rule of law or enforceable contracts and the prevalence of corruption create disincentives to invest, to start up new firms, and to expand existing firms with high-productivity jobs. This has a negative impact on capital formation and entrepreneurial activity. Second, *poor education,* which impedes the development of human capital. Workers without adequate education do not have the skills to take on high-productivity jobs or to adopt new technologies to increase the productivity of the jobs they do have. Third, *too many restrictions on economic transactions,* which prevent people from trading goods and services or adopting new technologies. Lack of openness to trade, state monopolies, and excessive regulation are all examples of restrictions that reduce incentives for innovation and investment needed to boost productivity.

The Specific Policies of the Bush Administration

With these ideas and facts as background, let me now discuss the Bush administration's new economic development agenda.

First, the agenda calls for a much greater emphasis than in the past on policies that reduce the impediments to higher productivity growth. Countries that follow good economic policies are to receive more aid, and the actual results of the aid are to be measured quantitatively.

Second, the agenda calls for an increase in funding for economic development. President Bush has proposed an 18 percent increase in the U.S. contribution to the African Development Fund and to IDA. He has called for a larger fraction of IDA assistance to the poorest countries to be provided in the form of grants rather than loans. And he has called for the creation of a Millennium Challenge Account, a new, separate account for development assistance.

The Millennium Challenge Account

Consider first the Millennium Challenge Account. This account will be funded by increases in the budget beginning in fiscal year 2004. The account is designed to increase to US$5 billion a year starting in 2006—a 50 percent increase over the approximately US$10 billion in existing U.S. development assistance. The idea behind the Millennium Challenge Account is to channel aid to those poor countries that have good economic policies that increase economic growth and reduce poverty. To access the account, developing countries must demonstrate strong commitments in three policy areas: (1) "ruling justly"—upholding the rule of law, rooting out corruption, and protecting human rights and political freedoms; (2) "investing in people"—education and health care; and (3) "encouraging economic freedom"—open markets, sound fiscal and monetary policies, appropriate regulatory environments, and support for private enterprise. Note that these are exactly the three policy areas I mentioned above when listing the impediments to economic growth.

President Bush has assigned Secretary O'Neill and Secretary of State Colin Powell the task of developing the objective criteria for measuring countries' policies in these areas, and we are hard at work on this task now. We are using empirical research on economic growth over the last 10 years and performing our own research. We place a premium on simplicity and robustness. We want something that easily can be understood.

Indeed, President Bush has asked us to reach out to the world community in the process of developing these indicators. The people in this room have a great deal to contribute to this process. Your ideas are welcome!

Results-Based IDA Replenishments

As I mentioned, the President's budget proposes a significant increase in the U.S. contribution to IDA-13. Under President Bush's proposal, funding would be 18 percent higher than the IDA-11 and IDA-12 replenishments in the 1990s. The proposal incorporates an $850 million contribution in the first year, $950 million in the second year, and $1,050 million in the third year. However, the increases in the last two years are explicitly linked to improvements in IDA's performance in such areas as combating disease and improving education.

Linking the size of the IDA replenishment to results is a new idea. I am glad to say that it appears to be having a good impact on other areas of the World Bank. Already we are hearing more about a greater focus on measurable results in the World Bank's operations.

IDA Grants

As many of you know, President Bush has proposed converting part of IDA loans to results-based grants. IDA loans have highly favorable terms. But the burden of repayment on some of the poorest countries has meant that the international community has to forgive many of these loans. The objective of the U.S. grants proposal is to prevent that problem, with all its disruptive consequences for economic growth, from ever occurring again. We want to "stop the debt."

A recent study by the U.S. General Accounting Office demonstrates that grants promote debt sustainability better than 100 percent debt forgiveness of old international foreign investment debt. And consistent with the Millennium Challenge Account and results-based IDA replenishment proposals, grants can be tied to performance measures, such as test scores in basic skills.

Conclusion

Conferences like this one provide a forum for sharing what we know and—just as important—what we do not know about economic development. Today I have tried to describe how recent advances in research on economic growth have informed the Bush administration's policies on foreign assistance.

But there is still much that we do not know about economic growth and development. For example, although studies demonstrate that aid is most effective when provided to countries with good policies, there is more work to be done on what *kinds* of assistance are most effective in promoting productivity growth in poor countries. If we are going to achieve the productivity growth goals I suggested in this talk, we are going to need more ideas. I look forward to benefiting from the research and insights of ABCDE conferences in the years ahead.