

New Policies for Economic Development

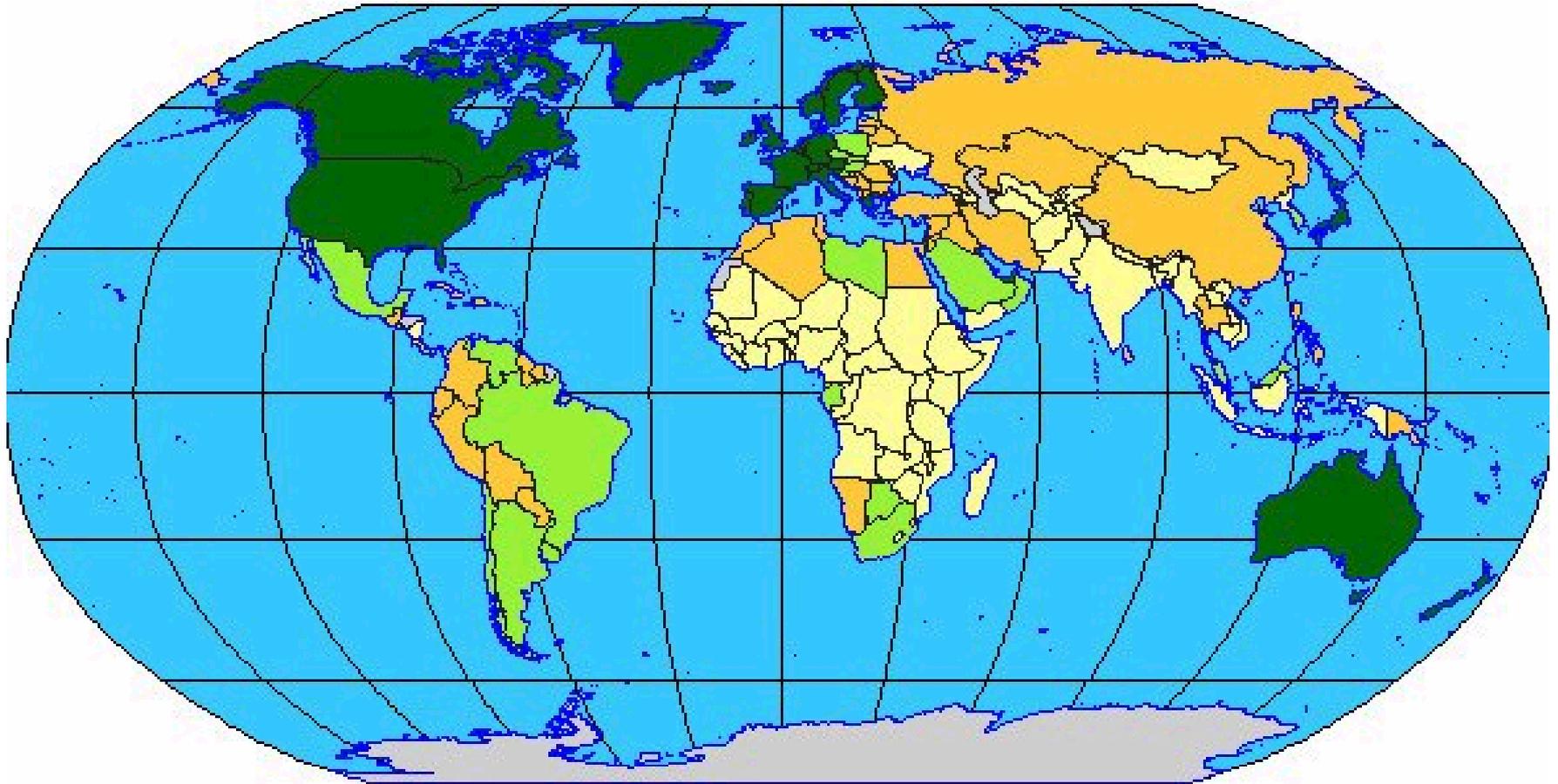
John B. Taylor

Under Secretary for International Affairs

United States Treasury

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1.3 billion people, less than \$1 per day
 $\frac{1}{2}$ world's population, less than \$2 per day
U.S. average, \$90 day. Why?

**Map source: World Bank*

The Key to Poverty Reduction is Higher Productivity Jobs

- *Productivity = output (Y) per hour of work (L) = Y/L*
 - Sometimes called labor productivity
- It's “the explanation” why some countries are rich and other countries are poor
- Countries that are behind in productivity are behind in income per capita
- Productivity growth is how to achieve higher income per capita

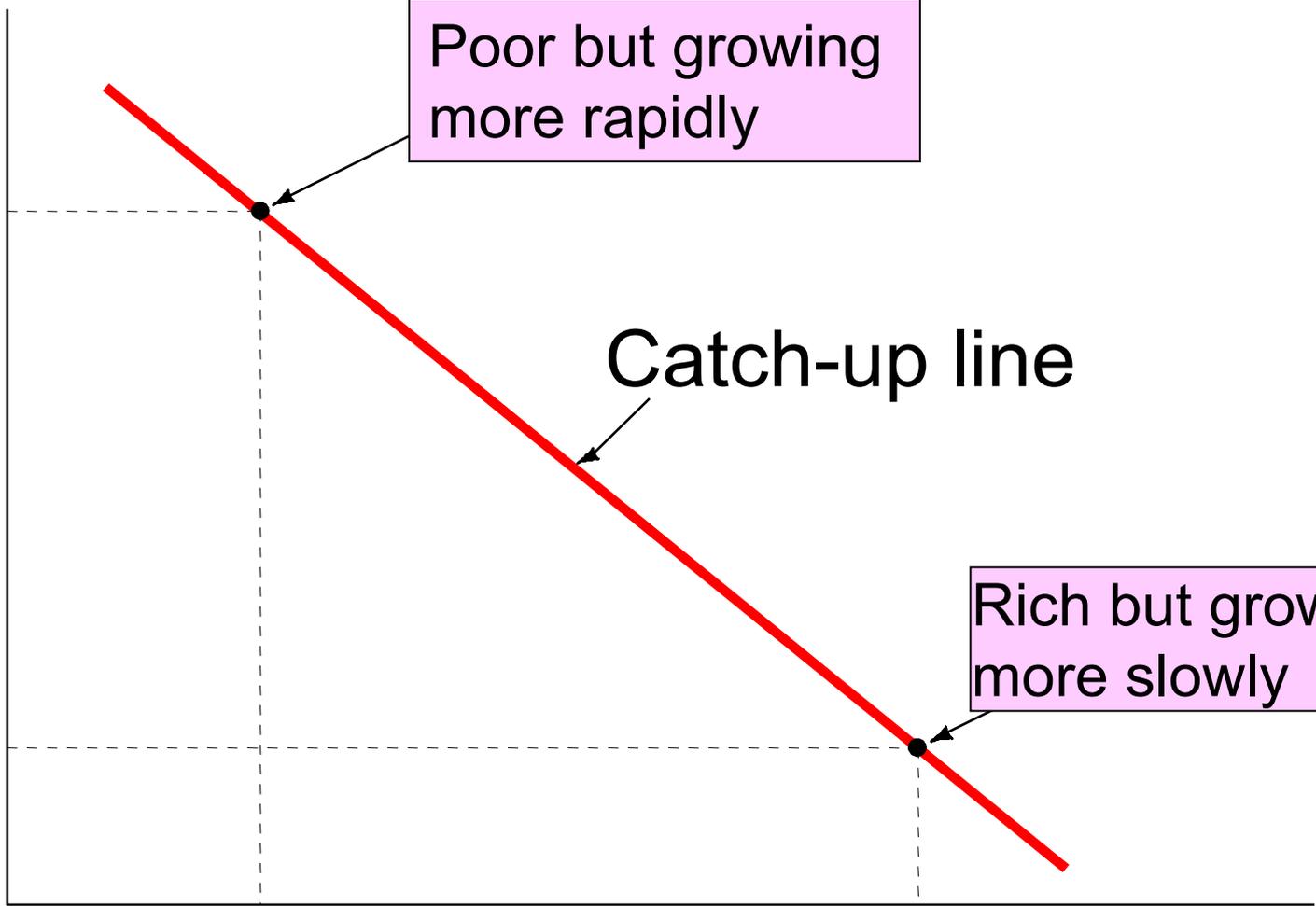
A Founding Principle of IDA

“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.” -- *Articles of Agreement for the International Development Association*

Economic Growth Theory

- Growth accounting: higher productivity jobs (Y/L) requires more capital (K/L) or better technology (T)
- If there are no impediments to the flow and use of *technology* and *capital*, then countries or regions that are behind in productivity should have higher productivity growth: they should be catching-up
- Three issues:
 - Capital should flow to where returns are relatively high
 - Spread of technology through education, foreign direct investment, internet, etc.
 - Private sector is the creator of higher productivity jobs

GROWTH RATE OF
PRODUCTIVITY
OR
GROWTH RATE OF
INCOME PER CAPITA



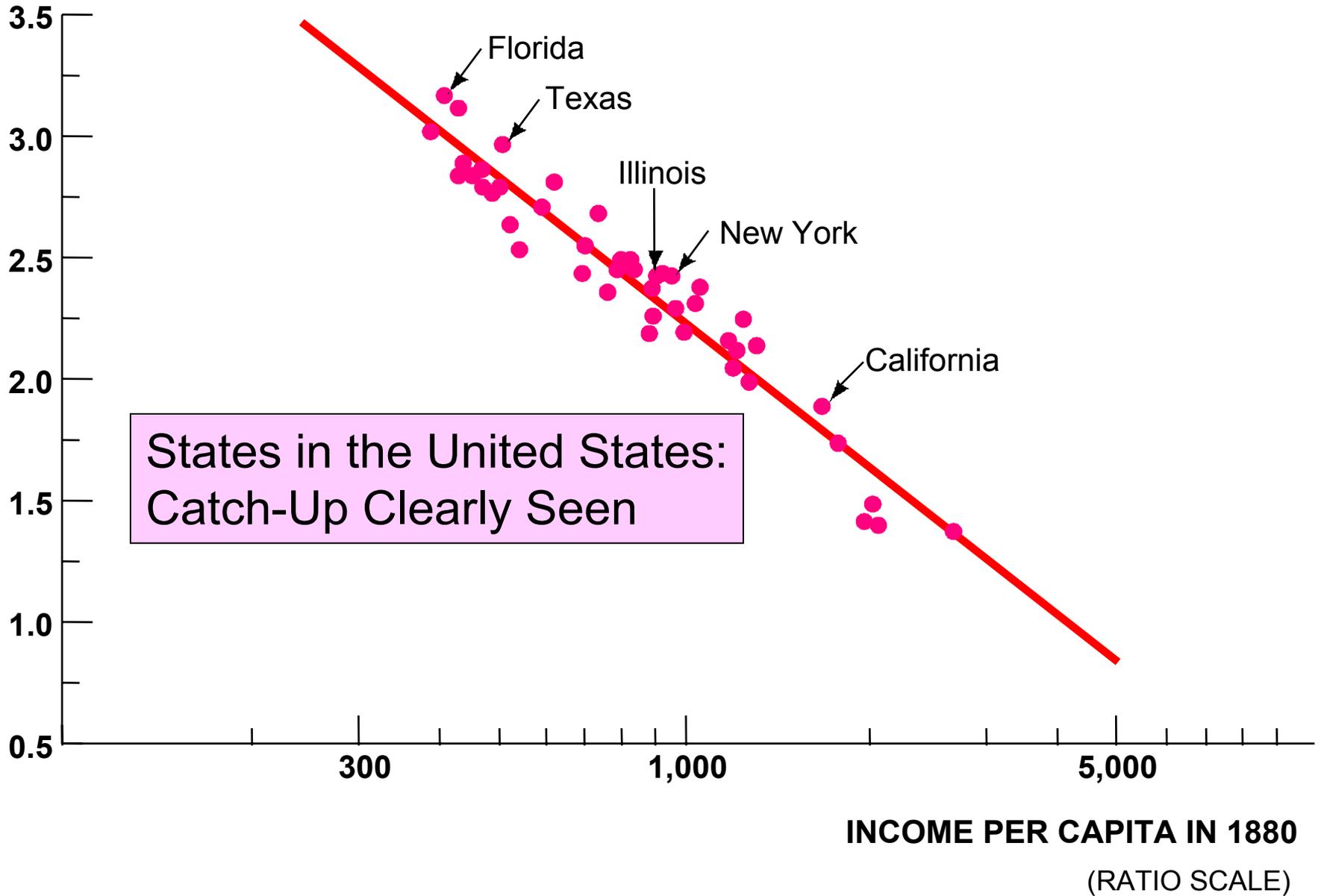
Poor but growing more rapidly

Catch-up line

Rich but growing more slowly

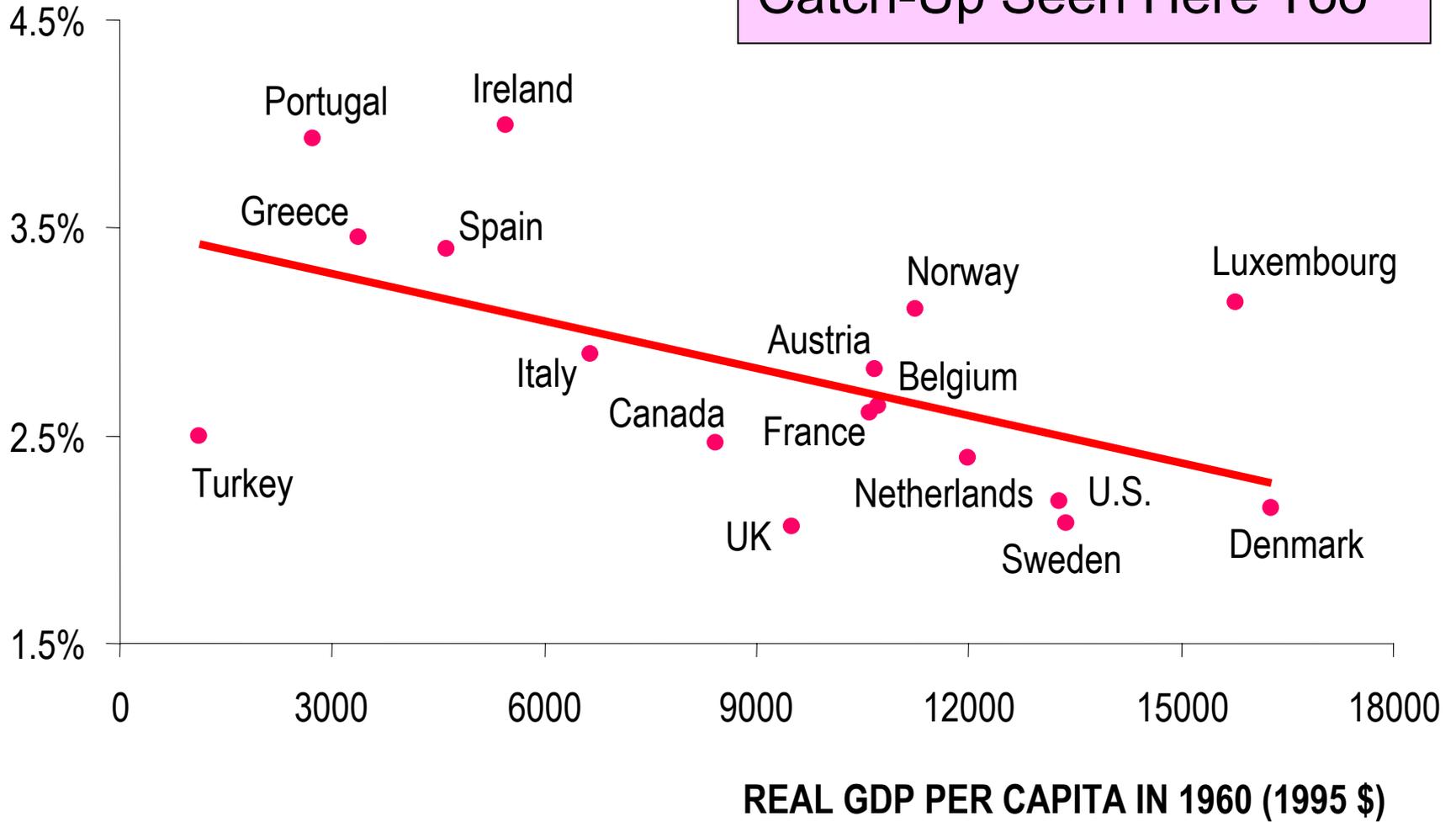
LEVEL OF PRODUCTIVITY
OR
LEVEL OF INCOME PER CAPITA

GROWTH RATE OF INCOME PER CAPITA, 1880-1980



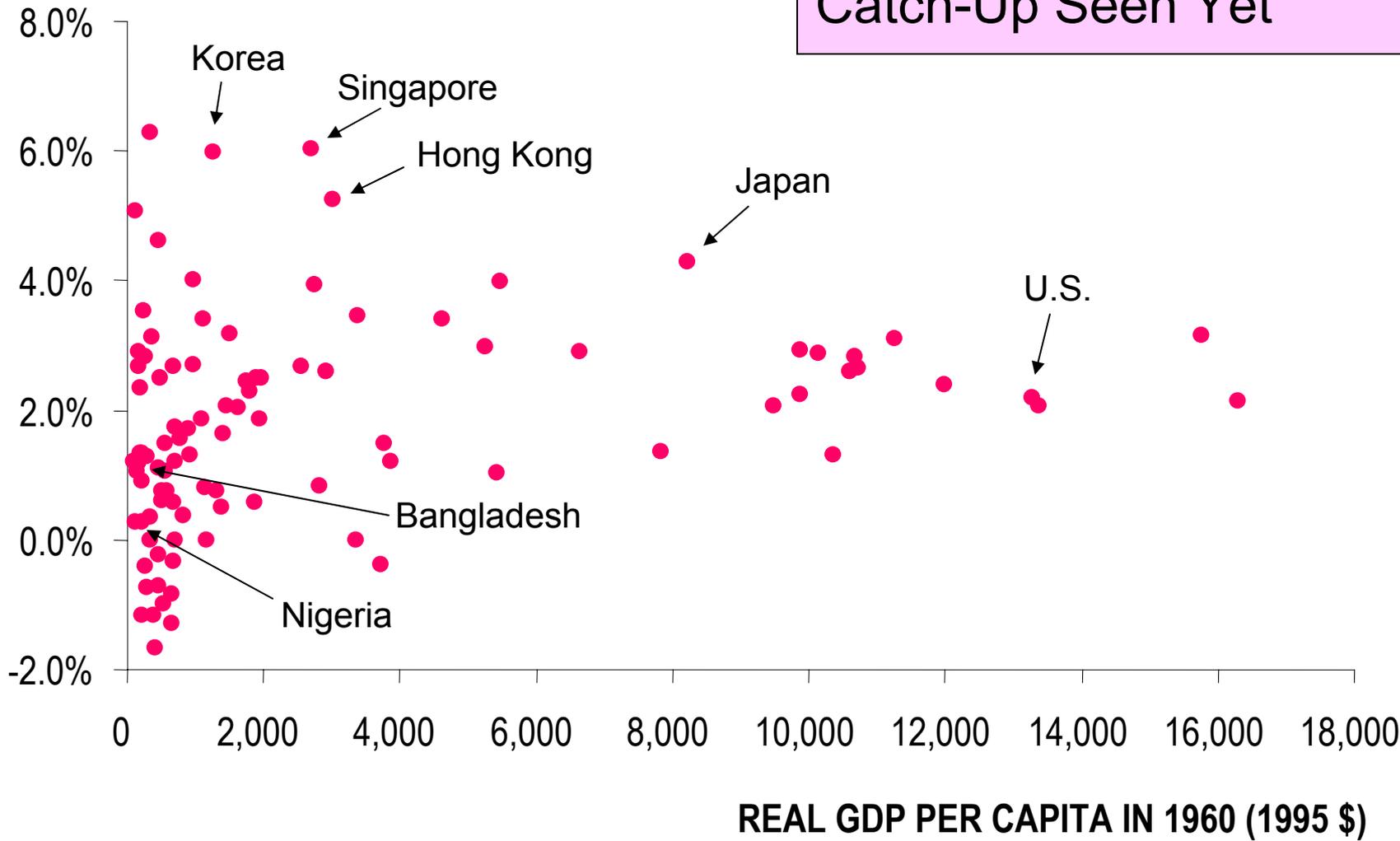
ANNUAL GROWTH RATE OF REAL GDP PER CAPITA, 1960-1999

More Advanced Countries:
Catch-Up Seen Here Too



ANNUAL GROWTH RATE OF REAL GDP PER CAPITA, 1960-1999

All Countries: Not Much Catch-Up Seen Yet



Recent Productivity Trends

Annual labor productivity growth, 1991-99 (%)

- East Asia 5.5
- United States 2.1
- Europe 1.2
- Latin America 0.7
- Middle East -0.1
- Africa (Sub-Saharan) -0.5

An Addition to the Millennium Goals: Productivity Growth

- Countries with lower productivity than the U.S. should grow faster than the U.S.
- The greater the productivity gap between the U.S. and a country the greater should be the productivity growth rate in that country
- Could the goal be quantified?
 - Productivity gap 5 times \Rightarrow growth rate difference 3
 - Productivity gap 10 times \Rightarrow growth rate difference 5
 - Productivity gap 100 times \Rightarrow growth rate difference 9

Poverty and Productivity Growth

- Some argue that the focus on economic growth will mean less focus on poverty reduction
- Simple logic: With productivity 100 times lower in poor countries, “catch up” in *average* incomes completely dominates changes in income *distribution*
- Empirical studies demonstrate that higher productivity growth increases the income per capita of the lowest quintile by about the same amount as the other quintiles

Why Isn't There More Catch Up?

- Very difficult question
- Key factor: impediments and disincentives to the spread and to the application of technology and capital

Reasons for Lack of Catch Up

- Poor governance
 - weak rule of law, corruption
 - creates disincentives to invest, to start up new firms, to expand existing firms
- Poor education
 - reduces human capital
 - impedes adoption of new technologies
- Restrictions on economic transactions
 - lack of openness to trade, state monopolies, and excessive regulation
 - reduce incentives for innovation and investment needed to boost productivity

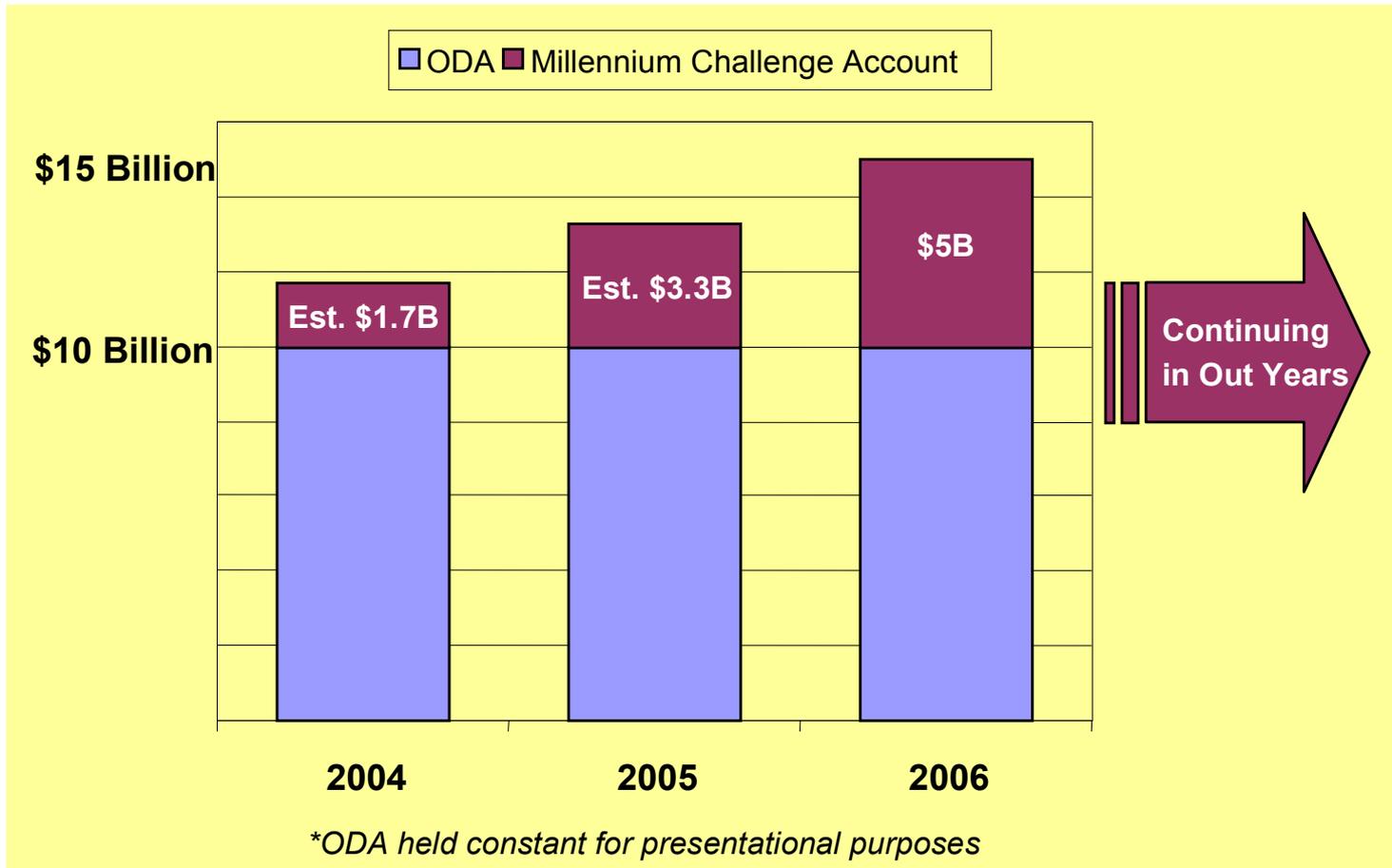
The New Agenda

- **Increase foreign aid**
 - (1) Funding for Millennium Challenge Account to increase to \$5 billion a year by 2006 — a 50% increase over and above existing U.S. development assistance
 - (2) Contribution to World Bank's International Development Association (IDA) increase by 18%
 - (3) Larger fraction of IDA aid in form of outright grants rather than loans
- Let **good performance** determine which countries get aid for economic development

Millennium Challenge Account

- Good policy performance in three areas:
 - “Ruling justly” (lack of corruption)
 - “Investing in people” (good education, health policy)
 - “Encouraging economic freedom” (reduce trade barriers)
- Theory and evidence says that these will increase productivity growth
- Now working on objective criteria in each area:
 - using “growth regression” research over last 10 years
 - needs to be simple, robust

Funding for the Millennium Challenge Account



Results-Based IDA Replenishment

- U.S. is proposing to increase IDA contribution by 18% in the current replenishment
 - Year One: \$850 million
 - Year Two: \$950 million
 - Year Three: \$1,050 million
- Each \$100 million increment in year two and three would depend on performance in combating disease and improving education

From Loans to Grants

- U.S. has proposed converting IDA loans to grants
 - Loans already have highly favorable terms
 - Yet inability to repay yields calls for debt forgiveness
 - So we want to “stop the debt”
 - Grants can be tied to performance, for example, better test scores in basic skills
 - Grants promote debt sustainability better than 100 percent debt forgiveness of old MDB debt (GAO)