
DRIVING ECONOMIC GROWTH

CHAPTER 2

THE UNITED STATES HAS BEEN GROWING ECONOMICALLY ever since 1776, while most of the world has not. Per person, economic growth in the United States has averaged only about 1.7 percent a year.¹ But over 225 years this growth has caused a 44-fold increase in per capita income. Thus high U.S. living standards are explained by the persistence of growth, not its speed. Sound institutions and economic governance allow individuals to become wealthier and more productive over time, secure that the fruits of their efforts will not be arbitrarily taken from them.

The challenge for developing countries is to promote growth long enough to achieve prosperity. In many ways it is easier for them to do so than it was for the United States. Many productivity-enhancing tools—discovered during the course of American growth—can now be easily acquired and applied. They do not need to be reinvented. But political, ethnic, tribal, and religious rivalries—and predatory governments—impede coherent, sound economic policies supported by the rule of law. Such policies offer the best hope for rapidly reducing poverty.

Effective economic governance makes development possible. Growth policies can be made to have the benefits reach the poor. But in most developing countries the real challenge is achieving any kind of sustainable growth—and over the long term, a growing economy is required to reduce poverty. At least for the next generation, U.S. efforts to reduce poverty in developing countries must focus on promoting growth in developing economies.

This chapter examines long-run patterns of economic growth in developing countries, identifying reasons for sustained growth in certain countries—and for its absence in others. Supporting agriculture is crucial for many developing countries and for many poor people. In addition, integrating with the world economy—through trade and foreign investment—helps economies become more competitive. Ultimately, however, a nation's productivity is determined by the productivity of its workforce—and their success is intertwined with the quality of the business climate.

NEW THINKING ON DRIVERS OF GROWTH

Economists have conceptualized the process of economic growth around three basic models:

specialization and trade, investment in machines, and increasing returns to knowledge. At different points in the history of economic thought, each model has been advocated as the fastest road to riches. Yet all three have a contribution to make. Adam Smith was highly optimistic about prospects for raising living standards through the higher labor productivity that results from specialization. Because specialization requires trade, low trade barriers are required so that manufacturers can access larger markets. Competition—the invisible hand—then induces greater specialization, raising labor productivity and living standards.

This trade-intensive strategy for economic growth requires many transactions, often at long distances and over time. Thus institutions that defend property rights and lower transaction costs, such as the rule of law, have come to be seen as the foundations of a market economy. This is why economic governance is considered an essential starting point for economic growth, not something to be tackled later.

The success of the industrial revolution in the 19th century, first in Britain and then in France and Germany, added technological change to strategies for growth. Such change was seen as embodied in machines using mechanical power. It was recognized that not all countries could invent and produce machines. But all were free to import them and reproduce the factory system that was making Europe so rich and powerful. This “capital fundamentalism” stressed accumulating savings and investing in machines that embodied the latest technologies. Investment and production did not have to rely on the profit motive of private investors, but instead could be directed by national planners. This model was used for German industrialization in the late 19th century and Soviet industrialization in the mid-20th century.

But the “machine model” could go only so far. It raised productivity but did not create self-sustaining growth. The machines involved were good at producing a fixed set of products but not at adapting to changing technologies and consumer desires. Only markets and capitalism can accomplish these tasks. With accelerating scientific innovation in advanced countries, productivity growth came to depend more on knowledge than on machines. Economies such as Brazil, Israel, the Republic of Korea, and Taiwan had institutions that could support the absorption of Western knowledge—rather than just

machines—and moved to modern economic growth. Economies without these institutions, including the Soviet bloc, nearly all of Africa, and most of the Islamic world, could not. As a result, they have slipped into economic stagnation or decline. Some have slipped even further, into chaos and conflict.

The model of economic growth that explains this performance is based on increasing returns to knowledge. Instead of diminishing returns as more of the same machines are used in a given labor force, returns to knowledge increase because of spillovers to additional users. Large payoffs from new knowledge, especially where there is patent protection, encourage entrepreneurs to develop it, in some cases by adapting findings from research universities and research centers.

Economic growth is now seen as an endogenous response to incentives throughout the economic system. The modern concern for enforcing intellectual property rights as well as property rights for land, goods, and financial assets is easy to understand from this perspective. Lack of protection for intellectual property rights will slow the search for new knowledge—and hence economic growth.

Self-sustaining growth is difficult for developing countries because generating knowledge and developing sophisticated human capital depend at least as much on institutions that ensure strong property rights and low transaction costs as on specialization and trade. The belief that there are shortcuts to the gradual evolution of such institutions is now seen as mistaken. For many developing countries, the quest for growth is quite elusive.²

THE RECORD OF GROWTH

Economists have developed myriad models to explain the empirical record of growth. The usual prescriptions—low inflation, macroeconomic stability, openness to trade, good institutions, government investment, democracy—can all be shown to contribute to growth in a certain set of countries or during a certain period. But they are far from a complete explanation.

Specific factors also influence economic growth. Unstable prices for commodity exports slow growth. Avoidance of urban bias in education speeds it up. Trade openness was bad for growth in the 1930s and 1940s, of little importance in the

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1950s and 1960s, and highly significant in explaining rapid growth in the 1970s and 1980s.

Rapid growth in the national stock of capital goods (such as infrastructure and industrial machinery) can lift a developing country onto the first rung of the development process. But eventually, total factor productivity—efficiency in using capital, labor, and other inputs—becomes the main source of higher incomes. This realization led to the “knowledge model” of development described above. Difficulties in moving to the “knowledge model” are evident in the growth record of the 1990s. More than a third of the 108 developing and transition economies had lower per capita incomes in 2000 than in 1990. The decade saw some of the fastest growth ever in global output and international trade, indicating that the external environment was favorable to growth. Thus sources of poor performance came from within the countries.

None of the 38 poor performers were affected by East Asia’s financial crisis in the late 1990s. In fact, none were in Asia. Nearly half (18) had been part of the Soviet Union. Africa accounted for another 14 countries. And despite reasonable economic performance for the region as a whole, 4 countries in Latin America and the Caribbean suffered decade-long declines.³

Such long-term economic problems point to deep-seated failures to establish the core elements required for modern economic growth: provision of public goods and social infrastructure, of a stable macroeconomic environment, and of a favorable business climate. Why do some governments fail to provide these essentials for growth—or even actively undermine them? Modern political economy has tried to answer these questions, but with only modest success.

**GOOD ECONOMIC GOVERNANCE BOOSTS
ECONOMIC GROWTH**

Institutions and rules have to be in place to sustain growth once it starts. To encourage competitive markets, governments must overcome vestiges of mercantilism and protectionism that stifle market activity and prevent new entrants into the economy. Good economic governance, founded on a predictable and fair system of law, is one way to do so. Since the times of John Locke, economic development has been linked to the protection of individual rights and especially of property.

In an empirically rich study of this linkage, Hernando de Soto shows how, without a legally integrated property system, poor people in developing countries cannot convert their work and savings into capital.⁴ Their property, both immovable and moveable, cannot be pledged as collateral for loans that would allow them to turn their assets into capital, and their assets have no representation—such as a title pledged against a mortgage. De Soto calls this lack of representation “dead capital.” Government has a crucial role to play in creating this system of representation so that capital can be mobilized to support investment and growth. Without national capital markets, economic growth cannot be sustained even with development assistance and foreign direct investment.

Good economic governance is the result of strong public institutions, with an important role for individuals, civil society organizations, and business and interest groups. Where fairness and equity exist to a reasonable degree, with an open society allowing for healthy competition among multiple interests, there is a greater possibility of developing policies for the greater good. Yet in many developing countries powerful interest groups impede economic activity by marginalizing large, potentially productive segments of society that lack legal and political means to affect public policy. Democratic processes, equitable and broadly based popular participation, and transparent laws and regulations are important for developing good governance and sound economic policies. They also result in higher levels of development.

Sound economic governance encourages private individuals and groups to engage in economic activities such as taking risks, investing capital, and, ultimately, exporting goods and services (figure 2.1). To encourage exports, governments must at least provide supportive, predictable laws and regulations. And as discussed below, the same enabling environment that supports private sector-led growth encourages foreign direct investment—because a safe, relatively unrestricted policy environment encourages foreign as well as local investment.

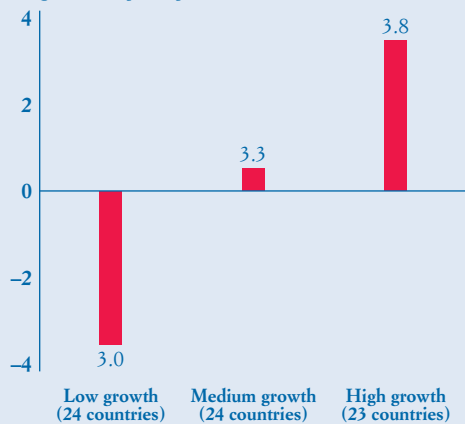
GROWTH IS GOOD FOR POOR PEOPLE

Poverty is closely linked to low economic productivity. Low productivity results from supply factors (such as limited availability of land, skills, or appro-

Good governance boosts economic growth

FIGURE 2.1

Average corruption index for countries grouped by growth in per capita PPP GDP, 1990–1999



Note: Per capita GDP adjusted for purchasing power parity (PPP).
Source: For index values, Transparency International; for growth rates, World Bank. Hannon and Rhee 2002.

priate technology) as well as demand factors (such as low prices for commodities, limited availability of productive jobs, and poor access to urban markets). Local markets can ease both types of shortcomings, providing an affordable and accessible arena of exchange for goods and services produced by poor people. Without market exchanges it is almost impossible to escape poverty.

The importance of market exchanges illuminates the role of governance in causing and easing poverty. Bad governance means poorly defined property rights, high transaction costs, large economic risks, and outright theft. Markets disappear in such environments—and with them, poor people’s hopes for escaping poverty.

Other factors also affect poverty. Cultural and religious values are often high on the list. At least in the short run, people’s attitudes, general levels of trust, traditions, religious taboos, preferences for leisure, and the like can impede rapid change. Research is now under way to quantify how value systems and world views affect growth.⁶ And once the links are better understood, they can be incorporated in models of development.

New data eliminate any doubt that rapid economic growth reduces poverty.⁷ In all but a few countries economic growth has increased per capita incomes for the poorest 20 or 40 percent of the population. Yet despite rapid global growth since World War II, the world still has a large—

and in some regions, growing—number of poor people. Are these people forever trapped in low-growth environments? Are there circumstances where economic growth does not reach the poor? Fortunately, it is possible to understand the relationship between reductions in poverty and changes in the distribution of income, and to strengthen the link between economic growth and poverty alleviation.

Income distribution matters because it reflects and affects how growth changes the lives of poor people. The sectors in which growth originates and the initial distribution of income help shape how well poor people connect to economic growth (box 2.1). In countries where the gap between the incomes of the poorest 20 percent and the richest 20 percent is less than twice the average per capita income—that is, where the income gap is relatively small—growth in both agricultural and nonagricultural productivity improves the distribution of income. Growth in agricultural productivity is slightly but consistently more effective in generating incomes for all people.⁷ Rising agricultural incomes spur growth in nonagricultural rural production as well. In the long run, the agriculture sector will absorb a smaller share of productive resources, and nonagricultural job opportunities will be more important for poor people.

Outcomes are strikingly different in countries where the income gap is more than twice the average per capita income. In such countries the poorest fifth of workers are disconnected from the economy and so do not benefit from growth in agriculture or nonagriculture. Instead higher agricultural productivity favors the rich—undoubtedly because of an unequal distribution of assets, particularly land.

Thus the distribution of assets matters. It is almost impossible to understand the impact of economic growth on income distribution and of income distribution on the rate and distribution of economic growth without considering the distribution of assets in society. Assets are likely to be distributed even more unequally than income.

Research in Latin America has linked poor people’s slow income growth to the unequal distribution of land and education.⁸ In addition, the higher is the initial poverty rate, the less effective is nonfarm economic growth in reducing poverty. Recent research has also shown that the composition of economic growth matters for poverty reduction in India:

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Box 2.1 Income inequality is declining—thanks to the global economy

In recent decades the main concern about global economic growth has been that the international distribution of income is worsening—often interpreted to mean that the rich are getting richer and the poor are getting poorer. Economic growth can produce this result, but it is empirically unusual. More often, a worsening income distribution means that poor people's incomes rise slower than rich people's.

This issue is important, because an unequal income distribution can create class conflict. But it is also a complex issue, because an increase in inequality is not necessarily undesirable. The important issue is the source of the inequality—whether it is wealth creation or exploitation by the rich.

Growth in Western Europe illustrates the issue. A thousand years ago the global distribution of income was much more equal: almost everyone was poor. Then Western Europe began developing institutions and technology that resulted in steadily increasing per capita incomes. (The timing of the region's rise is the subject of debate, with its average income moving ahead of the rest of the world sometime between 1000 and 1750.) From about 1500 onward this

wealth creation caused the world income distribution to become increasingly unequal. Bourguignon and Morrisson (2001) estimate that world income inequality increased steadily between 1820 and 1970, then fell. Dollar and Kraay (2002) conclude that world income inequality peaked around 1975 and has been declining since. (The largest factor in this decline has been rapid growth in China and India, which Dollar and Kraay attribute to these countries' increased participation in the global economy.)

Beyond the issue of wealth creation is the issue of the proper measure of inequality. A broader measure of inequality—one that takes into account life expectancy and access to education—would be preferable and would show more favorable trends than one that relies solely on income.

Finally, the focus on income distribution is often a diversion from a more important question: what is happening to the real incomes of poor people? This issue is more relevant for reducing deep poverty.

Source: Maddison 2001; Bourguignon and Morrisson 2001; Dollar and Kraay 2002.

poverty has persistently responded far more to rural than to urban growth. Both theoretical and empirical work, then, suggest that inequalities may persist and that certain inequalities particularly limit opportunities for the poor.

AGRICULTURAL GROWTH IS EVEN BETTER FOR POOR PEOPLE

In recent years many economists have ignored agriculture, arguing that market forces will favor the most appropriate sectors. Moreover, agriculture plays a shrinking role as economies make the structural transformation to urban-based activities and to industry and services. But in many economies agriculture is crucial for connecting poor people to economic growth. Most of the world's poor people live in or come from rural areas. Rising agricultural productivity offers economywide benefits, the first of which is cheaper food for urban residents. Pursuing agricultural strategies in line with market realities and institutional capabilities would provide many benefits to developing countries, including:

- *Better access to technology.* Agricultural exports often pay for imports of foreign technology, mostly machines.
- *Increased capital formation.* Income from agriculture can finance investments inside and outside the sector. Although savings may be less productive in government than private hands, public investments in infrastructure and public goods can raise the profitability of private investment in agriculture. If agriculture is more easily taxed than nonagriculture in the early stages of development, it may provide revenue for this important initial stage of public investment.
- *Better social outcomes.* Rural education levels are affected by growth in agricultural productivity and rural incomes. Such education can directly increase farm productivity. It can also make moving to cities much easier and more economically rewarding for children who leave the farm.
- *A more supportive environment for growth.* There are many reasons economies produce less than they could. Economic growth is slowed by weak institutions, ineffective

economic policies, political instability, and lack of economic freedom. How changes in agricultural productivity affect these growth determinants is a matter of much speculation and little empirical evidence. Still, evidence is accumulating on two points. Unstable prices for agricultural products may slow investment. Unstable politics—in the form of restless rural populations challenging political leaders if they are left behind during rapid economic growth—may have the same result.

To continue to be good for poor people, agricultural growth has to be sustainable. As global population and income grow, agriculture must be put on a sustainable footing. Government prices and policies are key determinants of how ecosystems are treated. They direct choices on what to consume and how to manage lands and resources. A farmer deciding what crops to plant and what chemicals to use, or whether to increase cultivated area by clearing adjacent forests, is guided by calculating commodity and pesticide prices as well as other farm costs. Similarly, economic factors drive a developer's choice on where to locate housing or a fisherman's decision on where to fish.

The institutions of governance are also important for managing the environment. These institutions control access and enforce private property rights—to land, water, and forests. They also help in managing natural assets not suited to private ownership, such as air. Where the institutions of governance are effective, the management of natural assets is also effective. But where they are weak—or captured by narrow interests—aquifers are depleted, forests are overexploited, and pesticide and fertilizer use is excessive.⁹

AGRICULTURAL DEVELOPMENT BOOSTS ECONOMIC GROWTH

In many countries agricultural development has made crucial contributions to economic growth, and investments in agriculture have had large economic returns. Lower food prices, stimulated by rapid technological change in agriculture, have raised living standards directly (especially for poor people, who spend a large share of their household budgets on food) and indirectly (by keeping real wage costs low in the industrial sector, fostering investment and economic transformation). Some argue that the benefits of low food prices can be obtained as easily by import-

ing food as by investing in domestic agriculture.¹⁰ But a pure trade strategy risks losing other benefits of agricultural modernization.

These benefits include the backward and forward linkages that connect cities with the countryside. Without such linkages societies are more vulnerable to fluctuations in world markets, inequities between rural and urban inhabitants, underemployment in rural areas, and excess migration. The returns to strong rural-urban linkages include a relatively smooth structural transformation—as in Taiwan, in contrast to Thailand. Surprisingly, given how long this debate has been going on, there are still no satisfactory tests of the impact of changes in agricultural productivity on the mechanisms of “catch-up” growth outlined above, or on the value of rural-urban linkages.

RURAL GROWTH REDUCES POVERTY

Rural growth connects poor people to economic growth. Much progress has been made over the past decade in identifying how this happens. Foremost in this effort is John Mellor's model of agricultural growth, rural employment, and poverty reduction, which emphasizes the role of nontradable goods and services in moving underemployed workers from agriculture into the nonagricultural rural economy.¹¹ This model emphasizes rural incomes as the driver of the demand for these goods and services and describes how this economy is linked to urban demand—especially when it is driven by rising incomes among workers in labor-intensive export industries.

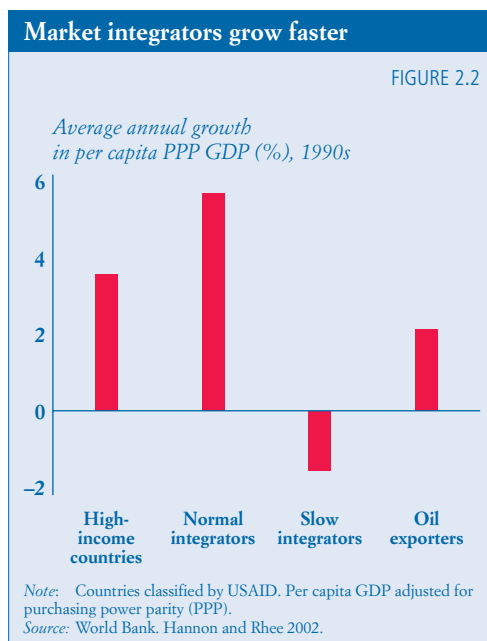
Mellor's model is the first to explicitly recognize this connection between manufactured export performance, the role of the nontradable sector in the rural economy, and subsequent reductions in poverty. Thus the model explains why countries with rapid growth from labor-intensive manufactured exports and substantial agriculture sectors have had such strong records of poverty reduction. Yet policymakers and donors often ignore the nontradable sector precisely because so much emphasis is placed on the importance of exports and open economy strategies for economic growth. Retargeting public spending to support a more balanced strategy will not sacrifice overall growth performance, and it will help reduce poverty.

Two other components of the relationship between rural growth and poverty reduction should be

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noted. First, political commitments to rural growth imply a more balanced political economy, with less urban bias than historically occurred in most industrial countries. In recent years many developing countries have reduced macroeconomic biases against agriculture, including overvalued currencies, repressed financial systems, and exploitive terms of trade. Further progress might be expected as democracy spreads and empowers rural populations in these countries.

The second component is the linkage between urban and rural labor markets, often in the form of seasonal migration and remittances. There is no hope of reducing rural poverty without rising real wages for rural workers. Rising wages have a demand and a supply dimension, and migration can affect both in ways that support higher living standards in both parts of the economy. Rural-urban migration also raises other issues depending on whether it is driven by the push of rural poverty or the pull of urban jobs. Either way, such migration has clear implications for food security, with urban markets becoming more important in supplying food for a country's people.

Whether the rural economy or the world market is the best source of this supply is a basic strategic issue for economic policymakers. Countries should focus their growth strategies on what they do best, and that frequently means agriculture, not high-tech manufacturing. That brings the discussion to the importance of trade—and the investment it encourages—in promoting growth.

MORE TRADE AND INVESTMENT MEAN FASTER GROWTH

Success in the global economy comes to countries that maintain fiscal discipline, open their borders to trade, privatize inefficient state enterprises, deregulate their domestic markets and invest in the health and education of their people.

—U.S. President George W. Bush
January 2002

Globalization—the economic integration of the world's countries—has been a defining force of the past decade. It offers unprecedented opportunities to direct resources toward development. During the 1990s the exports and imports of developing countries jumped from less than \$1.9 trillion to nearly \$4.6 trillion.¹² Private capital flows grew even more dramatically, with net foreign direct investment in developing countries rising from \$24 billion to \$184 billion.¹³ Countries that have experienced growth in trade and investment have achieved correspondingly faster economic growth.

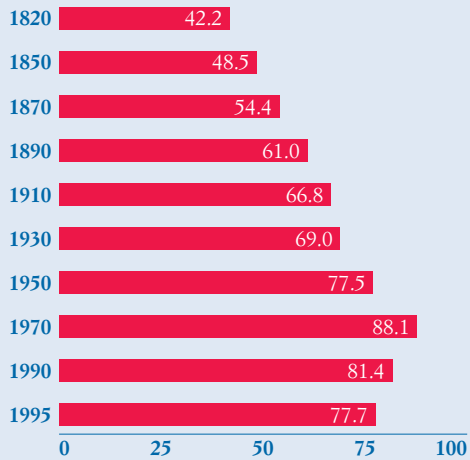
Yet globalization involves more than just increasing production. It also expands choices and creates opportunities for consumers and producers. As global competition pressures governments to reduce barriers and promote better economic and social conditions, globalization paves the way to reform. Governments realize that they must not only encourage trade and investment but also establish strong institutions that support markets and provide social assistance to people in need.

On balance, globalization and regional integration have benefited the countries involved regardless of their stage of development. These benefits have been identified in studies by the World Bank and other international organizations, U.S. government agencies, think tanks, and academics. Globalization has been a boon for countries willing and able to integrate with global markets—particularly developing countries that have adjusted prevailing conditions and mindsets (figure 2.2).¹⁴ Countries resistant to globalization or lacking capacity to develop investment and trade have not fared as well. Contrary to widespread expectations, income gaps have shrunk among countries that have integrated with global markets. Moreover, global income equality has improved in recent years (figure 2.3).

Global income inequality, up then recently down

FIGURE 2.3

Mean log deviation between a typical individual income and the average per capita income (%)



Source: Dollar and Kraay 2002.

In 1999 UN Secretary-General Kofi Annan noted that “the main losers in today’s very unequal world are not those who are exposed to globalization, but those who have been left out.”¹⁵ Similarly, the November 2001 World Trade Organization ministerial conference in Doha, Qatar, revealed that most developing countries want more globalization, not less. The challenge for developing countries left out is to enhance their capacity to participate in and benefit from the opportunities of the global market.¹⁶

Poor people in globalizing countries are less poor than they were a decade ago.¹⁷ Higher income inequalities, as in China, have been caused more by factors unrelated to globalization (such as regional differences and social and education variables) than by lower incomes among poor people. In fact, incomes have increased among the poorest 20 percent of the world’s people, though less rapidly than among other population groups. Increased trade usually accompanies faster growth and does not systematically change household income distribution, so it is generally associated with increased well-being among poor people.

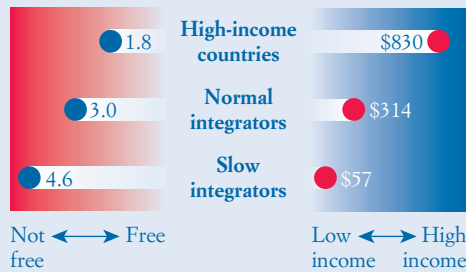
Countries are better able to enter global markets if democracy and the rule of law are in place and corruption and monopolistic policies are held in check (figure 2.4). There is also a strong correlation between freedom and growth, in keeping with the typology that normal integrators are freer than slow integrators. As a result globalization has been a sig-

Greater freedom means greater integration with global markets

FIGURE 2.4

Combined average Freedom House score, 2000

GDP (PPP \$billions), 2000



Note: Countries classified by USAID. GDP adjusted for purchasing power parity (PPP).

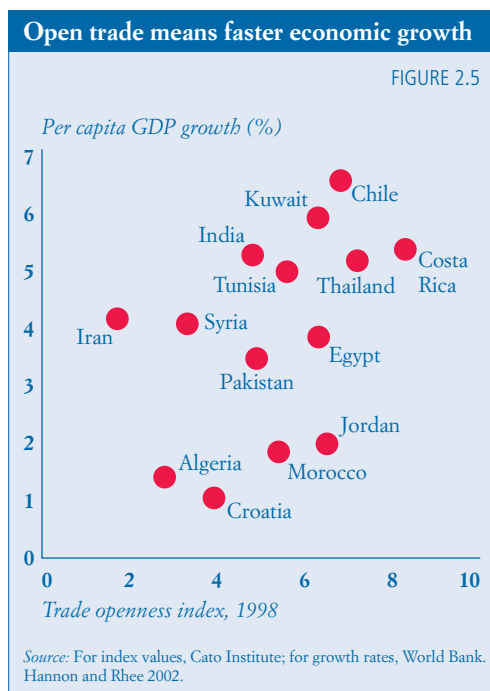
Source: For Freedom House scores, Freedom Foundation; for GDP, World Bank. Hannon and Rhee 2002.

nificant force not only in reducing inequality between states but also in reducing poverty.¹⁸

Globalization favors participants who liberalize trade—particularly those with industrial and manufacturing capacity—and leaves behind those who do not. In the 1960s the East Asian “tiger” economies (Hong Kong, Republic of Korea, Singapore, Taiwan) began to change their economic policies and become more integrated with global markets. Other economies inside and outside the region soon followed suit, often with impressive results. During the 1980s and 1990s many other countries—including Chile, China, India, Mexico, Uganda, and Vietnam—also recognized the correlation between freer trade and economic growth. In addition, the fall of the Berlin Wall in 1989 caused a surge in integration of regional and global markets. The gains from lifting the remaining restrictions to trade are nevertheless enormous: on the order of \$250 billion a year, \$108 billion of that developing countries, with 60% from developing country liberalization and 40% from rich country liberalization.¹⁹ Trade can thus be a powerful engine of growth. Over time it has become clear that successful globalization requires more than just liberalizing trade: other essential efforts include liberalizing domestic commodity and capital markets, establishing the rule of law to enforce property rights, and implementing effective regulation. (Liberalizing capital markets too soon and too fast creates other problems, however, indicating the need for a well-designed approach.)

Following the September 11, 2001, attacks on the United States, a close look at countries harboring

**MANUFACTURED
EXPORTS PLAY A KEY
ROLE IN ECONOMIC
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terrorists shows that their economies suffer not from the excesses of globalization, but from a lack of it. Some, such as Algeria and Pakistan, are among the most closed to trade in the world (figure 2.5). Many, including Iran, Iraq, Jordan, Qatar, Saudi Arabia, Syria, and the United Arab Emirates, saw real per capita incomes decline between 1985 and 1998.²⁰ These countries also have limited political freedoms and weak human rights, which have been linked to poor economic performance.

A recent survey of nine Middle Eastern countries concluded that a lack of trade openness and significant barriers to private sector development limit potential for foreign trade. Many of the barriers to private sector development are internal, ranging from government red tape and obstacles to business or product registration to weak or nonexistent capital markets.²¹ Indeed, many Middle Eastern governments have rejected free trade and open markets as a matter of choice. Relative to their Asian counterparts, most of which started from a lower economic base, Middle Eastern countries have poor productivity, weak private sector development, scarce job creation, limited trade (aside from oil), and low incomes. Excluding fossil fuels, the Arab world exports less than Finland, a country of 5 million inhabitants.²²

The region's poverty and lack of opportunity have undoubtedly contributed to the growth of radical anti-Western terrorist movements. But this poverty cannot be blamed on the West or on

globalization. Political elites in these countries have chosen to reject globalization—and in their efforts to shield themselves from Western values or the political reaction to those values, they reject integration as well.

Jordan shows how that can change. Under the new king's leadership, reforms were pushed through to enable the fastest accession ever to the World Trade Organization. Manufacturers thought that compliance would force their products off the shelves. Farmers thought that their products would not compete in Europe and that European farmers would flood Jordanian markets. The concerns were unfounded. Indeed, foreign investors are now coming in to take advantage of Jordan's high-tech labor force and possibly turn the country into an Arab silicon valley. Opening to the West has also included a U.S.-Jordan free trade agreement.

**WHICH COUNTRIES ARE SLOW
INTEGRATORS—AND WHICH ARE NORMAL?**

Two indicators are used to classify countries as slow or normal integrators with the global economy:

- The speed of each country's trade integration is measured by the change since 1980 in the share of merchandise trade in GDP (adjusted for purchasing power parity, or PPP).
- The depth of trade integration is measured by the share of manufactured exports in total merchandise exports in 2000.

Of 111 developing countries, 65 are slow integrators and 46 are normal (table 2.1).²³ About 87 percent of low-income countries are slow integrators. In 1999 slow integrators contained 22 percent of the world's population but accounted for just 9 percent of global GDP, and in 2000 they accounted for only 5 percent of global merchandise trade. Sub-Saharan Africa is by far the least integrated region, with 37 of 39 countries considered slow integrators. In 1999 the region's slow integrators contained 10 percent of the world's population, but in 2000 they accounted for just 1 percent of global GDP. The Middle East and North Africa and Central Asia also have more slow than normal integrators.

Among normal integrators annual growth in per capita GDP rose from less than 2 percent in the 1980s to more than 3 percent in the 1990s. But

Who's normal—who's slow

Developing countries by speed of integration, income, and region

TABLE 2.1

| Income group | Slow integrators | Normal integrators | Total |
|---|------------------|--------------------|-------|
| Upper middle income | 6 | 16 | 22 |
| Lower middle income | 14 | 23 | 37 |
| Low income | 45 | 7 | 52 |
| Total | 65 | 46 | 111 |
| Share of 1999 world population (%) | 22 | 63 | 85 |
| Share of 2000 world GDP (%) | 9 | 36 | 45 |
| Share of 2000 world merchandise trade (%) | 5 | 23 | 28 |
| <i>By region</i> | | | |
| Central Asia | 4 | 0 | 4 |
| East Asia and Pacific | 4 | 8 | 12 |
| Eastern Europe | 4 | 15 | 19 |
| Latin America and the Caribbean | 8 | 14 | 22 |
| Middle East and North Africa | 7 | 3 | 10 |
| South Asia | 1 | 4 | 5 |
| Sub-Saharan Africa | 37 | 2 | 39 |
| Share of 1999 world population (%) | 10 | 1 | 11 |
| Share of 2000 world GDP (%) | 1 | 1 | 2 |

Note: Table includes all developing countries for which data are available for 1980 or 1990 GDP (adjusted for purchasing power parity).
Source: Hannon and Rhee 2002.

among slow integrators per capita GDP shrank—and the annual rate of contraction slipped from less than -0.5 percent in the 1980s to almost -3.0 percent in the 1990s. Differences in trade, financial, and technological integration were the main causes of these dramatic gaps in growth rates.²⁴

There are at least three types of slow integrators:

- Failed states—those mired in conflict or civil war.
- Transition economies—those with problems caused by the transition from command to market economies.
- Countries with environments inimical to integration—those suffering from conditions that impede global integration and unable to encourage domestic and foreign firms to engage in activities that promote it.

These problems are rooted in weak governance, the effects of which—corruption, illegal activity, limited trade, inadequate fiscal policies—have already been discussed. Trade generally plays a catalytic role in integrating domestic and global economies. Without it, countries cannot take advantage of global opportunities.

One of the main lessons of 20th century development, particularly from East Asia's superstar

economies, is that manufactured exports play a key role in economic growth. Accordingly, over the past two decades many developing countries have tried to adjust their export patterns. But normal and slow integrators have exhibited extremely uneven changes in such patterns.

TRADE AND INVESTMENT FOR ECONOMIC DEVELOPMENT

The November 2001 World Trade Organization (WTO) ministerial conference in Doha, Qatar, initiated a new round of international trade negotiations, known as the Development Round because of its emphasis on the needs and interests of developing countries—particularly the world's least developed countries. The plan created at the conference is focused on ensuring that these countries achieve beneficial, meaningful integration with the multilateral trade system and the global economy.

The conference advocated a more active role in international trade negotiations for the representatives of developing countries, who stated an unequivocal desire to be integrated with the global economic system. And for the first time, industrial countries committed themselves to addressing the domestic protectionism that has so

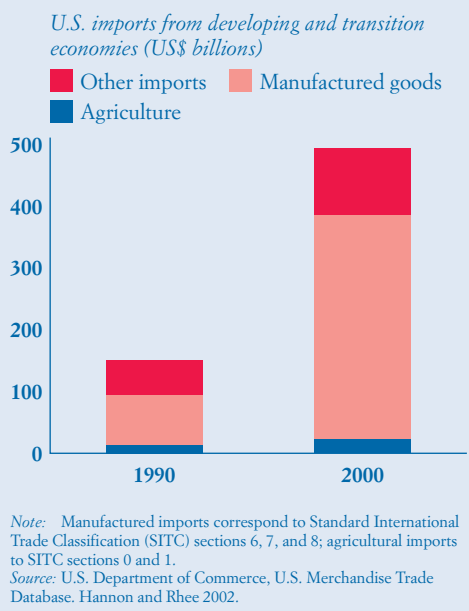
FOREIGN DIRECT
INVESTMENT IS ONE OF
THE MOST IMPORTANT
CAPITAL FLOWS THAT AN
OPEN ECONOMY CAN
ACHIEVE

DRIVING
ECONOMIC GROWTH

**DEVELOPING COUNTRIES
CAN ATTRACT FOREIGN
DIRECT INVESTMENT IF
THEY LIBERALIZE TRADE
AND INVESTMENT**

**The \$500 billion global market of choice
for developing and transition economies**

FIGURE 2.6



often thwarted the export potential of developing countries in sectors such as textiles, agriculture, and HIV/AIDS drugs. The conference also emphasized the importance of providing technical and financial assistance to integrate developing countries with the multilateral trade system. During its first three years the goal of the Development Round is to improve access to foreign markets for all participating countries. U.S. government departments and agencies will develop a U.S. government negotiating strategy for the Development Round.

OPENING U.S. MARKETS

Between 1985 and 2000 U.S. GDP doubled, from \$4.9 trillion to almost \$10 trillion.²⁷ Providing market access to its economy is one of the great

est benefits that the United States can give any developing or transition economy. In 1990 U.S. imports from developing and transition economies totaled \$151 billion. By 2000 these imports had more than tripled, to \$495 billion (figure 2.6).

Since the 1970s the United States has taken steps to open its markets to developing and transition economies. Efforts include the Generalized System of Preferences, which provides for duty-free imports from some 146 developing and transition economies. Between 1999 and 2000 duty-free U.S. imports from the 48 least developed countries, as classified by the United Nations, increased from \$2.2 billion to \$3.3 billion.²⁶ Nearly 90 percent of U.S. imports from the least developed countries are eligible to enter duty free.

As noted, growth in exports of manufactured goods is an important indicator of a country's capacity to increase economic growth over the long term. Developing exportable products is often a challenge. Taiwan, for example, started out manufacturing textiles and apparel but moved on to become one of the world's leading manufacturers of capital goods and information technology. Today countries such as Mauritius, which began developing a vibrant textiles manufacturing industry in the 1980s, are moving on to manufacture more sophisticated information technology and provide related services. Thus many countries have tried—with varying success—to develop textiles manufacturing as a first step toward competitive exports.

Industrial country quotas on textiles and apparel have long been a highly contentious aspect of textiles trade between developing and industrial countries. This system, called the Agreement on Textiles and Clothing (which replaced the Multi-Fiber Agreement during the Uruguay Round of international trade negotiations), will be phased out

Box 2.2 Increasing U.S. imports through the African Growth and Opportunity Act

With strong bipartisan support, in May 2000 the U.S. Congress enacted the African Growth and Opportunity Act (AGOA) to catalyze Sub-Saharan Africa's integration with the global economy. The 35 Sub-Saharan countries covered by the act enjoy duty-free, quota-free market access for 1,800 products on the U.S. tariff schedule as well as 224 items not covered by the Generalized System of Preferences.

For beneficiaries the most attractive part of this effort is duty-free, quota-free access to U.S. textiles and apparel markets. In the first half of 2001 the program accounted for 58 percent of the \$11.6 billion in U.S. imports from Sub-Saharan Africa—a dramatic increase in a short period. Moreover, the program takes a comprehensive approach to development, promoting good governance through political and economic reforms in beneficiary countries.

Source: Hannon and Rhee 2002.

by 2005. Most U.S. imports from least developed countries are quota free or subject to the quota phaseout under the Agreement on Textiles and Clothing or the tariff rate quotas under the Uruguay Round Agreement on Agriculture (box 2.2).

IMPROVING THE CLIMATE FOR FOREIGN INVESTMENT

Foreign direct investment is one of the most important capital flows that an open economy can achieve. Such investment has attracted growing attention in recent years because it is typically accompanied by transfers of production, marketing, and organizational technology. Just as important, foreign direct investment provides valuable financial stability because it is much less vulnerable to investor runs and cross-border contagion than are portfolio investment and bank loans.

Foreign direct investment in developing countries has also been a harbinger of globalization. During the 1970s and first half of the 1980s such flows were essentially flat, hovering around \$11 billion (in 2000 dollars).²⁷ These amounts were small relative to development assistance and other official flows. But in 1986 these flows began rising sharply, and between 1990 and 1999 net foreign direct investment in developing countries jumped from \$30 billion to \$188 billion in 2000 dollars. (About 20 percent of that investment went to China).²⁸

Developing countries can attract foreign direct investment if they liberalize trade and investment policies, support free domestic markets, and strengthen the rule of law—particularly to protect property rights. Clearly defined property rights have been an important legal development in many East Asian countries and largely explain the high foreign direct investment in these countries in the 1990s. These rights allow foreigners to own local assets as well as equity in a broad range of companies. In fact, many of the region's newly industrializing economies, including the Republic of Korea, Malaysia, and Taiwan, offer incentives to foreign investors, such as guaranteed repatriation of profits and tax relief.²⁹

Still, in many countries the investment climate remains clouded by corruption, trade barriers, and market distortions. Evidence from a large sample of countries suggests that corruption significantly reduces domestic and foreign investment. A favorable investment climate requires

transparent regulations, predictable laws, and low trade barriers. In developing and transition economies the environment for foreign direct investment is also directly related to the environment for private sector development. That brings the discussion to firms—the drivers of competitiveness in world markets and the main creators of jobs and wealth.

A MICROECONOMIC AGENDA FOR DEVELOPMENT

The traditional approach to economic development—focused on generic macroeconomic, legal, and political conditions—has delivered significant improvements in many parts of the world. But deeper efforts are needed to fully reap the benefits of past reforms. Indeed, without additional steps the sustainability of past achievements is in doubt.

A new microeconomic approach to economic development provides a framework for taking those additional steps. It is more country-specific, more long-term, covers more individual policies and activities, and involves far more participants. It is not a quick fix. But it is the primary way to increase developing countries' ability to compete in world markets while improving their living standards.

NEW THINKING ON THE MICROECONOMIC FOUNDATIONS OF COMPETITIVENESS

Many discussions of competitiveness focus on the macroeconomic, political, and legal features of successful economies. These features are becoming increasingly well understood. Stable political institutions, trusted legal mechanisms, and sound fiscal and monetary policies contribute enormously to a healthy economy. But they are not enough. Though they provide opportunities to create wealth, they do not create it. Instead, wealth is created through an economy's microeconomic foundations, rooted in company operations and strategies as well as in the inputs, infrastructure, institutions, regulations, and policies that constitute the business environment in which a nation's firms compete. To fully succeed, political, legal, fiscal, and monetary reforms must be accompanied by microeconomic improvements.

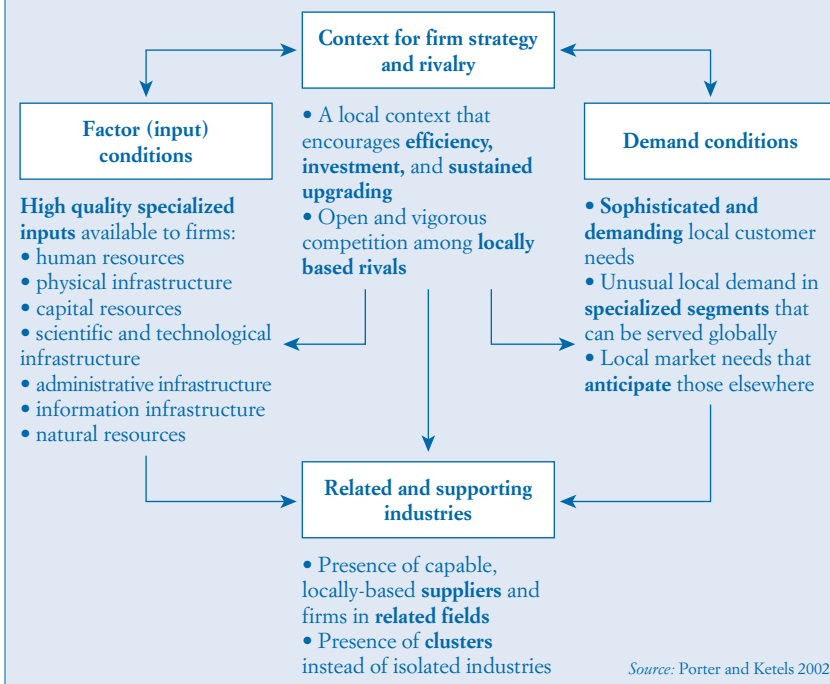
Many developing countries are continuously tripped up by microeconomic failures. Growth

A MICROECONOMIC APPROACH IS MORE COUNTRY-SPECIFIC, MORE LONG-TERM, COVERS MORE INDIVIDUAL POLICIES AND ACTIVITIES, AND INVOLVES FAR MORE PARTICIPANTS

DRIVING
ECONOMIC GROWTH

Determinants of the microeconomic business environment

FIGURE 2.7



competitive unless the companies operating in it are competitive. But the sophistication of companies is inextricably intertwined with the quality of the national business environment. More sophisticated company strategies require more highly skilled workers, better information, improving infrastructure, more advanced institutions, and stronger competitive pressure.

To support rising prosperity, companies must transform their ways of competing. The advantages that a nation's companies enjoy must shift from comparative advantages (low-cost labor or natural resources) to competitive advantages (resulting from more distinctive products made using more productive methods). Strengths in competing at earlier stages of development become weaknesses at more advanced stages. Copying of foreign technology, for example, must give way to development of indigenous technology. Yet companies often resist change because past approaches were profitable and old habits are deeply ingrained.

Efforts to move to more sophisticated ways of competing require parallel changes in the microeconomic business environment. This environment is determined by four related features: the quality of factor (input) conditions, the context for firm strategy and rivalry, the quality of demand, and the presence of locally related and supporting industries (figure 2.7).

STAGES OF ECONOMIC DEVELOPMENT

As economies develop, they move through three stages of competitive advantage and ways of competing. In the factor-driven stage, basic inputs such as low-cost labor and access to natural resources are the main sources of competitive advantage and international products. During this stage firms produce commodities or relatively simple products designed in more advanced countries. Technology is assimilated through imports, foreign direct investment, and imitation. Companies compete based on price and lack direct access to consumers. They have limited roles in the value chain and are focused on assembly, labor-intensive manufacturing, and resource extraction. A factor-driven economy is highly sensitive to global economic cycles, commodity price changes, and exchange rate fluctuations.

In the investment-driven stage, efficiency in producing standard products and services becomes

surplus can be generated through macroeconomic and financial reforms that exploit comparative advantages, attracting floods of capital and creating the illusion of progress. But unless firms can create valuable goods and services using increasingly productive methods—moving competition to higher levels—growth will be snuffed out as jobs fail to materialize, wages stagnate, and investment returns disappoint. Capital flows and investor attention will then shift elsewhere. The austerity that results from such cycles is at the core of the backlash against globalization that is becoming perhaps the world's most pressing economic problem.

DRIVERS OF COMPETITIVENESS

A central challenge in economic development is to create conditions for rapid, sustained growth in national productivity. The microeconomic foundations of productivity rest on two related elements:

- The sophistication of competition, reflecting the operations and strategies of domestic companies and of foreign subsidiaries based in the country.
- The quality of the microeconomic business environment.

A country's productivity is affected by the productivity of its companies: an economy cannot be

the dominant source of competitive advantage. Products and services become more sophisticated, but most technology and designs still come from abroad. Technology is accessed through licensing, joint ventures, foreign direct investment, and imitation. During this stage countries both assimilate foreign technology and develop capacity to improve it. The national business environment supports heavy investment in efficient infrastructure and modern production methods. Companies mainly serve original equipment manufacturing customers and extend capabilities more widely in the value chain. An investment-driven economy is focused on manufacturing and outsourced service exports. It is susceptible to financial crises and external, sector-specific demand shocks.

In the innovation-driven stage, the dominant source of competitive advantage is the ability to produce innovative products and services at the global technology frontier using the most advanced methods. The national business environment is strong in all areas and contains deep clusters of related industries. Well-developed institutions and incentives support innovation. Companies compete using unique strategies that are often global in scope. An innovation-driven economy has a high share of services and is resilient to external shocks.

DIFFERENT APPROACHES FOR DIFFERENT MICROECONOMIES

The traditional approach to economic development uses a generic model for all countries (see above). In contrast, the microeconomic approach allows countries to focus on priorities that reflect their stage of development—resulting in agendas for action that differ significantly by country. Specific agendas enable countries to leverage their advantages and avoid zero-sum competition based solely on cost.

Appropriate company operations and strategies, as well as the influence of various elements of the business environment, differ for countries at different income and productivity levels. Transitions between the stages of economic development—from factor-driven to investment-driven to innovation-driven—are particularly challenging because the stages involve different bases of competitive advantage and modes of integration with the global economy.

Low-income countries: enhancing sophistication in factor-driven economies. For companies in low-income countries the main challenge is to move beyond competing based solely on cheap labor or natural resources. Enhancing company sophistication can involve making production processes more sophisticated, introducing marketing and developing brands, and beginning to delegate authority. At this stage it is premature to advance other elements of corporate operations and strategies.

Complementary efforts to improve the business environment can also raise GDP per capita. These efforts include strengthening transportation and communications infrastructure, improving public education and manager training, liberalizing trade, reducing corruption, protecting intellectual property rights, and introducing a meaningful antitrust policy. Improving the quality of suppliers and tightening regulatory standards are also important, as is improving corporate governance through effective boards of directors. All these steps create a foundation of efficiency, transparency, and competitive pressure to improve factor-driven competition.

Middle-income countries: increasing efficiency in investment-driven economies. Companies in middle-income countries must move from the factor-driven stage to the investment-driven stage. Corporate priorities take on a stronger customer orientation, whereas in the factor-driven stage products were either commodities or designed by foreign original equipment manufacturers. Licensing foreign technology, developing capacity to improve technology, and spending on research and development become important. In addition, gaining control of international distribution is essential to moving beyond the role of passive commodity or labor exporter. Employee training is also important for increasing efficiency.

The investment-driven stage also places new demands on the business environment. Enhancing business efficiency requires reducing bureaucratic red tape and strengthening the legal system. In addition, financial markets become much more important in order to mobilize debt and equity capital. The investment-driven stage depends on high investment in products, processes, and technology. Increasing demand is important to foster improvements in producer quality. Industrial clusters should be fully developed to support higher efficiency. As countries reach the upper-middle-income stage, companies must use

ENHANCING BUSINESS
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DRIVING
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ONE OF THE MOST
IMPORTANT
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THE UNITED STATES CAN
MAKE IS TO PARTICIPATE
IN INTERNATIONAL
POLICY DISCUSSIONS,
TRADE NEGOTIATIONS,
AND TREATY
DEVELOPMENT

the best available foreign technology, produce products that meet international standards, and organize at high levels of efficiency.

HOW CAN THE U.S. SUPPORT GROWTH IN DEVELOPING COUNTRIES?

Several forms of U.S. foreign assistance will likely trump official development assistance in expediting economic growth in developing countries (see chapter 6). These mechanisms include access to U.S. markets, foreign direct investment by U.S. companies, remittances from foreign workers living in the United States, and the actions of U.S.-based or -funded nongovernmental organizations (NGOs). Still, official development assistance has a role to play by:

- Providing direct financial support for policies, programs, and projects through bilateral assistance, to improve agricultural productivity, implement competitiveness strategies, build infrastructure, and provide scholarships and technical training.
- Engaging developing countries in policy dialogues, often with the explicit or implicit promise of delivering more aid if policy actions are taken.
- Producing and disseminating new knowledge about development through economic research or project activities funded by USAID or other U.S. government agencies.
- Involving the United States in broader, often multilateral, discussions during diplomatic and trade negotiations—helping to open the door to the \$10 trillion U.S. economy.
- Connecting to the U.S. economy through trade and investment provides a vital engine of growth for developing countries.
- Helping countries build the capacity to trade—and to take part in multilateral trade negotiations.

The United States should seek to influence development processes primarily by engaging in policy dialogues, producing and disseminating new knowledge, and advocating trade-led growth at home and abroad.

Engaging in meaningful policy dialogue requires extensive knowledge of a country's political economy and capacity for pragmatic policy analysis. Here the U.S. role as a contracting agent can help it access knowledgeable analysts, especially if countries have made a long-term effort to build

the research and knowledge base needed to produce and retain such analysts. Policy dialogue and knowledge generation should be thought of as mirror images that require coordinated support over long periods. One of the most important contributions that the United States can make to economic growth in developing countries is to participate in international policy discussions, trade negotiations, and treaty development.

GETTING AGRICULTURE MOVING

Requirements for agricultural development have been understood for several decades. Adequate agricultural technology and sufficient prices for what farmers produce lead to farm investments and income streams that increase commodity output and reduce rural poverty. Educating rural inhabitants speeds up the process, as does assistance in developing new agricultural technology.

Sub-Saharan Africa's agriculture has long suffered from inadequate technology and insufficient prices in rural markets. Asia has had limited success in linking the rural nontradable sector to urban markets and to labor-intensive export growth. In Latin America many poor rural residents have migrated to urban areas, which now contain two-thirds of the region's population. But Central America and Mexico still suffer from severe and persistent rural poverty, and strategies are needed to reduce it.³⁰

Mechanisms for developing agricultural technology and providing rural price incentives have weakened since the 1960s. The system supported by the Consultative Group on International Agricultural Research (CGIAR) has an impressive record of increasing crop yields for many of the world's staple foods. But funding for the system has been threatened as market prices for these crops have dropped to historic lows, reflecting productivity gains in developing countries and government-subsidized crop surpluses in industrial countries. Few developing countries have the scientific resources to conduct basic crop research, so where will agricultural technology come from to provide food for the additional 3 billion people expected in the next 50 years?

Biotechnology holds out great promise—it is largely a product of scientific enterprise, public and private, in industrial countries. Pest resistance and drought tolerance are being integrated

already into crops of great importance to poor farmers—cotton, maize, and sweet potatoes. The science may be complex, but once the new varieties are developed and appropriate food safety and environmental risk analyses have been completed, their incorporation into both farming and food systems can be relatively swift. Farmers and consumers in the United States, Argentina, China, and South Africa are already beginning to realize the results of this evolution in agricultural science. With fewer pesticides to apply, production costs drop. With more resistance to pests and drought, harvests are greater.

The United States has an obvious role in this. First, U.S. leadership is essential in restoring agricultural research budgets and can encourage other donors to do the same. Second, U.S. universities are the best in the world at training scientists in basic biology and applied agriculture, and could provide the next generation of these scientists for the developing world.

Third, the United States can press to ease the damage to developing countries caused by agriculture policies in industrial countries. Industrial countries protect their farmers against low and unstable prices, but developing countries cannot afford such subsidies or defend the trade interventions that would be needed to do the same. Industrial country policies shift the adjustment burden to developing countries—sometimes with devastating effects on local farmers. Agriculture-led economic growth is impossible unless it is profitable.

Some observers hope that World Trade Organization (WTO) negotiations will solve problems in global agriculture markets. But such solutions are unlikely given the reluctance of Europe and Japan to expose their farmers to free markets. Strong interest groups in Washington also support subsidies to help ensure the profitability of U.S. farming—though the U.S. Department of Agriculture favors reduced subsidies and freer trade in agriculture. The department's research concludes that eliminating all global agricultural protection and support could raise world agriculture prices by 12 percent, mostly by removing tariffs. U.S. agricultural exports would grow 19 percent in such a free market.³¹ Removing such distortions would also increase global economic welfare by \$56 billion a year—about the same amount as all foreign aid provided by industrial countries.

At the November 2001 meeting of the WTO in Doha, Qatar, the United States joined the other WTO members to launch the Doha Development Agreement, which solidifies the importance of liberalizing agricultural trade.

In July 2002 the United States proposed bold reforms for agricultural trade:

- Eliminate export subsidies, phasing in the reductions over five years.
- Eliminate the export monopolies of state trading enterprises, thus allowing any producer, distributor, or processor to export, and end the special financial privileges of state traders.
- Prohibit export taxes on agricultural products, except for developing countries that rely on them for revenues.
- Cut and simplify agricultural tariffs.
- Limit trade-distorting support to 5% of the total value of agricultural production.³¹

International negotiations on agriculture desperately require leadership. Part of the challenge may involve achieving U.S. acceptance of agriculture's multiple functions as the basis for policy reforms with clear social, environmental, or security rationales. With this acceptance the United States could take the lead in the Development Round of WTO negotiations, designing rules that recognize agriculture's different functions in different countries at different stages of development. For example, environmental protection is an acceptable objective for agriculture policies in all countries, while policies that stimulate basic grain production to enhance domestic food security would be restricted to countries with limited access to global markets or weak internal marketing systems.

Beyond improving the external climate for agriculture, what are the components of a national agricultural strategy? The first is supportive macroeconomic policy—one that yields low inflation, a reasonably stable exchange rate, positive real interest rates, and perhaps some monitoring of short-term capital flows. Second, getting prices right extends good macroeconomic policy to the trade arena, where an open economy with low barriers to internal and external trade should generate a level playing field for both producers and consumers.

Once agricultural technology is in place as the basis for profitable farming, externalities from

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*INVESTMENTS IN PEOPLE
IMPROVE THE
DISTRIBUTION OF ASSETS
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rural growth argue for increasing policy attention and budget allocations to the rural nontradable sector. Part of this sector's profitability will come from a labor-intensive export sector linked to the global economy. Rapid growth in such exports creates demand for labor directly as well as for the goods and services of the rural economy, which raise demand for labor indirectly.

Improving rural financial systems is also essential to a successful structural transformation, both to permit farmers to make long-term investments and to handle intersectoral financial flows such as savings and remittances. Such improvements will take time. And while needed changes in agricultural and rural financial markets are not exceptionally difficult, they do require talented policymakers and government administrators. Training these workers in U.S. universities and empowering them when they return home is a powerful form of U.S. foreign assistance—and one in which USAID has considerable experience.

INVESTING IN PEOPLE

Investments in people improve the distribution of assets in the early stages of economic development. For pro-poor growth this means investing in rural schools, primary health clinics, household food security, and rural financial markets. At later stages it means creating opportunities for high school education and on-the-job training for unskilled and semiskilled workers. If broadly based and of adequate quality, such investments will keep the distribution of income from becoming highly skewed until well into the development process, leading to the near elimination of absolute poverty. The Republic of Korea and Taiwan managed to maintain such investments until they achieved middle-income status. Brazil, the Philippines, and Thailand did not.

Even the poorest countries can set themselves on a growth path that includes poor people in a fiscally manageable way. But that may not happen. Political forces or governance averse to investing in poor people are more likely in countries where poor people's lack of assets disconnects them from the growth process. But donors can deal with this situation: it gives them a rationale for investing in the people that country leaders might choose or be forced to ignore. In such cases the policy dialogue, and the resources mobilized behind it, can have dramatic effects.

JUMPSTARTING SLOW INTEGRATORS

Some forms of export-oriented collaboration between domestic and foreign firms that do not involve foreign equity—such as international sub-contracts and technical or marketing agreements—can be as effective as export-oriented foreign direct investment in promoting growth. But foreign firms that are potential sources of foreign direct investment and other types of collaboration have little interest in slow integrators, which have the most desperate need for them. Such collaboration could jumpstart nontraditional or manufactured exports from slow integrators, especially those in Sub-Saharan Africa.

Innovative approaches to development assistance can break this vicious cycle. For example, industrial countries can help slow integrators enter global markets for manufactured goods by:

- *Offering preferential market access*—such as that provided by the U.S. Generalized System of Preferences, Caribbean Basin Initiative, and African Growth and Opportunity Act, and by the EU Everything But Arms program. The declaration from the November 2001 WTO ministerial conference in Doha, Qatar, addresses the need for preferential market access.
- *Building capacity for trade*—such as through the U.S. TRADE program, similar programs sponsored by other industrial countries, and programs sponsored by multilateral development banks. Again, the Doha declaration advocates such efforts.

The United States is well positioned to help build capacity for trade given its companies' extensive experience with and dominant role in trade, investment, and enterprise collaboration in developing countries. U.S. companies could help design rational policies and strengthen the firm-level export capacity of slow integrators.

U.S. programs to build trade capacity among slow integrators could also promote international production sharing as an innovative complement to the other assistance.

IMPLEMENTING THE MICROECONOMIC AGENDA

The microeconomic approach to development has important implications for foreign aid organizations. It can help them set priorities for their

activities and concentrate on areas where they are best able to help—clarifying the roles of institutions focused on the macroeconomic, legal, and political preconditions for development and institutions focused on the microeconomic agenda for competitiveness.

The new approach requires donors to review their country policies, priorities, and programs. On a basic level, all country programs must pass two practical tests:

- Does the activity upgrade the elements of the business environment most essential to development in this particular country?
- What is the advantage of a donor performing this activity to upgrade the business environment?

A country's microeconomic agenda for competitiveness and development is based on assessments of its current economic performance, its business environment, and the cluster composition of its economy. Other factors that influence policy priorities include the country's location, internal geography, and often its economic history. Based on this information, the country can define priority actions to expedite growth and development.

Foreign aid organizations, public and private, have a distinct role in developing and implementing a developing country's microeconomic agenda. In their traditional role of financing development projects, donors must ensure that their capital is spent in line with a country's microeconomic priorities. Often more important, however, is a new type of technical assistance—to assess a country's competitiveness, develop the main elements of its microeconomic agenda, create tools to track performance, and set up institutions for implementation and continuing research on the microeconomic agenda.

This new technical assistance differs from standard macroeconomic, legal, and financial assistance in several crucial ways. Compared with stabilizing the government budget or fixing the exchange rate by government fiat, it usually takes much longer to see behavioral changes and later outcomes from this assistance. Microeconomic reform requires permanent, stable changes in many related policies. These policy changes influence company behavior and expectations. And if policymakers stay the course, the changes eventually become evident in economic outcomes. Microeconomic upgrading is a marathon, not a sprint.

A push for clean environmental technologies should be part of the microeconomic reform. U.S. firms, facing strict environmental standards, have led in the export of pollution-abating equipment and services. Developing country firms—in the face of similar standards, or more likely the stringent demands of overseas buyers—could be pushed to develop safer, cleaner products and services. And they could be assisted in their efforts by the new technical assistance.

The new technical assistance also requires the cooperation of many participants. It must include private companies, domestic and foreign, in assessing the competitiveness of a location and in implementing improvements. It must include nonprofit, educational, research, and trade organizations to organize the actions of individuals and companies and to make changes to the business environment. And it must include many different functional and regional parts of government, stretching beyond the traditional leadership of national ministries.

Finally, the new technical assistance must recognize the role of clusters and regions as important units of action. Clusters go beyond individual industries, which on their own control only some of the factors that drive their economic performance. But clusters are narrower than large sectors, such as manufacturing, that are too diverse to allow the development of policies that can make a material difference. Similarly, regions control many of the microeconomic conditions that determine whether companies are able to operate productively. But regions also differ significantly in their competitiveness and so require unique efforts to address their weaknesses. The national level, however, remains essential to provide the basic macroeconomic, legal, political, and social conditions that set the stage for microeconomic competitiveness.

*FOREIGN AID
ORGANIZATIONS HAVE A
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DEVELOPING AND
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AGENDA*

NOTES

1. Timmer 2002.
2. Easterly 2001.
3. World Bank 2002b.
4. De Soto 2002.
5. Deininger-Squire 1996. See Porter 1998. The concept of stages was first introduced in Porter 1990. See also Porter, Sachs, and Schwab (2001) and Porter (2000) for further discussion of these ideas.
6. Harrison 2000.
7. Collier and Dollar 2001.
8. Birdsall and Londano 2002.
9. World Bank 2002b.
10. Timmer 2002.

11. Timmer 2002.
 12. Hannon and Rhee 2002.
 13. Hannon and Rhee 2002.
 14. The 2001 World Development Indicators were used to create a set of countries that had a population greater than 500,000 people and purchasing power parity adjusted GDP since 1980. Slow Integrating Countries and Normal Integrating Countries are defined based on the speed and the nature of their trade integration with the global economy. One measure is an increase in the merchandise trade to PPP adjusted GDP ratio of a given country to determine whether they are slow or normal in integrating. The other measure is the share of manufactured exports as a percentage of a country's total merchandise exports is used to represent their level of trade integration. Countries with merchandise trade to PPP adjusted GDP ratios in 2000 were lower than those in 1980 or 1990 and whose manufactured export share of merchandise exports were less than 50 percent are classified as slow. Countries with merchandise trade to PPP-adjusted GDP ratios in 2000 that were higher than those in 1980 or 1990 and whose 1999 manufactured exports share of merchandise trade was greater than 30 percent are classified as normal.

15. Annan 2000.
 16. Hannon and Rhee 2002.
 17. Lindert and Williamson 2001.
 18. Dollar and Kraay 2002.
 19. World Bank 2002a.
 20. Maddison 2001.
 21. Hoekman and Messerlin 2002.
 22. Lewis 2002.
 23. Hannon and Rhee 2002. All the developing countries with a population of greater than half million and PPP-adjusted GDP data from 1980 or 1990 were included in the analysis. In addition, 27 high-income countries with a population of more than half million and PPP-adjusted GDP data were classified as developed countries. So the global total in our analysis includes 111 developing countries and 27 developed countries.

According to UN (2001b), as of 2001, 49 countries (34 in Africa, 9 in Asia, 1 in Caribbean, and 5 Pacific regions) were designated as the Least Developed Countries (LDCs) that are deemed structurally handicapped in their development process, and in need of the highest degree of consideration from the international community in support of their development efforts. Eleven island countries—population of many of these island countries is less than half million—and 15 land-locked countries are included in the LDC group.

24. These findings are broadly consistent with recent World Bank studies on globalization and poverty by Dollar and Collier (2001) and Dollar and Kraay (2001, 2002) even though the analysis here covers all 111 developing countries—including major oil exporters—with PPP-adjusted GDP data, while the Bank studies cover a sample of 72 developing countries.

25. Hannon and Rhee 2002.
 26. Hannon and Rhee 2002.
 27. Hannon and Rhee 2002.
 28. Hannon and Rhee 2002.
 29. Hannon and Rhee 2002.
 30. Timmer 2002.
 31. Timmer 2002.
 32. FASonline 2002.

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