

Securing the Future

A Strategy for Economic Growth

**U.S. Agency for International Development
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Executive Summary

Economic growth transforms developing countries and advances U.S. interests

Economic growth is key to transforming the developing world, which includes most of the world's countries and most of its people. Economic growth enables countries to reduce and eventually eliminate extreme poverty. It also provides the only means for countries to generate the resources they need to address illiteracy, poor health, and other development challenges on their own, and thus to emerge from dependence on foreign aid. Because of its growth, the developing world is emerging as the largest market for U.S. exports. Accelerating growth among those countries that have done well, and encouraging it in those countries that have not grown as quickly, will further increase their contribution to global and U.S. wellbeing. Economic growth creates the prospect that developing countries will become partners with the United States in the search for a stable, healthy and prosperous world.

Poor countries that fail to grow can pose serious problems. They are vulnerable to crisis – sometimes including violent conflict, can harbor terrorist activity, are subject to natural disasters, and make large claims on U.S. and international resources. Countries that stagnate are less able and sometimes less willing to help address transnational issues, many of which originate within their borders, including: illegal migration; trafficking in narcotics, weapons, and persons; health threats such as HIV/AIDS and avian flu; and environmental concerns such as loss of biodiversity. All considered, economic growth in developing countries is essential to securing their future and ours.

The new Foreign Assistance Framework gives economic growth a central position in the U.S. foreign assistance program. This makes it important that we develop a clear understanding of the growth process in order to accelerate it successfully. This strategy first reviews the principal insights into economic growth gained over the past 50 years. It then identifies priorities and approaches for promoting economic growth in the USAID assistance programs of the future.

Recent progress and future prospects are both encouraging

The developing world has achieved much more progress than is often recognized. Global growth since 1950 has been unparalleled in history. Average real incomes rose by at least half in *all* regions of the world, and the share of the world's population living in extreme poverty fell from 55% to 20% in 2000. Life expectancy rose by 50% over the same period, while equally dramatic progress was made in other measures of the quality of life - from literacy and nutrition to access to water and electricity. Although Africa has historically had the slowest growth of any region, its performance has improved substantially in recent years, lending hope for the future.

Looking forward, the global environment for growth in developing countries has improved markedly from a generation ago, and in many respects has never been better. Understanding of what makes for good and bad economic policies has spread, with groundbreaking new work in microeconomic reform. Rapidly increasing global trade and investment offer unprecedented opportunities for countries that are willing to compete. The increasingly free flow of information connects developing countries more closely to the world's fast-growing knowledge base.

But the challenge remains large. Despite widespread progress, there has been great variability in economic growth performance among countries and over time. The fact that 20% of the world's population still live in extreme poverty provides a sharp reminder of the urgent need to achieve faster growth and to spread its benefits more widely.

“Driving” and “enabling” factors increase productivity and growth

Economic growth is the sustained increase of a society’s output. The key is productivity growth – the ability to turn the same resources into ever-greater amounts of goods and services over time. All productivity growth takes place at the level of the firm – a term that includes producers in all sectors and of all sizes, from the family farm and the vegetable seller with a handcart to the largest global corporation. Productivity growth, and the investment that stimulates and sustains it, result from the efforts of myriad individual producers. Seeking profit and spurred by competition, each works to increase sales, reduce costs, improve quality, and serve or create new markets. For growth to be sustained, producers must be motivated to search for and adopt a never-ending stream of such improvements. Any single improvement in technology or management boosts growth only temporarily.

Producers’ decisions are strongly influenced by the incentives and disincentives created by government policies and regulations - and by the capacity of government to enforce these “rules of the game” in market-friendly ways. Key issues include the impact of macroeconomic policy on overall economic stability; along with effects of microeconomic policies including taxes and regulations as well as the enforcement of property rights and the system for resolving economic disputes. This paper refers to these macroeconomic and microeconomic policies as the “*drivers*” of economic growth, because they are the primary determinants of the rate and sustainability of an economy’s expansion.

Sound macroeconomic policy is essential. But most developing countries have learned the principal macroeconomic lessons and made the principal reforms. Hyperinflation has almost disappeared and multiple exchange rates have become rare. Most governments recognize that deficits must be controlled. Macroeconomic reform will not, therefore, be the centerpiece of most USAID programs. However, in certain situations macroeconomic stabilization may emerge as USAID’s highest economic priority, especially in countries emerging from conflict and in selected cases elsewhere.

Microeconomic drivers of growth have emerged as the new frontier. New data show that business regulation is much more extensive and onerous in poor countries than in rich ones. Some business regulation is essential, but must be done well. In many poor countries, complex and costly regulations discourage firms from employing workers or investing in new technologies, and inhibit those firms from achieving high and growing productivity. Many such regulations place considerable discretion in the hands of government officials, creating enormous scope for corruption. There is tremendous opportunity over the next decade to address these constraints, and to improve the microeconomic environment more generally by strengthening systems of property rights, competition policies, and commercial law.

If macroeconomic and microeconomic policies and institutions drive the growth process, other factors “*enable*” growth to move forward. The quality of a country’s financial system, infrastructure, and human resources, for example, can influence the rate and direction of growth. However, they cannot by themselves cause growth to occur where the drivers are not in place. Work in these areas is important, but its impact is much reduced in a poor macro- and/or microeconomic environment.

Politics and flexibility matter a lot

The greatest obstacles to growth stem not from nature, but from politics. Because almost every economic change creates losers as well as winners, identifying the correct economic prescription is rarely enough to ensure that it is adopted. Understanding local interests is important in determining with whom to work and what to do. This often means that one size does not fit all when it comes to designing and prioritizing interventions. The basic principles – macro stability, market-based competition, etc. – can be applied in different ways to suit different situations. Governments committed to reform have sometimes found new and surprising ways to apply these principles successfully to accelerate growth.

Donor flexibility matters as well. Among the top reforming countries, some 85% of microeconomic reforms occur within 15 months of a change of government. While countries' past performance must be taken into account when setting aid levels and designing interventions, the ability to refocus support rapidly when opportunities arise is essential to take advantage of political breakthroughs affecting the local will to reform.

USAID has several advantages in this regard and in relation to other donor agencies: a strong private-sector orientation, in-country staffs, the ability to field long-term technical assistance teams, grant funding, and the ability to respond quickly and flexibly to emerging needs. These allow USAID country staff to develop partnerships with reform-oriented counterparts in the public and private sectors and to be on the scene in situations where arriving in time counts for more than the dollar value of assistance.

We will pursue rapid, sustained, and broad-based growth

USAID's overarching goal in economic growth will be to help partner countries achieve rapid, sustained, and broad-based growth. Per capita growth of 2% per year should be regarded as the minimum acceptable. Experience shows that per capita growth rates of 3%, 4% and above are possible and are clearly preferred. Sustained growth is growth that is maintained over the long term. Prices, property rights, and other policies to encourage the responsible use of natural resources and an appropriate response to environmental concerns play an important role in supporting sustained growth. Broad-based growth is growth that includes all major income groups, ethnic groups and women, and that significantly reduces poverty.

In support of this goal, USAID will endeavor to:

- *Develop well-functioning markets* in developing countries, working with the drivers and enablers underlying productivity growth to create the conditions for faster and more sustained economic expansion. This is the central challenge and the main area of opportunity. Efforts will likely focus on supporting policy reforms, while building local capacities to implement them and to continue the reform process. Capacity building can be more expensive than policy advice alone, but both are inexpensive compared with many efforts in other sectors; both have the potential to achieve transformational results many times the cost of the investment. Activities are likely to include a growing emphasis on microeconomic reform and competition, development of the financial and infrastructure sectors, trade capacity building, and agricultural development. Macroeconomic reform and capacity building is likely to be pursued on a more selective basis.
- *Enhance access to productive opportunities* for the poor, women, and other disadvantaged groups, to help ensure that they benefit from growth. Faster growth is the basic source of new opportunities for the poor as well as the non-poor. But complementary efforts are needed to help the poor and other disadvantaged groups gain access to those opportunities. Expanding the coverage of basic education to include poor children and girls, expanding access to financial services, promoting more flexible labor markets, and securing property rights for small farmers and urban slum dwellers are some examples of such efforts.
- *Strengthen the international framework of policies, institutions, and public goods* that support growth prospects and opportunities for poor countries. Examples include research on agricultural, health, and other problems specific to developing countries, and promoting international standards – from accounting to customs operations – that provide sound models for developing countries to emulate.

We will seek systemic and catalytic impact in light of political opportunities and constraints

Economic growth is a complex process. Moreover, differences in country conditions and opportunities create a wide variety of potential donor interventions. Core principles are important to ensure that the interventions chosen focus sharply on results. In particular:

- *Programs should seek large and systemic impacts.* The success of a few firms, farms, or communities is not enough. The goal is growth that affects thousands of firms and millions of people. This typically requires improvements in policies affecting all businesses within a sector or across the entire economy. This means that USAID will generally not finance development directly, but will seek instead the systemic reforms that can mobilize much larger savings and investment by others.
- *Where systemic reform is not achieved, catalytic impact is essential.* Demonstration projects can be valuable, but they should either demonstrate approaches that cause a far larger number of people or firms to follow suit without subsidies, or should have the clear potential to catalyze policy or institutional changes with a much wider, systemic impact.
- *Close attention to the politics of economic change is important for results.* When change is slow, support to reform-oriented leaders – public and private – can help to generate political will. External factors – such as a desire to join the WTO or a regional organization like the EU, or a low ranking on some widely recognized index of country policies and performance – have motivated significant changes in the past and should be used creatively to leverage further change.

The Foreign Assistance Framework provides a new beginning

The Foreign Assistance Framework (FAF) adopted in 2006 places recipient countries into five categories based on their policy performance, level of development, history of conflict, and other factors. This strategy distinguishes among the kinds of interventions most appropriate to each country category, while emphasizing the need to recognize and respond to the differences among countries within each category. It explains why achieving the goals of the FAF, and significantly increasing growth and incomes in the developing world, require both a clear – and higher – priority to economic growth funding for USAID, as well as concerted attention to rebuilding the Agency's cadre of economic growth professionals.

The FAF provides the opportunity to recommit USAID to promoting economic growth in the developing world – the only route for developing countries to eliminate extreme poverty and generate the domestic resources needed to address their own development challenges. The clarity of the FAF programming framework, a clear conceptual understanding of economic growth and its dynamics, priority to systemic and catalytic change in USAID's economic growth activities on the ground, and adequate funding and technical staff will be key to pursuing that goal. Reaching the goal will provide the people of the developing world the opportunity to secure a better future. Achieving that, in turn, will help us secure our own.

Securing the Future

A Strategy for Economic Growth

Economic Growth Transforms Societies

In 1950, South Korea's per capita income was roughly \$770 in dollars of 1990 purchasing power; Ghana's was considerably higher, at \$1,122.¹ Over the next five decades, per capita income in South Korea rose dramatically to \$14,343, while Ghana's crept upward to just \$1,280.

The consequences for ordinary people have been enormous. In 1950 life expectancy in South Korea exceeded that in Ghana by four years. The gap has since grown to 20 years. Most citizens of both countries lived on less than \$2 per day in 1950. By 1998, 78% of Ghanaians, but less than 2% of South Koreans still lived in such poverty. Similar gaps emerged in education, health, and other measures of well-being. Due largely to their contrasting records in economic growth, Korea has achieved transformational development, whereas Ghana remains at a much earlier stage of this process.

The consequences for U.S. interests have been dramatic as well. South Korea has become a significant and constructive actor on the world stage as well as one of America's top trading partners, with two-way trade exceeding \$70 billion in 2005. U.S. trade with Ghana remains less than \$0.5 billion. Korea supports development in other countries through its own foreign aid program; Ghana remains dependent on assistance.

How can more countries be transformed through economic growth? Country experience provides important insights into the way that growth takes place. These insights form the basis for practical advice for assisting partner countries to achieve faster, more sustained, and more broad-based growth.

1. The Key to Economic Growth is Productivity

Sustained economic growth means *ongoing increases in per capita income and output*.² In most cases, the increases achieved seem small from one year to the next. But compounded over a generation, they can produce dramatic improvements in the well-being of ordinary people.

The United States never achieved the sustained high growth rates of a South Korea. It became rich by growing at more modest rates for more than two centuries. Estimates of average per capita U.S. GDP growth since independence range from 1.7% to 2.2%. This suggests 2% per year as a benchmark of minimally acceptable per capita growth. If a poor country grows at this rate, it is doing as well as the United States has done over the long term. If it does so consistently, it will eventually achieve affluence. If it grows faster – and many have – its living standards will gradually gain on those of the United States and other rich countries.

Economic growth occurs as societies accumulate and equip workers with more and better physical capital (e.g., factories and infrastructure) and human capital (skills and knowledge), and use these assets ever more productively to produce goods and services of increasing value. Among these sources of growth, *increases in productivity account for most of the differences in economic growth among countries*.³ Productivity grows as producers find ways to squeeze more output from a given set of inputs – by adopting more efficient production methods, applying technical knowledge to create better products, changing their product mix, etc. Capital accumulation and productivity growth both result from the independent efforts of millions of individual producers, constantly working to create new, better, and less costly goods and

services through ingenuity and investment. Those efforts, in turn, are guided by the incentives producers face – incentives strongly influenced by public policies, regulations, and economic governance.

2. Growth in Developing Countries is in the U.S. Interest

Development is critical for national security

Development is a pillar of U.S. national security. The 2002 *National Security Strategy* emphasized development – along with defense and diplomacy – as fundamental to U.S. foreign policy. It called for the United States “to actively work to bring the hope of democracy, development, free markets and free trade to every corner of the globe.” U.S. policy since then has affirmed this message. The 2006 *National Security Strategy* emphasizes that “Development reinforces diplomacy and defense, reducing long-term threats to our national security by helping to build stable, prosperous, and peaceful societies.”

Economic growth is essential for development

Economic growth provides the material basis for progress in all other dimensions of development. Rapid growth – as in South Korea and Taiwan since the 1960s, and in China, India, and Mauritius more recently – can lift a country from grinding poverty to relative affluence in a few generations. It is key to reducing and eventually eliminating extreme poverty, and an essential part of the solution to almost all other development challenges – from poor health and education to gender inequality and vulnerability to crisis.

Growth also provides the only means for countries to generate the public and private resources they need to address these and other development challenges on their own, and thus to emerge from further dependence on foreign aid.

The benefits of economic growth are not only material. Nobel Prize-winning economist Amartya Sen points out that the ultimate value of growth lies in *expanding freedom*: giving people greater choice over what they can do with their lives, from the material dimension at one extreme to the spiritual at the other. Similarly, Benjamin Friedman emphasizes the intangible, moral benefits of growth: “The value of a rising standard of living lies not just in the concrete improvements it brings ... but in how it shapes the social, political and ultimately the moral character of a people.” Prosperity tends to make people more tolerant, more willing to settle disputes peacefully, more inclined to favor democracy. Stagnation and decline are associated with intolerance, ethnic strife, and dictatorship.⁴ Recent research points to the positive impact of economic freedom on peace, concluding that economic freedom significantly reduces violent conflict.⁵

Economic growth promotes other U.S. interests

Economic growth and development promote U.S. interests on many fronts:

- The broad political interest of the United States in a prosperous, well-functioning community of nations that cooperate to address global issues and concerns;
- Our humanitarian interest in reduced poverty and suffering, including those caused by man-made and natural disasters. Countries that grow have a sharply reduced incidence of poverty and a greater capacity to care for those who remain in need, whether chronic or transitory.
- Our economic interest in an open and expanding world economy. Growing economies offer better markets for U.S. goods and services than those that are stagnant or declining.⁶ Extrapolating recent trends, developing countries will become a larger market for U.S. products than industrial countries by 2011.
- The improved living standards we experience from imports of goods and services that can be produced at lower cost abroad; and

- Our economic security interests in having stable sources of supply for key resources, for which growing economies with stable institutions and representative government are much preferable to corrupt or potentially unstable sources of supply.

Poor countries that fail to grow can pose serious problems for the U.S. and the world. They are prone to crisis, can harbor terrorist activity, are vulnerable to natural and man-made disasters, and make large claims on U.S. and international resources. Countries that stagnate or decline are less able and sometimes less willing to help address global and transnational issues – issues that often originate within their borders, including: illegal migration; trafficking in narcotics, weapons, and persons; health threats such as HIV/AIDS and avian flu; environmental concerns such as deforestation and loss of biodiversity; among others.

For all these reasons, achieving more rapid, more sustained, and more broadly based economic growth among developing and transition countries is important to securing a prosperous, peaceful, and healthy future, both for those partner countries as well as for the United States. How USAID can best contribute to these outcomes is the focus of this strategy.

3. Much has been Accomplished

Worldwide growth since 1950 has been unparalleled in human history. Global GDP per capita nearly tripled over that period; average real incomes rose by at least half in all regions of the world; and all except Africa and the former Soviet Union more than doubled their per-capita GDP. As a direct result, the share of the world's population living in extreme poverty fell from 55% in 1950 to 21% in 2004.⁷

Progress in other dimensions of development has also been dramatic. Life expectancy has risen by more than 50% since 1950, from 41 years to 63 years. Equally dramatic gains were made in literacy, nutrition, infant mortality, gender equality, and access to water and electricity.⁸ Gains were achieved in all regions, including those that grew more slowly. With few exceptions, however, countries that grew faster achieved greater gains in other dimensions of human wellbeing.

There has been considerable variation in the rate of progress, both among and within regions and over time. Specifically:

- *Asia* has made the most progress. First Japan, then South Korea, Taiwan, Hong Kong and Singapore made the leap from poverty to affluence in little more than a generation. Rapid growth began in the 1970s in Thailand, Malaysia and Indonesia, and then during the last two decades in China, India, and Vietnam. Pakistan and Bangladesh have grown more slowly over the past 20 years, though exceeding the 2% per capita growth benchmark suggested earlier.
- At the other extreme, *Sub-Saharan Africa* has had the slowest overall growth and most severe declines in individual countries. Only four small countries – Mauritius, Botswana, Lesotho, and Cape Verde – have consistently achieved per capita growth of 2% per year or more since 1960. Many initially promising countries were taken over by “rent-seeking” elites. In others, flawed economic policies led to dependence on mineral exports and economic collapse when commodity prices fell sharply in the 1980s. Elsewhere, civil wars have created states of extreme economic insecurity.

However, Africa's performance and prospects have improved significantly. Since the mid-1990s, 22 out of 40 African countries have maintained per capita growth of 2% annually or better. Improved economic policies in most countries were key to the turnaround, with additional support from debt relief and stronger commodity prices.

- Latin America has proved a disappointment. The region grew rapidly between 1950 and 1980, stagnated during the “lost decade” of the 1980s, and since then has achieved at best modest growth. Even this has often involved short spurts of growth followed by economic crisis and decline. Only 6 out of 22 countries have maintained per-capita growth of 2% or more over the past decade. Explanations for this poor performance range from unstable macroeconomic management and poor microeconomic policies, to extreme inequality in income and asset holdings, to weak educational systems.
- In *Eastern Europe and the former Soviet republics*, the transition from Communism has generally involved sharp declines followed by recovery. The initial declines resulted from products and production methods that were years or decades behind countries that had competed with the rest of the world. As entrepreneurs scrapped obsolete technologies and mind-sets, entrepreneurs in these countries found ways to compete, resulting in very rapid growth in almost all countries since the mid- or late 1990s.
- The *Middle East and North Africa* offers a generally positive picture for countries that have been part of development cooperation: Tunisia, Morocco, Algeria, Egypt, Turkey and Cyprus all grew at rates above 2% per capita over the past decade, while Yemen, Jordan and Lebanon each recorded growth of 1.5% or better.⁹

Thus, global progress since 1950 has been enormous. At the same time, progress in some countries was uneven or slow, and a few retrogressed. The fact that “only” 20% of the world’s population still live in extreme poverty means that 1.2 billion people remain on the margin of subsistence. What USAID does to address those problems must be shaped by what we’ve learned, by the changing global environment for economic growth, and by a clear assessment of what we do best.

4. Much has been Learned

Productivity change and growth begin with competitive firms

To understand how to encourage faster and more sustained growth, it is essential to understand how increases in productivity take place. Economist Arnold Harberger reminds us that “all economic growth takes place at the level of the productive enterprise”¹⁰ – a term encompassing producers in all sectors and of all sizes, from microenterprises and family farms to multinational corporations. A country’s income increases as its producers find ways to increase sales and reduce their costs of production – by using new and better machinery, hiring more and better-skilled workers, or more generally finding lower-cost ways to organize production and distribution, and improve the quality of their goods and services to serve or create new markets. To sustain a higher rate of growth, producers must be motivated to adopt a never-ending stream of such improvements. Any single improvement in technology or management boosts growth only temporarily.

Incentives “drive” the growth process

Competition provides the most powerful incentive for producers to raise productivity. Where new firms are free to enter the market, existing producers must work relentlessly to improve their products and reduce costs in order to stay in business and earn profits. Yet governments in many developing (and developed) countries shelter producers from competitive forces, undermining incentives for higher productivity. It is in this arena – encouraging host country governments to adopt policies and practices conducive to competition and productivity, and helping to build the institutions needed to develop and apply growth-supporting policies – that USAID can play the strongest role in supporting economic growth.

The role of the public sector in supporting economic growth extends beyond simply ensuring that competition takes place. It must establish and maintain:

- macroeconomic stability, especially avoiding high inflation and unsustainable fiscal policies;

- an equitable system to protect and enforce property rights and maintain the rule of law; and
- a fair and efficient dispute resolution system to deal with economic conflicts that arise among firms and individuals.

Together, the incentives for productive effort created by public policies and institutions can be regarded as the *drivers* of economic growth, in the sense that they are the primary factors that determine the rate and sustainability of the growth process (see Figure 1). If the drivers are seriously misaligned, economies will stagnate or decline. Broadly speaking, the drivers of growth include the **macroeconomic policy environment** (fiscal, monetary, and exchange-rate policies) along with those **microeconomic factors** most relevant to entrepreneurial activity (business regulation, property rights and the rule of law, trade policies, and the extent to which market forces are allowed to operate in labor and other markets.)

Other factors “enable” growth to move forward

Other factors – such as the quality of a country’s financial system, its infrastructure of roads, telecommunications, and electricity grids, its educational and research systems, and its health conditions – represent growth *enablers*. Where the enablers are missing, the pace of growth can be undermined and its pattern distorted – problematic because improvements in these areas require substantial resources and sustained, long-term effort. But improvements in growth enablers cannot by themselves cause economic growth to occur in a country where the drivers are not in place.

There are no insurmountable obstacles ...

Many explanations have been put forward for the failure of countries to grow – including geographical disadvantage, climate, difficult terrain, lack of natural resources, over-abundance of natural resources, overpopulation, endemic disease, high illiteracy, and culture to name a few. Such conditions may indeed pose special challenges. But countries facing each of these challenges have found ways to overcome them and achieve rapid, broad-based, and sustained economic growth. Bangladesh, Indonesia, Uganda, and Mauritius are only the most conspicuous cases of growth under allegedly “impossible” conditions.

But political economy is critical to reform

The greatest obstacles to growth stem not from nature, but from politics. Most policy reforms involve a political cost – going against the interests of those who benefit from the current situation. Because there will be winners and losers from almost every policy change, identifying the correct economic prescription is rarely enough to ensure that it is adopted. Change can be slow and circuitous as a result. Almost every rapidly growing developing country today, for example, first introduced economic reforms in limited areas of the country - typically industrial or free trade zones – to demonstrate their value and override political opposition before extending them to the rest of the economy.¹¹ Patience, along with a clear understanding of the interests and politics of domestic groups, are critical to focus decisions about the pace and sequence of reforms, and to identify whom to work with in the government and private sector.

Political considerations also mean that donors need to react quickly to changes in local circumstance. For example, recent research shows that among the top microeconomic reforming countries, 85% of such reforms occurred within the first fifteen months of a change of government.¹² The ability to move fast when opportunities to facilitate reform arise is important to success.

One size does not fit all

Although policies and the incentives they create play a central role in driving economic growth, this does not mean that all countries can or should adopt a one-size-fits-all set of policies. As Dani Rodrik has emphasized, fundamental economic principles – “protection of property rights, contract enforcement, mar-

ket-based competition, appropriate incentives, sound money, debt sustainability” – can be applied in different ways, depending on local constraints and opportunities.¹³ Where governments have made growth a priority, they have sometimes found new and surprising ways to apply those core principles. One lesson for donors is that identifying and supporting governments committed to growth is essential to ensure the effective use of aid. A second lesson is that not all policy and institutional weaknesses need be resolved simultaneously. Rather, the challenge is to identify and address those weaknesses that pose the *binding* constraints to faster growth for a particular country at a particular time, *and* whose reform is politically feasible.¹⁴ For this purpose, understanding local circumstances can be as important as identifying “best practices” based on the experience of other successful countries. Those best practices may need to be applied differently, depending on the local context.

Macroeconomic “drivers” are the first consideration

Macroeconomic stability is essential. Without it, domestic entrepreneurs perceive the returns to investment as too uncertain to risk tying up their funds in factories and other fixed capital, and often look for safer options abroad. Banks and other financial institutions limit their lending to only the safest borrowers, while international investors look elsewhere for better business climates. Historically, the main threat to macro stability in poor countries has arisen from the temptation to run budget deficits in order to increase public spending beyond the limits permitted by domestic revenues. In countries undertaking financial sector reform, high levels of non-performing loans in the portfolios of commercial banks – especially those owned by the government – has emerged as a second serious threat to macroeconomic stability.¹⁵ A third major macro issue concerns the exchange rate, which affects overall stability as well as the profitability of producing for export versus for domestic markets.

Most poor countries have learned the principal macroeconomic lessons and made the basic reforms. As more and more governments have come to recognize the harm imposed by high inflation, for example, hyperinflation has almost disappeared, and most countries of the world have reduced inflation below 10%. The previously widespread and damaging use of multiple exchange rates has also become rare. And most governments have learned that stability requires that deficits be controlled, and that openness to the international economy contributes to growth.

Nevertheless, macroeconomic stabilization may emerge as the highest economic priority in particular countries, especially those emerging from conflict. In such cases, technical support to stop hyperinflations, establish new currencies, stabilize macroeconomic conditions, and rebuild economic institutions can be vital for establishing political stability and restoring economic growth. More generally, developing countries remain vulnerable to economic shocks in an increasingly open world, so that macroeconomic assistance is likely to remain relevant in certain additional cases.

Microeconomic “drivers” are the new frontier

In contrast to their gains in macroeconomic policy, poor countries have made much less progress in reforming *microeconomic* policies – the drivers of economic behavior that affect incentives in individual markets and sectors. In part, this reflects the difficulty of quantifying microeconomic policy problems, which vary greatly among sectors and across countries. A lack of good data has led to a relative neglect of microeconomic issues until recently.

Microeconomic policies have drawn growing attention, especially since 2003 when the World Bank began to issue its *Doing Business* reports. These offer annual country data on a range of variables linked to enterprise performance, including: How hard is it to enforce a contract if the buyer refuses to pay? How hard is it to export or import goods? To start a business? To hire a new worker? To dismiss a worker? If a borrower defaults, what recourse does the lender have? And dozens of other questions that impinge directly on the ability of firms to create value, employ workers, and increase their productivity.

The central conclusion from this new source of data is that government regulation of business is dramatically more extensive and time-consuming for firms in poor countries than in rich ones. Some regulations serve essential economic or social purposes, but even these should be designed so as to minimize costs, uncertainty, and the potential for abuse. In practice, many regulatory obstacles exist because of inattention, or because they serve special interests – including the interest of powerful incumbent firms in blocking competition from newcomers. In addition, many regulatory systems place substantial discretion in the hands of government officials, creating fertile ground for corruption: each additional required signature creates another opportunity to offer or demand a bribe or other favor in exchange for preferential treatment. Efforts to improve microeconomic regimes - from the processes measured by *Doing Business* on one hand to competition policy, company law, land tenure and other property rights on the other – must be grounded in a good understanding of local politics and institutions if they are to succeed.

Growth is good for the poor

The evidence overwhelmingly confirms that growth is good for the poor. Survey data from the 1970s through the 1990s consistently show that on average across countries, consumption among poor households grew at the same rate as average consumption levels, with no general trend toward greater or lesser inequality. On average, growth was as good for the poor as for the non-poor.^{16, 17}

However, around this average there is substantial variation among countries in the impact of growth on poverty. Much depends on how strongly poor households “connect” to the overall growth process, allowing them to gain access to the opportunities created by growth. In part, this is a matter of where growth is taking place in the country, regionally and across sectors. Among a sample of countries studied by the World Bank, the most rapid growth tended to occur outside of agriculture, whereas most poor households were agricultural. In these circumstances, the impact of growth on the poor partly depends on whether workers can easily migrate out of agriculture and find jobs in the emerging non-agricultural sectors, which depends in turn on the flexibility of labor markets and on whether those workers have the literacy and other skills needed for those new jobs.¹⁸ Meanwhile, poverty reduction also depends on whether agriculture itself is living up to its economic potential.¹⁹ Education and labor market flexibility also strongly affect the impact of trade reform on the poor, affecting how easily workers can move from sectors that have lost trade protection to emerging sectors that have become more competitive due to reform.²⁰

The distribution of assets also affects the distribution of income and opportunity. In general, government redistribution of existing assets is politically explosive and economically damaging except under highly unusual circumstances. But policies that broaden the opportunities for the poor to accumulate assets can reduce large income disparities over time. In particular, governments play a key role in providing education, which plays a large and growing role in the distribution of income as countries develop. Public funding of basic education can help break the transmission of poverty from one generation to the next, by ensuring that the children of the poor gain the skills needed to take advantage of emerging economic opportunities. Other examples include financial sector reforms and easier titling of small farms, business property, and homes.

Growth depends on more than what happens at home

The policy choices that governments make, and their capacity to implement them, are the main determinants of a country’s growth. But forces beyond national borders have an influence too. Faster growth in the world economy, for example, boosts demand for the exports of poor countries. Lower barriers to trade have the same effect, while also creating opportunities for poor countries to expand the range of goods and services they export. Stable international financial markets offer well-managed countries access to funds at far lower cost than attainable domestically, while global financial turmoil can drive up interest rates on existing debt and cut off the availability of private finance. The pace and direction of

technological advance affect poor countries in many ways, including the level of scientific and technological effort directed to the specific problems that poor countries face, such as the need to achieve higher yields on the crops that feed their populations and to combat diseases that mainly affect tropical countries. This list could be expanded, but illustrates the point that efforts to improve economic prospects for poor countries as a group are needed alongside those directed toward individual countries and regions.

5. The International Environment for Growth in Developing Countries has Never Been Better

The international factors affecting the growth prospects of poor countries are quite different from a generation ago, and as favorable as at any time in history:

- **Policymakers around the world have gained a broad understanding of the conditions needed to promote economic growth.** While there is much “art” to improving economic policy at the country level – mostly relating to the politics of reform – the broad outlines of a growth-enhancing economic policy environment are more widely understood than ever before.
- **Business climates have improved,** and many governments are now actively working to improve their treatment of business enterprises. The business climate ratings published in the World Bank’s *Doing Business* series complement similar ratings by Transparency International, the Fraser Institute, the Heritage Foundation, and the World Economic Forum. These ratings help policymakers in poor countries see how their own regulatory environment compares with that of other countries – providing the basis for a “race to the top.”
- **The expansion of the world trading system offers unprecedented opportunities for poor countries.** Despite some protectionism by most countries, especially in agriculture and services, the current world trading system provides the greatest opportunity for global integration and poverty reduction the world has ever seen.
- **Private international financial flows have grown enormously, and now dwarf official aid in both magnitude and diversity.** In all but some very poor countries, private international financial flows vastly exceed donor assistance. In many countries, private finance mainly takes the form of portfolio investment or short-term loans (both risky because of the potential for rapid reversals at the most inconvenient times). Direct foreign investment is more stable, because it is dependent on long-term results in the recipient country. Private remittances to many countries have grown dramatically, sometimes reaching 15-20% of GDP.
- **The international flow of information and knowledge is faster, cheaper, and easier than ever.** Along with large-scale migration from poor countries to rich ones, information transmitted through the internet means that people in poor countries are rapidly becoming better connected to the world’s fast-growing knowledge base.
- **It is increasingly easy to identify and adopt “best practice” standards from experience elsewhere.** There has been an enormous growth of “international public goods” provided by organizations that establish standards for a wide range of economic, political, social, health, gender, and environmental issues. Governments and civil society groups in poor countries – from professional associations of accountants or customs directors to stock-market regulators – can easily find information on best international practice, dramatically simplifying the challenge of developing appropriate national regulations.

One negative factor for late-developing countries today is that garment exports no longer provide the easy first step to export manufacturing exports that they did for poor countries in the past, when the Multifiber

Agreement sheltered textile and garment exports through quotas. The end of the MFA is producing a consolidation of global production, leading to a loss of exports and jobs in less competitive countries.

6. USAID's Strengths Determine its Role

In what ways has USAID been most successful in promoting economic growth? The choice of sector seems to have little to do with it. In many of the best-performing African countries, USAID assistance contributed significantly to broad-based economic reform programs, both at the level of overall policy, and at the sector level – but has been particularly effective in helping create functioning markets for agricultural inputs and products. In Eastern Europe and the former Soviet Union, USAID helped create critical market institutions irrespective of sector, including systems of commercial law, trade regimes, banking systems, stock markets, and competent tax collection. Current or recent examples of success suggest that the approach more than the choice of sector matters the most:

- In *Liberia*, a USAID/Treasury team is helping to implement a new collection system that doubled revenues for essential services between January 2005 and January 2006. President Johnson-Sirleaf has called for extending this system to other sources of government revenue.
- In *Vietnam*, the USAID-financed STAR project has helped put in place 19 new laws to help Vietnam conform with international practice, protect intellectual property (facilitating Vietnam's accession to the WTO), and increase transparency in the legal sector and the enforcement of court decisions. The Vietnam Competitiveness Initiative is stimulating vigorous efforts by provincial governments to improve their business climates at the local level.
- In *Central America*, where coffee and bananas accounted for the great majority of exports in 1980, USAID worked with government and the private sector to develop new export sectors, including computer chips, a wide variety of light manufactures, and high-value, labor-intensive agricultural products. By 2000, coffee and bananas had fallen to only 25% of exports to the U.S., replaced by more dynamic sectors. This transformation was an important contributor to the region's desire for a free-trade agreement with the United States.
- In *Kazakhstan*, USAID supported reforms to build a modern financial sector. The politically sensitive pension system has largely shifted from an unsustainable pay-as-you-go system to a fully funded basis; mortgages have doubled in volume since 2001; and the government has introduced consolidated financial supervision to maintain the stability of the financial system.

The common thread among these examples is that USAID responded to a country- or region-specific problem based on an understanding of the key development issue and the motivation of local players – public and private – to reform and innovate. They usually required only modest financial resources, and gained acceptance because of the capacity of USAID to deliver timely expertise on the ground in response to the conditions and opportunities relevant to the country at that time.

The examples also reflect USAID's relative strengths in promoting economic growth:

First, among donor programs that promote private-sector-led economic growth, USAID has the **strongest orientation toward the private sector**. Many donors avoid working directly with the private sector, by statute or fearing (sometimes appropriately) that they will simply strengthen entrenched interests. Development banks sometimes try to support the private sector by underwriting governments' outreach to the private sector, with often disappointing results. USAID support to local business associations that advocate for policy reform has often yielded high pay-offs.²¹ Direct support to pioneer firms and industries has sometimes succeeded in cases where a clear success led numerous others to copy the approach without subsidy.

Second, compared with many other donors, USAID often has larger **in-country staffs**, including high-quality local professionals. Unlike donors with limited in-country presence, USAID is usually perceived in countries where it has worked for decades as being a good partner of the country. This is different from showing strong support for the current government. USAID is more likely than many other donors to be seen as developing its view of the country's problems on the ground and is better situated than many to identify and encourage local initiatives for change.

Third, many donors can send an expert to address a specific issue. Multilateral banks are able to field long-term teams in response to a request from a government. But the delays, discussed below, between conception and implementation of these operations often mean that support arrives when the host organization is no longer interested, or has identified other priorities, or when an open window of opportunity has already closed. USAID's **ability to field long-term teams** that build in-country capacities, and to do so relatively quickly, can be important to success.

Fourth, many recipient countries find USAID to be the donor agency that can act most quickly and provide the most **flexible response** to emerging needs. This is important in an environment where the politics of change can matter as much as the economics and where arriving in time can count for more than the dollar level of assistance. A complementary dimension of USAID's flexibility is its ability to support regional development initiatives. The West African Power Pool, through which the region's countries are developing a reliable and cost-saving source of electrical power to meet their joint needs, and the harmonization of collateral laws between the countries of Central America as a follow-up to CAFTA, are just two of many examples.

Finally, most funding from multilateral agencies is in the form of loans. Even highly concessional loans typically require ratification by the national legislature, whereas grants can be implemented by the executive branch. The process of legislative approval can stretch the gap between the initial agreement for a project and the start of implementation into months or years. In the meantime conditions may change – a dedicated minister is replaced by one less committed to reform, or the conditions necessary for the passage of a key law or regulation are no longer in place. USAID's **grant funding** helps avoid this problem.

In sum, a strong private-sector orientation, in-country staffs, the ability to field long-term teams, flexibility, and grant funding allow USAID to effectively address economic growth challenges in a wide variety of contexts, as long as there is local commitment to change.

USAID's role will be distinct from those of other development agencies. Overall, the U.S. share of grant aid has risen over the past several years, and now accounts for one-quarter of the total from all OECD countries. For lending at near-market interest rates, the multilateral banks are the dominant players, and USAID has no role. USAID's comparative advantage vis-à-vis the World Bank, regional development banks, and the IMF reflects several of the factors mentioned above: smaller, more nimble, grant-funded programs that can adjust relatively quickly to changing circumstances; a greater propensity to work directly with the private sector and to develop private sector solutions to development problems; an ongoing on-the-ground presence that leads to deeper relationships and linkages with local institutions and individuals; and a strong tradition of building institutions and local capacity.

The Millennium Challenge Account (MCA), administered by the Millennium Challenge Corporation (MCC), supports economic growth in selected low-income countries that have relatively good policies. Not all "good performers" will become MCA-eligible, however, and not all MCA-eligible countries will successfully negotiate compacts. Further, the compacts that have been approved so far tend to focus on infrastructure and/or rural development. This should accelerate growth in those sectors but may not contribute to ongoing improvements in the drivers of economic growth across the board. As the earlier discussion emphasized, maintaining rapid growth depends on continued efforts to improve the "drivers" of

economic growth that affect incentives and productivity across a wide range of markets. Much work remains to be done in countries that are good performers but do not receive MCA funding, as well as in countries with narrowly-focused MCA compacts.

7. USAID Will Promote Rapid, Sustained, and Broad-Based Economic Growth

USAID's goal is to help countries achieve economic growth that is *rapid, sustained, and broad-based*. "Rapid" means growth of at least 2% per capita per year, and preferably faster. Any developing country that grows at this rate will dramatically improve the living standard of its population within a generation. Growth at this rate will also enable most low-income countries to meet the Millennium Development Goal of cutting extreme poverty in half within 25 years. Experience shows that per capita growth rates of 3%, 4%, or 5% and higher are feasible, and lead to more rapid progress in reducing poverty and improving other measures of the quality of life.

"Sustained" refers to growth that is maintained over the long term. Sustaining a higher rate of growth requires *continuing* improvements in the drivers and enablers of the growth process. In countries where natural resources play a large role in the economy, sustained growth requires prices, property rights, and other incentives that encourage responsible resource use. Growth often brings other environmental issues to the fore and, with them, the challenge of balancing different policy approaches to ensure that both growth and the environment are sustained in the long run.

"Broad-based" refers to growth that includes major income groups, ethnic groups, and women, and that significantly reduces poverty. Growth in low-income countries has typically, but not always, met these criteria. Donors and governments have a range of opportunities to reinforce the impact of growth on the poor and on specific groups; some are discussed below.

Three approaches will help achieve this goal

USAID will encourage rapid, sustained and broad-based growth through efforts to:

- Develop well-functioning markets, working with the drivers and enablers underlying growth, to create the conditions for sustained productivity increases over time;
- Enhance access to productive opportunities for the poor, women, and other disadvantaged groups, to help ensure that they benefit from growth; and
- Strengthen the international framework of policies, institutions, and public goods that support growth prospects and opportunities for poor countries.

These approaches are distinct but related. Strengthening the overall performance of markets, for example, often increases participation by the poor. Much of the microeconomic reform agenda falls into this category. Similarly, measures to improve access will in most cases also improve the performance of markets. Nonetheless, most USAID interventions will be primarily directed toward one or another of these approaches, and should be judged accordingly.

Developing well-functioning markets

This is the central challenge and the main area of opportunity for USAID. The widespread global improvement in macroeconomic policies and the capacity to implement them means that microeconomic distortions to the business climate are emerging as the principal constraints to growth in many countries.

Nevertheless, certain aspects of macroeconomic assistance will remain important in many situations, including:

- **Fiscal policy reform and administration**, to help countries improve their tax systems so that public funds are raised in ways that are fairer, easier to implement, and less distorting to economic activity.
- **Monetary policy and capacity-building**, to help central banks apply exchange rate and interest rate policies that respond to the market and contribute to the development of a healthy financial sector.

In the emerging field of microeconomic reform, in-country presence has helped USAID develop a strong comparative advantage in many areas of microeconomic reform, and the Agency is a leading supporter of such reforms in the developing world.²² In many cases, success has involved working with business associations to identify the most burdensome regulations and lobby for their simplification. Another approach involves working with both public and private stakeholders to reform and strengthen laws and institutions that are critical for efficient markets. Important areas include:

- **Reforming regulatory and administrative practices** in order to reduce obstacles to enterprise growth, while also reducing the scope for corruption;
- **Strengthening systems to allocate and enforce property rights** to reduce investment risks;
- **Developing systems of commercial law** and the public and private institutions needed to implement them effectively, including judicial and alternative systems for dispute resolution; and
- **Developing and implementing competition policies** to ensure that market-based incentives drive productivity.

Other areas of activity where USAID can work to improve the functioning of markets include:

- **Trade capacity-building**, which complements and integrates many other categories by expanding the markets that countries participate in. Training and technical assistance help countries analyze and participate in international trade negotiations, implement commitments made in trade agreements, facilitate the efficient import and export of goods and services, and build the supply-side capacity needed to participate in the global trading system. Trade enhances the competitive forces that drive productivity change and growth.
- **Financial sector reform and capacity-building**, to encourage the growth of efficient, competitive, and growth-supporting financial systems while strengthening transparency and supervision to enhance the stability of financial markets. Priority should be given to systemic reforms and capacity building that mobilize saving and investment by others, rather than to financing development directly.²³
- **Support for infrastructure** to better serve growing populations, including in urban areas where economies of scale can boost efficiencies in the production and distribution of services from electricity to health. USAID will finance little infrastructure directly, except for post-conflict and post-disaster reconstruction and in some strategic states. But it has worked successfully, and will continue to work in many countries to improve policies in telecommunications, power, water, transport, housing, and urban planning in ways that leverage the impact on growth of infrastructure investments by others.
- **Agricultural development programs**, to help increase the productivity of farmers, agricultural input distributors, and food processors, and to improve their access to domestic and export markets. Developing well-functioning markets stimulates growing demand for cost-reducing and quality-enhancing technologies from USAID-supported agricultural research. Increased productivity within the agricultural supply chain boosts the income of farms and related businesses and helps them diversify into high-value, labor-intensive products, contributing in turn to more rapid growth in other sectors and in

the national economy. In addition, a more nutritious, stable, abundant, and lower-cost supply of food and fiber raises the real incomes of urban residents and improves the health and productivity of the workforce.

- **Enterprise development and privatization**, to help accelerate the private sector response to an improving business climate by facilitating the flow of knowledge and expertise to firms and industries that would otherwise adjust slowly. Privatization, when done well, improves the incentives for business managers and owners to enhance the productivity of their enterprises. Developing a local capacity to provide business services and education to local firms can help enterprises adapt to changing environments. Synergies can be developed with other areas of USAID focus. The development of private ecotourism industries, for example, facilitates enterprise growth with specific benefits for environmental and natural resource sustainability.

Enhancing access to productive opportunities

Faster growth is the basic source of new economic opportunities for the poor as well as the non-poor. Correcting many of the microeconomic distortions inhibiting growth can be especially beneficial for poor people, women, and other disadvantaged groups. Even in a sound policy environment, however, economic and social obstacles may still limit access to emerging opportunities. USAID works to identify and remove such obstacles. Some of these interventions fall outside the scope of economic growth programs. In particular, arguably the most powerful means to improve economic access is to expand the coverage of basic education to include more poor children and girls, while improving educational quality so that all children gain literacy and other basic skills.

Other interventions to enhance access to opportunity fall squarely within the scope of economic growth programs. These often run parallel to those aimed at strengthening markets economy-wide, but are more sharply focused on the particular problems confronting the poor, including:

- **Access to finance.** In many poor countries, poor households – and poor women in particular – lack safe places to keep their savings, lack access to credit due to their inability to offer collateral, and cannot obtain insurance to protect themselves or their businesses.²⁴ Microfinance programs of USAID continue to address these problems, with a particular focus on women.
- **Access to business services.** Along with finance, micro and small enterprises require access to non-financial business services such as technical and supply chain services in order to improve their productivity and compete in the global economy. USAID encourages development of local private providers of these services.
- **Land.** Lack of secure tenure to land is a particularly large threat to the poor, and especially for women who own less than 2 percent of all land in developing countries. More secure rights to agricultural land encourage greater investments in irrigation and other land improvements, as well as more productive cropping patterns. Urban land rights are also important. USAID supports land titling, formalization of de facto tenant rights and, generally, the policies and institutions needed to making land markets work for all.
- **Labor markets and productivity.** For workers to receive higher wages and contribute to rising productivity, labor markets must continuously create new jobs and help workers move from less productive to more productive employment. Excessive job protections make it risky for firms to hire full-time employees, leaving many poor workers – especially youth – either unemployed or stuck in low-paying jobs in agriculture or the urban informal sector, where they enjoy neither benefits or legal protections. USAID encourages countries to reduce unnecessary barriers to job creation and labor mobility, helps improve workers' job skills and productivity, helps firms understand how good labor prac-

tics can contribute to productivity and competitiveness, and helps governments design and implement flexible and effective labor protections and benefits programs.

- **The judicial system.** In most developing countries, poor people lack access to an independent, impartial justice system. This disenfranchises the poor in cases where the powerful infringe on their rights. Women often suffer an additional disadvantage, holding fewer legal rights than men in key economic areas such as land ownership and inheritance. USAID works to strengthen judicial systems and encourage equal rights for women.
- **Burdensome business regulation.** In many countries, regulatory obstacles to operating a formal enterprise cause many firms to remain in the informal sector, where opportunities for growth (and access to finance) are limited.²⁵ Women constitute the majority of those working in the informal sector in many countries, and so are particularly affected.
- **Inadequate infrastructure.** Many poor countries have inadequate basic infrastructure (water, sanitation, electricity, roads, etc.) in urban centers and even more limited coverage in rural areas. Small farms, small and microenterprises, and low-income households in general usually have the poorest access. Policy changes that lead to better coverage and quality can offer greater opportunities for growth and help connect the poor to those opportunities.

Strengthening the international framework of policies, institutions, and public goods

This approach spans efforts carried out on a global or multilateral basis rather than through country programs. Examples of such efforts include:

- **Developing new knowledge important to poor countries.** The centers for international agricultural research have long demonstrated their value in raising agricultural productivity in poor countries. The rates of return to agricultural research are high.²⁶ USAID-funded smallpox research conducted in West Africa achieved a key breakthrough that allowed the disease to be eradicated worldwide within a few years. USAID currently supports research on malaria and HIV/AIDS, among other major diseases affecting poor countries.
- **Supporting trade liberalization.** Multilateral trade liberalization has played a central role in promoting the growth of world trade within a framework of rules that ensures opportunities for rich and poor countries, and subjects both to the same rules in resolving disputes. USAID strongly supports continued multilateral trade reform, which would spur economic growth in developing countries – especially if they reduced barriers to trade amongst themselves. The lack of a breakthrough in the Doha Round of trade negotiations means that, in the near future at least, further reductions in trade barriers may mainly arise through regional and bilateral trade agreements and unilateral liberalization. Most economists view these as “second-best” approaches to trade reform. But whatever avenue trade reform takes, it usually prompts developing countries to pursue complementary economic policy reforms that often boost their productivity and growth more than the liberalization of trade per se.
- **Promoting international standards.** One of the most valuable contributions the international community can offer poor countries is the development and propagation of widely applicable, growth-supporting international standards – for customs operation, business accounting, intellectual property, sanitary and phytosanitary regulations, financial market oversight, and in many other areas. The availability via the internet of international “best practice” helps poor countries understand and implement practices that can ease their engagement in world commerce.
- **Supporting U.S. policies conducive to growth in poor countries.** At times, U.S. policies are formulated with little consideration of their economic impact on poor countries. More active participation

by USAID in interagency decision-making processes can help achieve greater balance among competing U.S. interests, and ensure that development is duly considered as a priority of U.S. foreign policy.

8. Three Principles will Guide Economic Growth Programs

Three principles will be important in USAID's economic growth work. First, **programs should seek large and systemic impacts.** The success of a few firms or communities can provide a sense of tangible accomplishment, but sustained economic growth that affects thousands of firms and millions of people depends on *systemic change* – especially improvements in government policies and practice that significantly improve the incentives facing all businesses.

Second, **where systemic impact is not sought, catalytic impact is essential.** Demonstration projects can be valuable, but they should a) demonstrate approaches that cause a far larger number of entrepreneurs and communities to invest their own resources in similar ways and to continue doing so, or b) lead to policy changes that affect significant parts of an economy.

Third, **political economy is critical.** A clear understanding of the interests and political standing of domestic groups supporting or opposing reform can help focus decisions concerning pace and sequencing, and can also help identify whom to work with in the government and private sector. Where change is slow, support to reform-oriented leaders – public and private – to press for change can help galvanize the needed internal political will. When the will to change emerges, the opportunity can be short. Rapid and flexible response is important.

External factors can galvanize political commitment to promoting economic change in dramatic ways and should be used creatively. The fear of falling short in the global competition of *Doing Business* indicators and the World Economic Forum's Growth Competitiveness Index, for example, has generated significant policy change in the last few years. The negotiation of free-trade arrangements and the prospect of joining institutions like the European Community have also catalyzed reforms. Specific reforms required for MCA compact status are generating momentum for change in some cases that USAID can capitalize on through MCA Threshold programs.

9. Economic Growth in the Foreign Assistance Framework

In 2006, USAID and its programs were placed under the newly created Directorate for Foreign Assistance (DFA), housed within the State Department. Key goals of the DFA include creating a more unified and rational structure that will more fully align assistance programs in State and USAID, increase the effectiveness of those programs for recipient countries, ensure the best possible stewardship of taxpayer dollars, and focus U.S. foreign assistance on promoting greater ownership and responsibility on the part of host nations and their citizens.

Strategic planning under the DFA began immediately, organized around a matrix of five country categories and five broad objectives – the Foreign Assistance Framework (FAF). Economic Growth was adopted as one of these objectives, alongside Peace and Security, Governing Justly and Democratically, Investing in People, and Humanitarian Assistance.

Under the FAF, country strategies are developed by combining programmatic interventions drawn from one or more of the five objectives, depending on the development situation of the country in question. Although the details of each country strategy must be tailored to the particular circumstances of that country, the country categories are defined so that each contains a set of countries that are broadly similar in development status, performance, and prospects. As a result, all country programs within a particular country category are expected to emphasize a broadly similar set of interventions to promote economic

growth (or any other objective). The remainder of this section briefly defines the five country categories, and suggests some broad generalizations about the kinds of economic growth activities likely to be emphasized in each.

Developing countries are low- or lower-middle income countries that do not meet criteria for Millennium Challenge Account (MCA) eligibility and/or criteria pertaining to political rights. They cover a wide range in terms of policy performance, conflict and stability, and level of development. The overall goal of U.S. assistance in these countries is to support progress towards transformational development and eventual graduation from foreign aid.

In Developing countries, a preliminary question that needs to be resolved is whether or not the existing macroeconomic situation is sufficiently stable to support growth and job creation. If not, re-establishing macroeconomic stability should be regarded as a top priority.

Where the macroeconomic environment is reasonably stable, efforts should mainly focus on improving the microeconomic environment in general and for growth in key sectors. Going beyond these general principles to identify specific priorities requires a deep understanding of the specific circumstances of countries, in order to identify the binding constraints to growth.

Lower priority should generally be assigned to direct support for investments in productive capacity. In most cases, weaknesses in the business climate pose the main constraint to increasing productive capacity by discouraging private investment. As the business climate improves, private investment – domestic or foreign – can provide a much greater volume of resources to enhance productive capacity than would normally be available from the USG or from other donors, and can direct those resources more efficiently to the most growth-enhancing areas.

Transforming countries are also low- or lower-middle income countries but, unlike Developing countries, have met criteria for MCC eligibility and criteria pertaining to political rights. The overall goal in these countries is to support rapid progress in terms of transformational development and graduation from developmental foreign aid.

Because they are (by definition) relatively good performers, most Transforming countries have achieved reasonable macroeconomic stability, though some may experience temporary setbacks. Most economic growth programming should be focused on further strengthening the microeconomic environment generally and for specific sectors, building on the foundation of basic measures that distinguishes these countries from those in the Developing country category to undertake the higher-order reforms needed to maintain progress toward faster and more sustained growth. Many countries are likely to have particular areas in which policy remains especially weak, despite their above-average policy environment overall. As in the Developing country category, other priorities should be determined on a case-by-case basis depending on the binding constraints.

Rebuilding countries are those in or emerging from internal or external conflict. The overall goal of U.S. assistance in Rebuilding countries is to establish the foundations for development progress.

Economic growth efforts in Rebuilding countries will generally differ significantly from those in Developing or Transforming countries. Countries currently embroiled in conflict typically offer few immediate opportunities for economic growth. Where the USG seeks to support the government of a country in conflict, the key economic intervention is generally budgetary support to allow the government to manage without resorting to inflationary finance. Countries rebuilding after conflict are likely to require immediate attention to macroeconomic policies, including stabilization. Rapid employment growth is also important, especially when there are large numbers of demobilized combatants.

The immediate post-conflict period can be a valuable opportunity for economic reform, both because the political power of the special interests that benefited from economic distortions has been weakened, and because the case for simply returning to pre-conflict policies has been undermined. However, the rate at which reforms can actually be implemented is often limited by weaknesses in government capacity, which can in most cases only be addressed gradually. As a result, careful attention to sequencing, along with a strong emphasis on simple, basic reforms, are important to ensure that existing capacities are used as effectively as possible. This will help ensure that the opening for reform is not wasted. It is also important to identify those components of the economic system that functioned before the conflict erupted and that might be resuscitated quickly, in order to help jumpstart economic activity and job creation.

A recent study of major U.S. post-conflict reconstruction efforts offers useful principles for sequencing efforts to improve economic governance in such settings.²⁷ One basic principle is to undertake high-priority and time-consuming activities toward the beginning of the reconstruction effort. High-priority activities include actions to ensure security, improve budgetary execution systems (critical for reducing the scope for large-scale and high-level corruption), and reduce inflation and otherwise restore macroeconomic stability through appropriate fiscal, monetary, financial, and exchange-rate policies. They also can include addressing the short term need for employment in the period before the growth-inducing effects of peace, stability and economic reforms take effect. Time-consuming activities include efforts to build new institutions for economic governance, train a professional class of analysts and policymakers, and develop systems to generate reliable economic data.

Once the efforts identified above have been set in motion, attention can begin to turn to improvements in other areas – in all cases, beginning with the basics and postponing more sophisticated efforts until the country has emerged from post-conflict vulnerability. For example, efforts in the financial sector should begin with creating a payments system along with a rudimentary system for regulating private banks; tax reform should begin with simple, indirect taxes; reforms of commercial law and institutions should concentrate on such basics as registering businesses with minimum red tape, protecting private property, and enforcing contracts. More thorough, but more complicated reforms can wait.

Safety nets comprise an additional area flagged for attention: in particular, programs focused on key political and social constituencies, including social programs for the most vulnerable population groups and efforts to give veterans and decommissioned soldiers a stake in the new society.²⁸ In the Foreign Assistance Framework, some of these programs are included within the Economic Growth objective; others have been placed under Investing In People.

Finally, reconstruction and rehabilitation of basic infrastructure will often be a priority in Rebuilding countries, especially where conflict has damaged the country's infrastructure or allowed it to deteriorate. In contrast to other country categories, it will often be necessary and useful to provide direct support for such investments in infrastructure in order to help jump-start economic activity more broadly. The specifics of the country situation will generally dictate priorities in this area.

Sustaining partnership countries are upper-middle or higher income countries for which foreign aid is provided to sustain partnerships, progress, and peace *in areas of mutual interest*. In most such countries, foreign aid plays a relatively minor role. The major programmatic area within economic growth is likely to be trade and investment.

Finally, ***Restrictive countries*** are those in which there are significant governance issues and/or legislative restrictions on direct U.S. funding. Foreign aid aims to strengthen civil society to generate demand for improved freedom, governance, and accountability. Economic growth efforts will typically play little, if any role in Restrictive country programs.

10. Resources and Resource Allocation

A renewed USAID commitment to economic growth has clear implications for budget and staff. With respect to budget, a recent study concluded that only 4% of the U.S. government's foreign aid budget of \$15 billion was programmed for economic growth in a flexible and unconstrained way.²⁹ Another 6% went to the new MCC, while an additional 13% promoted growth subject to constraints, usually country or sector earmarks. These relatively small amounts reflect a lack of consensus between the executive and legislative branches of government about the importance of economic growth programs. The result is that economic growth funding has become largely a residual after other demands have been met. But if rapid, sustained, and broad-based growth is indeed the only way for poor countries address all other development goals and emerge from further dependence on foreign aid, funding for economic growth programs should be a clear - and higher - priority.

The distribution of economic growth funding among countries also matters: Until recently, some 80 percent of total economic growth funds under USAID management were concentrated in strategic programs financed from the Economic Support Fund account and programs in Eastern Europe and the Former Soviet Union. Economic growth initiatives in countries funded under the Development Assistance account are highly constrained, which biases assistance in those countries away from the programs that could do the most to reduce their dependence on foreign assistance over the medium and longer terms. The allocation of economic growth funding among countries funded out of different budget accounts should be revisited to ensure that broader U.S. interests are being met. Finally, this paper argues that flexibility in funding (and contracting procedures) for economic growth programs matters a great deal to their success. The ability to quickly concentrate funds and expertise when and where opportunities arise can significantly increase impact.

With respect to staffing, the last time that USAID gave central importance to promoting economic growth in poor countries – the early 1980s – the Agency attracted a substantial number of experienced, mid-career economists and private-sector officers. The latter brought to the Agency an understanding of the way that private businessmen and women think and operate and earned USAID the reputation of being the most innovative and successful donor agency in the area of private sector development. But the overall strength of USAID's cadre of economists and private-sector development officers declined sharply in the 1990s as other priorities were given emphasis, and USAID missions were downsized. The Reduction in Force (RIF) in the mid-1990s particularly depleted the Agency's economic staff.

Four staffing issues require attention in order to sustain and improve program quality. First, USAID needs on-the-ground direct hire expertise in economic growth and its component areas such as agriculture and private sector development. Success in the challenging environments in which USAID is asked to work depends on the ability to interact effectively with local leaders in government and the private sector. Second, the needs of Rebuilding countries will be broad-based, including the capacity to make and implement macroeconomic policy. To be effective in these situations, USAID must retain a broad range of expertise in economic growth. Third, even though the approach, priority, and sequencing of economic growth initiatives depend heavily on local conditions, global best practice remains an important benchmark. USAID needs to dedicate staff to manage lessons learned in the "tradescraft" of promoting economic growth, and disseminate those lessons effectively to field staff. Last, but not least, active participation by USAID in interagency decision-making processes on policies that affect developing countries will require mobilizing the expertise in Washington to assess and assert the economic growth perspective effectively. Across the board, human resource quality will be at least as important as quantity.

11. In Conclusion

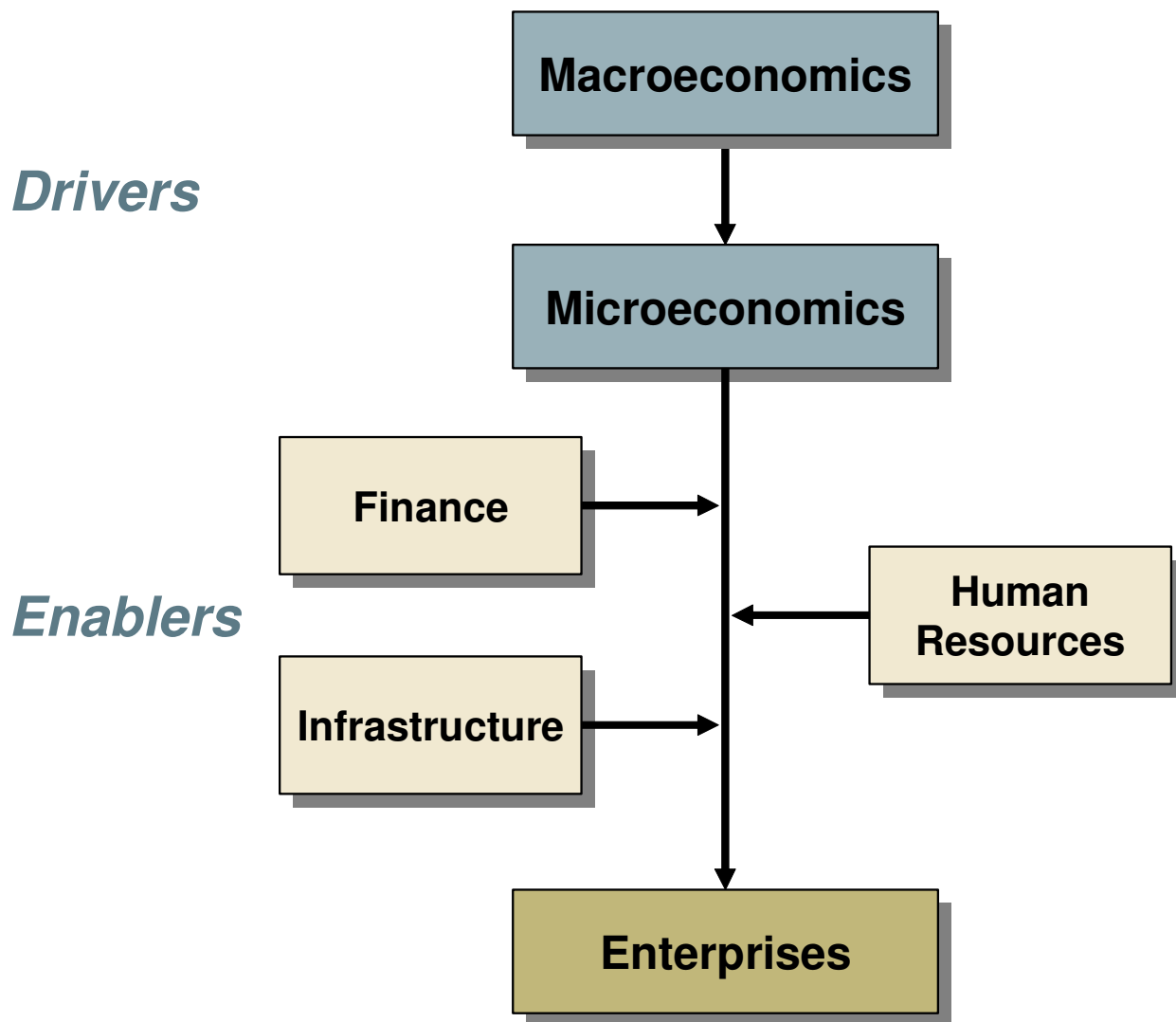
This strategy has highlighted the profound and wide-ranging benefits – to the U.S. and to the world - of achieving more rapid, more sustained, and more broadly based economic growth among developing and transition countries.

Burdensome and corruption-prone regulations, weak property rights, and other microeconomic issues are emerging as the binding constraints to economic growth in a wide range of countries. USAID is well-positioned to respond: the Agency's strong private-sector orientation, in-country staffs, its ability to field long-term teams, and its flexibility all contribute to USAID's effectiveness in this key area of economic reform.

For the United States to take advantage of these strengths, USAID's economic growth efforts must receive adequate funding and the flexibility to apply financial and human resources where they can do the most good. On the financial side, this means allowing and encouraging USAID missions – especially those in DA-funded countries – to devote a larger share of their country budgets to spurring economic growth. On the personnel side, it requires greater scope to hire highly qualified, experienced economic growth professionals.

The FAF provides an opportunity to recommit USAID to promoting economic growth in developing countries – the only way that they can eliminate extreme poverty and generate the domestic resources needed to address their own development challenges. The clarity of the FAF programming framework, a clear conceptual understanding of economic growth and its dynamics, priority to systemic and catalytic change in USAID's economic growth activities on the ground, and adequate funding and technical staff will be key to pursuing that goal. Reaching the goal will provide the people of the developing world the opportunity to secure a better future. Achieving that, in turn, will help us secure our own.

Figure 1: Framework for Economic Growth



Endnotes

¹ Angus Maddison. *The World Economy: A Millennial Perspective*. OECD Development Center 2001.

² In a market system, income and output are closely related, both conceptually and as measured statistically. This paper uses these terms interchangeably.

³ According to the most painstaking estimates, differences in productivity growth account for 90 percent of the differences among countries in the growth rate of output per worker. Peter J. Klenow and Andres Rodriguez-Clare A., "The Neoclassical Revival in Growth Economics: Has it Gone Too Far?" in Bernanke, B. and Rotemberg, J. eds., *NBER Macroeconomics Annual*, Cambridge, MA, MIT Press, 1997.

⁴ *The Moral Consequences of Economic Growth*, Benjamin M. Friedman, 2005; reviewed in *The Economist*, November 12, 2005.

⁵ "Economic Freedom and Peace", Chapter Two of *Economic Freedom of the World: 2005 Annual Report*; pp 29-44, The Fraser Institute, 2005.

⁶ Since 1984, the share of exports in overall U.S. GDP has doubled; and the share of developing countries in U.S. exports has risen from 36% to 45%.

⁷ For the global incidence of extreme poverty in 1950, see François Bourguignon and Christian Morrison, "Inequality Among World Citizens: 1820-1992," *American Economic Review*, September 2002. The estimate for 2004 is from Shaohua Chen and Martin Ravallion, "Absolute Poverty Measures for the Developing World, 1981-2004," World Bank Policy Research Working Paper 4211, April 2007. Both sources use the same threshold of extreme poverty: per-capita expenditure of \$1.08 per day or less, calculated at 1993 Purchasing Power Parity.

⁸ *Foreign Aid in the National Interest*, USAID 2002

⁹ Based on data from the IMF's *World Economic Outlook*, April 2006. See "Economic Performance and Prospects for Developing Countries", PPC/P Background Paper, May 2006.

¹⁰ Arnold C. Harberger, "On the Process of Growth and Economic Policy in Developing Countries." USAID Bureau for Program and Policy Coordination Brief, December 2005.

¹¹ Steven Radelet, "Overview on Global Trends, Growth Determinants, and Aid Effectiveness," presentation at USAID workshop "Promoting Economic Growth in a New Era," June 28, 2004.

¹² *Doing Business 2007: How to Reform*. World Bank.

¹³ Dani Rodrik, "Growth Strategies." Working Paper, Kennedy School of Government, Harvard University 2004.

¹⁴ Ricardo Hausmann, Dani Rodrik, and Andrés Velasco. "Growth Diagnostics." Working paper, Kennedy School of Government, Harvard University 2005.

¹⁵ Since 1994, an increasing number of macroeconomic crises have originated in the financial sector rather than in budgetary imbalances. With the important exception of Indonesia, most of the affected countries have been upper-middle-income countries like Mexico and Thailand, where private financial institutions had gained access to international capital markets but where the government had not developed the capacity or political will to exercise adequate prudential supervision over the more complex financial transactions involved. In keeping with its overall organization and to avoid repetition, this paper treats financial sector issues and interventions as primarily microeconomic, rather than providing a separate discussion of their potential macroeconomic impacts. Mishkin (2001) provides a good overview of these complex issues against the backdrop of recent crises. (Frederick S. Mishkin, "Financial Policies and the Prevention of Financial Crises in Emerging Market Countries." National Bureau of Economic Research Working Paper, January 2001.

¹⁶ David Dollar and Aart Kraay, "Growth is Good for the Poor," *Journal of Economic Growth*, September 2002. Moreover, for periods averaging around 10 years, differences in country growth rates account for fully 90 percent of cross-country differences in the rate of poverty reduction. Aart Kraay, "When Is Growth Pro-Poor? Cross-Country Evidence." IMF Working Paper, March 2004.

¹⁷ A new pattern may have emerged in the 1990s, with inequality increasing in countries that achieve especially rapid growth (Humberto Lopez, "Did Growth Become Less Pro-Poor in the 1990s?" Working Paper, World Bank 2006. *Pro-Poor Growth in the 1990s: Lessons and Insights from 14 Countries*, World Bank 2004.) The problem seems to be that most rapid growth is taking place in non-agricultural sectors, whereas most of the poor live in rural areas and work in agriculture. The implication is not that growth has become less important for poverty reduction,

but rather that complementary measures to ensure that the poor can gain access to the new opportunities created by growth have become more important – measures such as those discussed under the second approach, “enhance access to economic opportunities.”

¹⁸ *Pro-Poor Growth in the 1990s: Lessons and Insights from 14 Countries*. World Bank, 2004.

¹⁹ Sarah Lucas and Peter Timmer. “Connecting the Poor to Economic Growth: Eight Questions.” Center for Global Development Brief, April 2005.

²⁰ USAID. “The Impact of Trade Liberalization on Poverty: Conference Proceedings.” 2006

²¹ Among other activities, USAID-supported business associations provide their members with information and training that promotes understanding of the benefits of reform.

²² USAID assistance has been critical in supporting many of the most important reforms captured in the World Bank’s *Doing Business* rankings, notably in such top reformers as Georgia, Serbia, and Egypt. USAID currently has active programs to improve the business environment in more than 50 countries, devoting several hundred million dollars each year to such programs.

²³ Direct financing often diverts attention from fundamental problems in the business climates of assisted countries – or problems with their financial systems - and is unsustainable in the long run.

²⁴ Without access to financial services, the poor find it especially hard to obtain “usefully large” amounts of funds for investing in productive inputs, and even harder to accumulate the larger sums needed to buy assets like land, business premises, and housing.

²⁵ Hernando de Soto. *The Other Path: The Invisible Revolution in the Third World*. 1989.

²⁶ Donald G. McClelland. “Investments in Agriculture: A Synthesis of the Evaluation Literature.” USAID Program and Operations Assessment Report, 1996. The international research centers are organized under the Consultative Group for International Agricultural Research.

²⁷ Stephen Lewarne and David Snelbecker for The Services Group. “Lessons Learned about Economic Governance in Wartorn Economies: From the Marshall Plan to the Reconstruction of Iraq.” USAID Bureau for Policy and Program Coordination, PPC Evaluation Brief, February 2006.

²⁸ Lewarne and Snelbecker, previously cited.

²⁹ James W. Fox and Peter C. Timmer. “The United States and Economic Growth in Poor Countries.” Prepared for USAID/EGAT Office of Economic Growth by Development Alternatives, Inc, July 2005.