USAID
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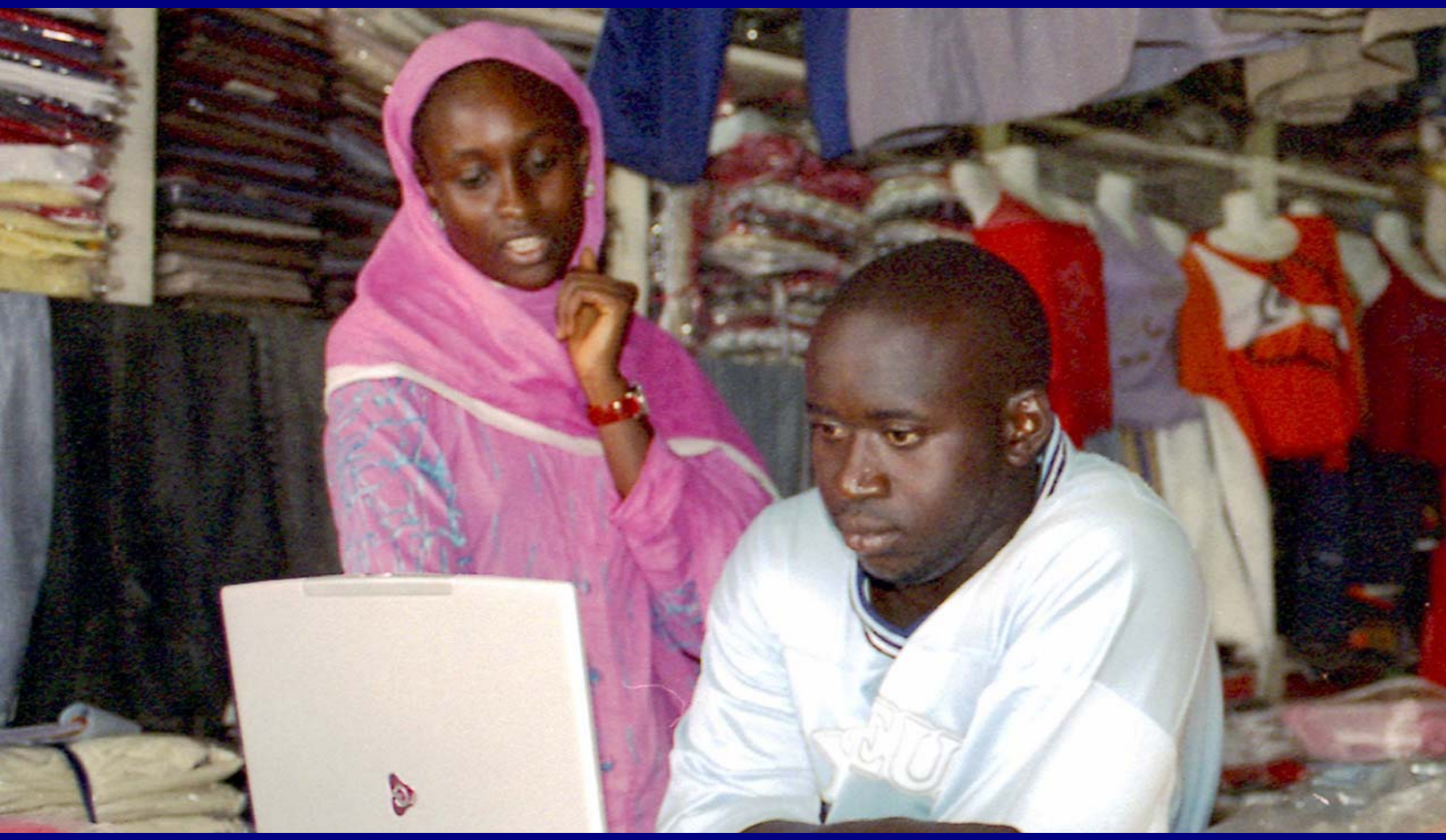
Economic Growth Strategy

Securing the Future



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Cover: Facoumba Gueye, left, explains how information technology can help Dakar's Sandaga Market clothing merchant Omar Fall increase efficiency and profits. .Photo by USAID/Richard Nyberg

Executive Summary

Economic growth strategy in context

The United States Agency for International Development (USAID) promotes economic growth in accordance with the 2006 *National Security Strategy of the United States*[1] and the goal of transformational diplomacy. Economic growth, in tandem with the promotion of democracy, is an important key in achieving the Secretary of State's goal of transforming the developing world, which includes most of the world's countries and most of its people. Free markets and free societies are vital to achieving the development goals of the United States. As stated by Secretary Rice,

> *…the United States must assist the world's most vulnerable populations through our transformational diplomacy—using our foreign assistance and working with our partners to build state capacity where little exists, help weak and poorly governed states to develop and reform, and empower those states that are embracing political and economic freedom. These are three main goals of our country assistance programs, with the ultimate purpose being "graduation" from foreign economic and governance assistance altogether. Vibrant private sectors in free, well-governed states are the surest form of sustainable development.*[2]

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 is the surest way 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.

Economic growth in developing countries creates important benefits for the United States as well. The developing world is emerging as the largest market for U.S. exports. Accelerating growth among developing countries that have done well, and encouraging it in those that have not grown as quickly, will further increase their contribution to global and U.S. wellbeing. Economic growth creates the prospect that more developing countries will become effective partners with the United States in working toward a more stable, healthy, and prosperous world.

Poor countries that fail to grow can pose serious problems. They are vulnerable to crisis, sometimes including state failure and violent conflict; can harbor terrorist activity; are vulnerable to the impact of 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 Framework for U.S. Foreign Assistance (hereafter, the Framework) gives economic growth a central position in the U.S. foreign assistance program. This makes it important to have a clear understanding of the growth process in order to help countries grow more quickly. 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 18% in 2004. 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 over the past decade, 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 expanded, with groundbreaking new work in microeconomic reform. Rapidly increasing global trade and investment offer unprecedented opportunities for countries that are willing and able 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 18% of the world's population still lives in extreme poverty provides a sharp reminder of the urgent need to achieve faster growth and to spread its benefits more widely.

Economic growth begins with competitive firms

Economic growth is the sustained increase of a society's output. The key is ongoing growth in productivity – turning 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.

By shaping producers' incentives, economic governance "drives" growth

Producers' decisions are strongly influenced by the incentives and disincentives created by government policies, regulations, and other aspects of economic governance, including the capacity of government to enforce these "rules of the game" in market-friendly ways. Key examples include the impact of macroeconomic policy on overall economic stability, along with the effects of microeconomic policies including taxes, regulations, and the enforcement of property rights and contracts. Macroeconomic and microeconomic policies represent the *"drivers"* of economic growth, because they are the primary determinants of the rate and sustainability of economic expansion.

Sound macroeconomic policy is essential. Fortunately, 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.

Microeconomic governance has 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 regulations are essential, but they should be designed so as to minimize costs, uncertainty, and the potential for abuse. 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, giving rise to pervasive corruption and rent-seeking. 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.

Other factors "enable" growth

If macroeconomic and microeconomic policies and institutions drive the growth process, other factors "*enable"* growth to move forward. The availability of finance, of infrastructure, and of an educated and healthy workforce, 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 country with a poor macro- or microeconomic policy environment.

Political context matters

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 – and plays to USAID's strength

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 genuine opportunities arise is essential to take advantage of political breakthroughs affecting the local will to reform.

USAID has several advantages in this regard 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. Additional flexibility arises from USAID's technical capacity to address the full range of issues that ultimately affect a country's growth – including issues of democratic governance, health, education, and other areas complementary to economic reform.

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 minimally satisfactory. Experience shows that per capita growth rates of 3%, 4%, and higher 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 mainly focus on supporting policy and regulatory reforms, while building local capacities to implement them and to continue the reform process. Principles of sound governance – openness, transparency, and accountability – will be important across the board. Capacity building can be more expensive than policy advice alone, but both are inexpensive compared with many efforts in other sectors. Moreover, both have the potential to achieve transformational results many times the cost of the investment. Activities should include a growing emphasis on microeconomic reform including support for greater competition and stronger property rights, improving the enabling environment for agricultural development, infrastructure, the financial sector, and trade capacity building. 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 access to improved basic education for 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 for achieving the greatest results should guide the choice of interventions. 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 requirements for joining the World Trade Organization or the European Union, or a low ranking on a 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 Framework for U.S. Foreign Assistance provides a new beginning

The Foreign Assistance Framework adopted in 2006 places recipient countries into five categories based on their policy performance, level of development, experience with conflict, and other factors. The Framework also divides programmatic interventions among five broad objectives; efforts in these five

program objectives are intended to be complementary and mutually reinforcing. This strategy suggests the kinds of economic growth interventions likely to be most appropriate in 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 Framework, and significantly increasing growth and incomes in the developing world, require both a clear and visible priority to economic growth funding for USAID, as well as concerted attention to rebuilding USAID's cadre of economic growth professionals.

This Strategy focuses most strongly on the challenges of achieving faster and more sustained growth in Developing and Transforming countries – those with a reasonable degree of political stability. Rebuilding countries have an equally compelling need to achieve sustained higher growth rates. The distinctive issues related to restoring economic growth in Rebuilding countries – particularly those emerging from conflict – are referenced in this Strategy, and are also addressed in detail in a separate document.[49]

The Framework for U.S. Foreign Assistance 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. This Strategy establishes the basis for setting priorities within the Framework so that USAID's economic growth programs will have the greatest impact. Through increased support for systemic and catalytic change in the economies of partner countries, and with adequate funding and technical staff, USAID can multiply the results of its work and help much larger numbers of people in partner countries secure a better future. In an interdependent world, a better future for the people of developing countries means a more secure future for us all.

USAID Economic Growth Strategy
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Economic Growth Strategy in Context

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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.[3] 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 Rising Productivity

Sustained economic growth means *ongoing increases in per capita income and output*.[4] 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 the average growth in per capita U.S. output since independence range from 1.7% to 2.2% per year. 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.* [5] Productivity grows as producers – entrepreneurs operating at all scales – find ways to squeeze more output from a given set of inputs. They do so 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 that producers face – incentives strongly affected by public policies and regulations, macroeconomic stability, the enforcement of contracts and property rights, the prevalence or absence of corruption, and other aspects of 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* identified 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 reaffirmed 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. The Nobel Prize-winning economist Dr. 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; as political scientist Michael Mandelbaum observes, "Many studies have found that the higher a country's per capita output, the more likely that country is to protect liberty and choose its government through free and fair elections."[6] Economic stagnation and decline are associated with intolerance, ethnic strife, and dictatorship – complex relationships that can run in both directions.[7] Recent research points to the positive impact of economic freedom on peace, concluding that economic freedom significantly reduces violent conflict.[8]

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 experience a decline in the prevalence of poverty, while gaining 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.[9] Projecting 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 reliable sources of supply for key resources, for which growing economies with stable, accountable, and representative governments 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 political crises, including state failure and recurrent civil wars – especially in countries experiencing a "bulge" of young people who find few opportunities in a stagnant economy, making it easy to recruit them into rebel armies. Economically stagnant countries can also harbor terrorist activity, are more vulnerable to the impact of natural 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; and environmental problems such as deforestation and loss of biodiversity.

For all these reasons, achieving more rapid, more sustained, and more broadly based economic growth is important to help developing and transition countries secure more prosperous, peaceful, and healthy futures, and to help the United States secure its own future in turn. This Strategy focuses on how USAID can best contribute to these outcomes.

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 18% in 2004.[10]

Progress in other dimensions of wellbeing 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.[11] 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, Sub-Saharan Africa's performance and prospects have improved significantly. Since the mid-1990s, 17 out of 40 African countries have maintained per capita growth of 2% annually or better, rising to 24 of 40 countries since 2001. 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 from 1950 to 1980, stagnated during the "lost decade" of the 1980s, and has since achieved at best modest growth. Even this has often involved short spurts of growth followed by economic crisis and decline. Only 8 out of 22 countries maintained per capita growth of 2% or more over the decade ending in 2006. 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 those in countries that had competed with the rest of the world. As entrepreneurs scrapped obsolete technologies and mind-sets, entrepreneurs in these countries found new 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. Among countries currently or previously receiving aid, Tunisia, Morocco, Algeria, Egypt, Jordan, Turkey, and Cyprus all grew at rates above 2% per capita over the past decade; only Yemen and Lebanon fell short of that benchmark.[12]

Thus, global progress since 1950 has been enormous. At the same time, progress in some countries has been uneven or slow, and a few have retrogressed. The fact that "only" 18% of the world's population still lives in extreme poverty means that 1.2 billion people remain on the margins of subsistence. USAID's strategy for addressing those problems must be shaped by what we have 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 at the firm

To understand how to encourage faster and more sustained growth, it is essential to understand how increases in productivity occur. Economist Arnold Harberger reminds us that "all economic growth takes place at the level of the productive enterprise" [13] – 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 in order to serve or create new markets. To sustain a higher rate of growth, producers must face incentives that motivate them 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 markets are open to entry by new firms, existing producers must continue to behave as entrepreneurs, working relentlessly to improve their products and reduce costs in order to stay in business and earn profits. Instead, governments in many developing (and developed) countries shelter established producers from competitive pressure, undermining incentives for higher productivity. It is in this arena – encouraging host country governments to adopt policies and practices of economic governance conducive to competition and productivity, and helping build the institutional capacity needed to develop and apply growth-supporting policies – that USAID can play the strongest role in supporting economic growth.[14]

The role of the public sector in supporting economic growth extends beyond simply promoting competition. It must also establish and maintain:

- macroeconomic stability, especially avoiding high inflation and unsustainable fiscal policies;
- a predictable and transparent system to enforce property rights and contracts; and
- a transparent, accountable, and efficient system for resolving economic disputes among firms and individuals.

Public policies, regulations, property rights, and other aspects of economic governance shape the incentives for productive effort. As such, they represent the *drivers* of economic growth, in the sense that they primarily determine the rate and sustainability of growth (see Figure 1). If public policies create incentives that are seriously misaligned, economies will stagnate or decline. Broadly speaking, the drivers of growth include **macroeconomic policies** (fiscal, monetary, and exchange-rate policies) along with those **microeconomic aspects of governance** 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 product, financial, and labor markets.)

Other factors "enable" growth to move forward

Other factors – such as the availability of credit or other financial resources; the availability of roads, telecommunications, and electrical infrastructure; and the human resources embodied in the education, training, and health of those working in any particular sector or in the labor force overall – represent *enablers* of growth. 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 where the drivers are not in place.[15]

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.

Political economy is key to reform

The greatest obstacles to growth stem not from nature, but from politics. Growth takes place within a complex setting of social and political conditions and forces. Most policy reforms involve a political cost – overriding the vested interests of those who benefit from the current situation. As a result, 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.[16] 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 potential allies in the government and private sector.

These considerations also mean that donors need to react quickly to changes in local political circumstance. For example, recent research shows that among the top microeconomic reforming countries, 85% of such reforms occurred within the first 15 months of a change of government.[17] This means that being able to move fast when an opportunity arises to facilitate reform is important to success.

Politics affects growth on a deeper level as well. Achieving rapid and sustained growth requires secure property rights, so that producers can invest without fear that the product of their efforts will be seized by the government or by politically favored private interests. Similarly, sustained growth benefits from honest and efficient administration of well-designed policies and regulations, to ensure that producers devote their energies to creating value and raising productivity, rather than paying bribes and lobbying for favors from government. These and other dimensions of economic governance depend on the domestic political context. As the economist Robert Barro recently stated, "A country's economic performance depends on various aspects of government policy, but no aspect is more important than the quality of political, legal, and economic institutions."[18] Well-functioning democracies, complete with effective checks on government power and mechanisms to ensure accountability, can achieve these goals. On average, democracies tend to achieve faster growth than autocracies. By comparison, autocracies include both the growth superstars of East Asia – where leaders committed themselves to support growth – as well as many slow-growing or stagnant countries whose rulers have sacrificed growth out of greed, ideology, or incompetence. Progress toward effective democracy and good political governance can strengthen the institutions that support and sustain growth over time.[19]

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, market-based competition, appropriate incentives, sound money, debt sustainability" – can be applied in different ways, depending on local constraints and opportunities.[20] 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.[21] 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 – have emerged as a second serious threat to macroeconomic stability.[22] 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. In fact, most countries have reduced inflation below 10%. The previously widespread and damaging use of multiple exchange rates has also become rare. In addition, 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 hyperinflation, 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, regulations, enforcement of contracts and property rights, and related forms of economic governance, which together shape the incentives that drive economic behavior in individual markets and sectors. In part, this lack of progress has reflected the difficulty of quantifying microeconomic policy problems, which vary among sectors and across countries. A lack of good data has, until recently, contributed to a relative neglect of microeconomic issues.

Microeconomic issues have drawn growing attention, especially since 2004 when the World Bank began issuing its *Doing Business* reports. These reports offer annual country data on a wide range of measures of microeconomic governance, 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?

The central conclusion from this new source of data – and complementary indicators from other sources – 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 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 a lack of broad representation and accountability in decision-making has given rise to regulations that serve special interests – including the interest of powerful incumbent firms in blocking competition by newcomers. In addition, because they place substantial discretion in the hands of government officials, many regulatory systems have become "seedbeds of corruption"[23] and rent-seeking behavior: each additional required signature creates another opportunity to offer or demand a bribe or other favor in exchange for preferential treatment.

The burden of overregulation falls disproportionately hard on small and micro firms, which employ a large share of the labor force in most developing countries. For example, barriers to business registration and operation force these firms to remain in the informal sector, where they lack legal status.[24] Operating in the legal shadows imposes a wide range of disadvantages on informal firms – restricting their access to financial services, to the courts when disputes arise with other firms, and to legal services such as property registration.[25] The net effect is to slow growth and to skew the distribution of income toward the (usually politically well-connected) owners of established firms.

Efforts to improve the microeconomic dimensions of economic governance – whether focused on the regulatory processes measured by *Doing Business* and other indices or on competition policy, company law, land tenure and other property rights, and reducing corruption – must be grounded in a good understanding of local politics and institutional strengths and weaknesses if they are to succeed.

The impact of improved microeconomic governance can be dramatic. Independent estimates suggest that through modest improvements in their regulatory environments, poor countries could boost their growth rates by 1.4 to 2.2 percentage points per year – enough to raise incomes by 32-54% within two decades.[26]

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 consumption among non-poor households, with no general trend toward greater or lesser inequality. On average, growth was as good for the poor as it was for the non-poor.[27, 28]

However, the impact of growth on the poor varies considerably from one country to another. 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.[29] Meanwhile, poverty reduction also depends on whether agriculture itself is living up to its economic potential.[30] 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 sectors that have become more competitive due to reform.[31]

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 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 they will need 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 also matter. 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. Regional cooperation can provide access to more reliable and lower-cost power, while disruptions to global or regional sources of energy can bring growth to a sudden halt. The pace and direction of technological advance affect poor countries in many ways, including the extent to which scientific and technological effort is 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 helps illustrate 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 principles laid out in this strategy remain valid regardless of fluctuations in the global economy. Nevertheless, it is important to recognize that the international factors affecting the growth prospects of poor countries are quite different from a generation ago, and are 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 compare their own regulatory environment 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 development 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 are 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. Broader access to information on economic performance in other countries provides an important tool to help citizens press their governments for greater transparency and hold them accountable for better performance in economic affairs.
- **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 and private firms – can easily find information on best international practice, dramatically simplifying the challenge of developing appropriate national regulations.

Today, one negative factor for late-developing countries is that garment exports no longer provide poor countries the easy first step toward exporting manufactures that they did in the past, when the Multifiber Agreement (MFA) 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.

A second negative factor has recently been suggested, which also applies to countries that have not yet emerged from economic stagnation and political fragility. According to this argument, the economic success of so many other developing countries in Asia and elsewhere has made it harder for late-developing countries to get moving, by making them appear even more unattractive to potential investors or trading partners – especially those countries that are landlocked or otherwise geographically disadvantaged.[32] This is a serious argument. Nevertheless, almost all such countries can grow faster than they have in the past by reducing or eliminating self-imposed barriers to growth.

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 has contributed significantly to broad-based economic reform programs, both at the level of overall policy and at the sector level. In many of the same countries, USAID has been effective in helping create functioning markets for agricultural inputs and products. In Eastern Europe and the former Soviet Union, USAID helped create critical market-supporting institutions irrespective of sector, including systems of commercial law, trade regimes, banking, stock markets, and competent tax collection. Current or recent successes suggest that the approach matters more than the choice of sector. For example:

- 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*, a USAID-financed project has helped Vietnam put in place dozens of new laws to help the country conform to international practice, increase transparency in the legal sector and the enforcement of court decisions, and protect intellectual property -- facilitating Vietnam's accession to the World Trade Organization. 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 governments 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 one; 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 USAID's capacity 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, often with disappointing results. USAID support to local business associations, think-tanks, and other civil society groups that advocate for policy reform has often yielded high pay-offs.[33] 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 and opportunities. 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 the Dominican Republic-Central American Free Trade Agreement, are just two of many examples.

Fifth, most funding from multilateral agencies is in the form of loans. Even highly concessional loans typically require ratification by the legislature, whereas grants can be implemented by the executive branch. The process of legislative approval can stretch the gap between initial project agreement 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.

Finally, among U.S. Government agencies that provide assistance to developing countries, USAID is the only one with the **mandate and capacity to address the full range of issues** – from macroeconomic policy and microeconomic issues to democratic governance, health, and education – that ultimately affect a country's growth.

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

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 donor 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, the International Monetary Fund, and the regional development banks 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 local institutional capacity.

The Millennium Challenge Account (MCA), administered by the Millennium Challenge Corporation (MCC), supports economic growth in selected low-income countries that have better-than-average policies, at least as compared with other low-income countries.[34,35] To remain eligible, countries must maintain their standing as good policy performers. A significant number of countries have slipped in relative terms, and have been cautioned that they risk losing eligibility as a result.

USAID has a critical role to play in helping countries cross the threshold of MCA eligibility – and keep improving beyond that threshold. This task includes helping countries design and implement market-oriented policies and strengthen institutional capacity in order to improve economic governance, reduce corruption, and foster broad-based, private sector-led growth.

The need for USAID support does not necessarily diminish when countries become eligible for MCA assistance, or even when they sign compacts. Although policies in MCA-recipient countries compare favorably with those in other poor countries, they remain much weaker than needed for MCA recipients to achieve and sustain growth, join the middle-income tier, and emerge from further dependence on aid. In all such countries, ongoing improvements in policies and institutions – the drivers of economic growth – remain essential for achieving growth that is rapid, sustained, and broad-based. In contrast, most MCA compacts have focused on a relatively narrow range of investment needs, primarily in infrastructure and rural development. Continuing USAID support for a broader range of policy reforms and institutional capacity building is needed to complement and reinforce MCC investments, and, in fact, may be critical to their ultimate success. Finally, unlike MCC, USAID can provide support for regional integration, which can be essential for countries to realize the market opportunities created through MCC compacts.

MCC enthusiastically supports these complementary USAID efforts. Both agencies consult closely – both in Washington and in the field – to ensure that their efforts are mutually reinforcing and not redundant.

7. USAID Will Promote Rapid, Sustained, and Broad-Based 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 growth, giving producers both the incentive and the means to keep adapting and improving. In the many low and middle-income countries where natural resources play a large role in the economy, sustained growth also requires appropriate prices, clear and consistently enforced property rights, and other incentives that encourage responsible resource use. Weak property rights discourage investment by creating uncertainly, while encouraging unsustainable resource-stripping like deforestation. In the worst case, disputes over resource ownership can lead to violent conflict. Meanwhile, inappropriate prices lead to costly and often irreversible decisions, as when low water tariffs contribute to the depletion of aquifers and salinization of farmland. Inadequate environmental policies can lead to serious environmental and health impacts and stress to water, forests, energy, and other natural resource reserves. To reduce these impacts and achieve truly sustainable growth, it is essential to develop and enforce sound environmental policies and regulations, to create incentives for private and public enterprises to invest in environmentally sound production technologies, and for households to adopt more environmentally friendly consumption practices.

"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

To help partner countries achieve rapid, sustained and broad-based growth, USAID will:

- Develop well-functioning markets, working with the drivers and enablers underlying growth, to create the conditions for sustained growth in productivity, output, and incomes;
- 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. Measures that strengthen the overall performance of markets, for example, also tend to enhance poor households' access to economic opportunities. 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. Widespread improvement in macroeconomic policies and the capacity to implement them means that microeconomic distortions to the business climate have emerged as the binding constraints to growth in many countries. Nevertheless, certain aspects of macroeconomic assistance will remain important in many situations, including:

- **Fiscal policy and administrative reform,** to help countries adopt tax systems that are fairer, easier to implement, less vulnerable to corruption, and less distorting to economic activity, and to help them develop the administrative capacity to implement tax policy transparently and accountably.
- **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 many areas of strong comparative advantage, allowing it to become a leading supporter of such reforms in the developing world.[36] In many cases, success has involved working with business associations to identify the most burdensome regulations and lobby for their simplification or removal. Another approach involves working with both governments and private stakeholders to reform laws and strengthen the institutions that carry out functions of economic governance essential for the efficient operation of markets. Important areas include:

- **Reforming regulatory systems** to reduce barriers to entry, foster competition, and remove obstacles to enterprise growth. In general, greater reliance on market forces and less on administrative discretion promotes faster productivity growth and reduces the scope for corruption;[37,38]
- **Strengthening systems to establish and enforce property rights** to reduce investment risks; and
- **Developing systems of commercial law** and the public and private institutions needed to implement them effectively, transparently, and accountably, including judicial and alternative systems of dispute resolution and enforcement.

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

- **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 countries where agriculture accounts for a large share of national income, increased agricultural productivity can play an important role in boosting productivity and income overall. 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. Opportunities for promoting agricultural development are covered in much greater detail in USAID's 2004 *Agriculture Strategy: Linking Producers to Markets.*[39]

- **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 USAID has worked successfully, and will continue to work in many countries to improve policies in energy, telecommunications, water, transport, and housing in ways that leverage the economic impact of infrastructure investments by others. Power grids and other networked infrastructure often represent "natural monopolies." As such, they require government oversight and competent, transparent, and accountable regulatory institutions to maintain an enabling environment that ensures good performance, rational prices, and environmental protection, while encouraging much-needed private investment.
- **Trade capacity-building**, which complements and integrates many other categories, and which assists countries to participate in the global trading system. 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. Opportunities in trade capacity-building are the focus of a complementary USAID strategy, issued in 2003.[40]
- **Financial sector reform and capacity-building** to encourage the growth of competitive financial systems while strengthening transparency and supervision to enhance the stability of financial markets. Financial sector performance strongly affects productivity growth: where spurred by competition, banks and other financial firms must search for the most productive investments to finance, rather than simply relying on business from established clients.[41] By doing so, they enable entrepreneurs to invest in new technologies and expand rapidly in response to new market opportunities. Priority should be given to systemic reforms and capacity building to help mobilize savings and channel domestic and international private capital to support productivity growth, rather than financing development directly.[42]
- **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.
- **Workforce development** to ensure that young people and adults can gain the vocational skills they need to find jobs and remain productively employed in a changing economy. The private sector holds a strong comparative advantage in delivering the job skills demanded by the market. Where appropriate policies are in place, private sources of training emerge to deliver job skills, either on-the-job or through stand-alone training providers. As a result, priorities include lifting burdensome regulations that discourage private sources of skills training, and limiting subsidized competition from government training facilities. USAID's 2005 Education Strategy briefly reviews priorities in workforce development.[43]

The potential for improvements in these different areas to contribute to faster and more sustained growth will differ considerably from one country and one region to another, as will the opportunities for achieving such improvements. Setting programmatic priorities among them is beyond the scope of this strategy. Rather, such priorities should be set on the basis of specific country circumstances, after

careful consideration by experienced economic growth experts with a clear understanding of those circumstances.

Enhancing access to productive opportunities

Faster growth is the basic source of new economic opportunities for the poor as well as the non-poor. Many of the microeconomic distortions that impede growth arise from policies adopted to advance the economic interests of elites relative to those of the politically less powerful. Correcting such distortions 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:

- **Inadequate 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.[44] Microfinance programs of USAID continue to address these problems, with a particular focus on women.
- **Poor 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 allow them to participate in the global economy. USAID encourages development of local private providers of these services.
- **Insecure land tenure and other property rights.** Lack of secure tenure to land is a particularly large threat to the poor, and especially for women who own less than 2% 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 and other property markets work for all.
- **Inflexible labor markets.** 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 nor legal protections. USAID encourages countries to reduce unnecessary barriers to job creation and labor mobility, helps improve workers' job skills and productivity, assists firms in understanding how good labor practices can contribute to productivity and competitiveness, encourages governments to adopt policies that respect internationally recognized core labor rights, and facilitate their design and implement flexible and effective labor protections and benefits programs.
- **Weak and inaccessible judicial systems.** In most developing countries, poor people lack access to an independent and 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.[45] 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 generally have the poorest access. For example, inadequate and poorly maintained roads raise the prices farmers pay for fertilizer and other inputs, while depressing the prices they receive for their marketed surpluses. 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.[46] 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 to the extent to which it causes them to reduce barriers to trade amongst themselves. Further reductions in trade barriers may also arise through regional and bilateral trade agreements and unilateral liberalization. But whatever avenue trade reform takes, it usually prompts developing countries to pursue complementary economic policy reforms, which 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. Access to information on international "best practice" via the internet helps poor countries understand and implement practices that can ease their engagement in the world of commerce.
- **Supporting U.S. policies conducive to growth in developing countries.** At times, U.S. policies are formulated with little recognition or consideration of their economic impact on developing countries. More active participation by USAID in interagency decision-making processes can help achieve greater balance among competing U.S. interests, ensure that development is duly considered as a priority of U.S. foreign policy, and thus contribute to the adoption of policies that better serve the broad, long-term interests of the United States.

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 potential allies in the government and private sector. Where change is slow, support to reform-oriented leaders – in both the public and private sectors – to press for change can help galvanize the needed internal political will. When the will to embrace economic reform emerges, the opportunity can be short. Rapid and flexible response is important.

External factors can galvanize political support for growth-enhancing reforms, creating opportunities that 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 international bodies like the European Community have also catalyzed reforms. Specific reforms required for MCA Compact status are generating momentum for change, on some of which USAID can capitalize through MCA Threshold programs.

9. Economic Growth in the Framework for U.S. Foreign Assistance

In 2006, USAID and its programs were placed under the newly created Director for U.S. Foreign Assistance (DFA), housed within the U.S. Department of State. Key goals of the DFA include creating a more unified and rational structure that will more fully align the foreign assistance efforts of the State Department 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 program objectives, which together constitute the Framework for U.S. Foreign Assistance. Economic Growth was adopted as one of these program objectives, alongside Peace and Security, Governing Justly and Democratically, Investing in People, and Humanitarian Assistance. Efforts in these five program objectives are intended to be complementary and mutually reinforcing. For example, country evidence suggests that political democracy can help strengthen economic governance, though the East Asian experience makes clear that democracy is not a precondition for growth, and the initial period of a democratic transition often yields slow or negative growth.[47] Similarly, improved health contributes to faster growth through its impact on educational attainment, savings rates, and worker productivity.[48] Together, these efforts contribute toward the overall goal of U.S. foreign assistance in each country category.

Under the Framework, 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 appropriate in each. Readers should note that this Strategy focuses most strongly on the challenges of achieving faster and more sustained growth in Developing and Transforming countries – those with a reasonable degree of political stability. The distinctive problems arising within Rebuilding countries – particularly those emerging from conflict – are addressed in detail in a separate document, which complements this Strategy.[49]

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 into Sustaining Partnership countries.

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, both generally and for growth in key sectors. Going beyond these general principles to identify specific priorities requires a deep understanding of the specific circumstances of each country, 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 United States 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 to Sustaining Partnership status.

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 with 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 United States seeks to support the government of a country in conflict, the key economic intervention is generally budgetary support to allow the embattled government to manage without resorting to inflationary finance. Countries rebuilding after conflict often 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, in most cases, can only be addressed gradually. As a result, careful attention to sequencing, along with a strong emphasis on simple, basic reforms, is important to ensure that existing capacities are used as effectively as possible. This will help ensure that the opening for reform is not wasted, and that the legitimacy of the new government is enhanced in the eyes of the public. 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 work offers useful principles for sequencing efforts to improve economic governance in such settings.[50] One basic principle is to initiate 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 macro-economic 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 of 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 shift toward improvements in other areas, beginning with the basics and postponing more sophisticated activities 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 supporting 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, especially programs focused on key social and political constituencies, such as social programs for the most vulnerable population groups and efforts to give veterans and decommissioned soldiers a stake in the new society.[51] In the Foreign Assistance Framework, some of these programs are included within the Economic Growth program 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 high 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 greater freedom, improved governance, and stronger 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. foreign aid budget of $15 billion was programmed for economic growth in a flexible and unconstrained manner.[52] 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 – a residual that has shrunk precipitously since the early 1990s.[53] But if economic growth is indeed essential to enable poor countries to address all other development goals and to emerge from further dependence on foreign aid, funding for economic growth programs should be a clear and visible priority.

The distribution of economic growth funding among countries also matters. Until recently, some 80% of total economic growth funds under USAID management were concentrated in strategic programs financed from the Economic Support Fund (ESF) account and in programs in Eastern Europe and the Former Soviet Union. Economic growth initiatives in countries funded under the Development Assistance (DA) 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. These differences in funding for economic growth programs in countries funded from different budget accounts should be revisited to ensure that broader U.S. interests are being met. Finally, 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 genuine opportunities arise can significantly increase impact.

With respect to staffing, the last time USAID gave central importance to promoting economic growth in poor countries was in the early 1980s. At that time, USAID attracted a substantial number of experienced, mid-career economists and private-sector officers. The latter brought an understanding of how 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. However, the overall strength of USAID's cadre of economists and private-sector development officers declined sharply in the 1990s, as emphasis shifted to other priorities and as USAID missions were downsized. The Reduction in Force in the mid-1990s particularly depleted USAID's economic staff.

Four staffing issues require attention to sustain and improve program quality:

- First, USAID needs on-the-ground, direct-hire experts 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, skill requirements in Rebuilding countries will be especially broad, including the capacity to make and implement macroeconomic policy. To be effective in these situations, USAID must retain a similarly broad range of expertise in economic growth.
- Third, although 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 "tradecraft" of promoting economic growth, and to 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 assert the economic growth perspective effectively. To maximize its effectiveness both in the field and in interagency policy fora in Washington, USAID must work to rebuild its cadre of senior economic growth professionals, seasoned through experience with both policy and program issues in the field. In all cases, human resource quality will be at least as important as quantity.

11. In Conclusion

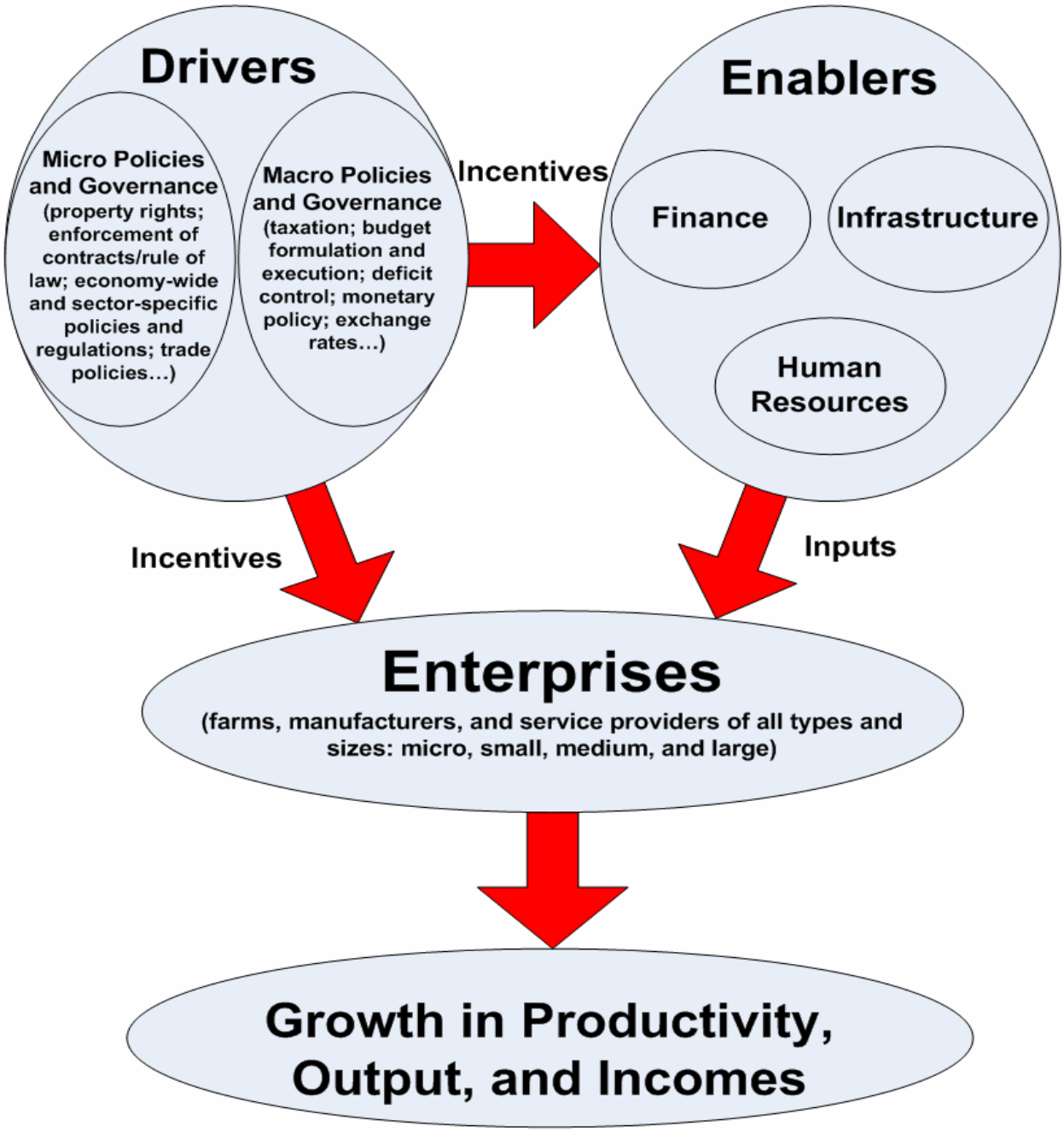
This strategy has highlighted the profound and wide-ranging benefits – to the U.S. and to the world - of achieving more rapid, more sustained, and more broadly based economic growth in poor countries.

Burdensome and corruption-prone systems of regulation, weak property rights, and other microeconomic manifestations of poor economic governance are emerging as the binding constraints to growth in a wide range of countries. USAID is well-positioned to respond. Its 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 field offices – especially those in countries funded out of the Development Assistance account – 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 Framework for U.S. Foreign Assistance 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. This Strategy establishes the basis for setting priorities within the Framework so that USAID's economic growth programs will have the greatest impact. Through increased support for systemic and catalytic change in the economies of partner countries, and with adequate funding and technical staff, USAID can multiply the results of its work and help much larger numbers of people in partner countries secure a better future. In an interdependent world, a better future for the people of developing countries means a more secure future for us all.

Figure 1: Framework for Economic Growth



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[2] Condoleezza Rice, Secretary of State, Testimony Before the Senate Foreign Relations Committee, Washington, DC, February 15, 2006, http://www.state.gov/secretary/rm/2006/61209.htm
[3] Maddison (2001).
[4] In a market system, income and output are closely related, both conceptually and as measured statistically. This strategy uses these terms interchangeably.
[5] According to the most painstaking estimates, differences in productivity growth account for 90% of the differences among countries in the growth rate of output per worker. Klenow and Rodriguez-Clare (1997).
[6] Mandelbaum (2007).
[7] Friedman (2005), Collier (2007).
[8] Fraser Institute (2005).
[9] 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%.
[10] For the global incidence of extreme poverty in 1950, see Bourguignon and Morrison (2002). The estimate for 2004 is from Chen and Ravallion (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.
[11] USAID (2002), *Foreign Aid in the National Interest.*
[12] Based on data from International Monetary Fund (2007). See also Crosswell (2007).
[13] Harberger (2005).
[14] To avoid ambiguity, this strategy uses the word "institutions" as a synonym for "organizations," rather than in the much broader sense of "formal and informal rules, enforcement mechanisms, and organizations" associated with the New Institutional Economics and World Bank (2002).
[15] Easterly and Levine (2001); Pack and Paxson (1999); Devarajan, Easterly, and Pack (2003); Bils and Klenow (2000); Pritchett (2006).
[16] Radelet (2004).
[17] World Bank (2007).
[18] Barro (2000).
[19] A large and growing body of literature provides insights into the important links between democracy and economic growth. Examples include Rivera-Batiz (2002); Shen (2002); Halperin, Siegle, and Weinstein (2004); Barro (2000); Rodrik and Wacziarg (2005); Collier, Hoeffler, and Söderbom (2006); Gehlbach and Keefer (2007); and Keefer and Teksoz (2007).
[20] Rodrik (2004).
[21] Hausmann, Rodrik, and Velasco (2005).
[22] 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 strategy 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.
[23] Address to Economic Freedom of the World Network, 2006; cited with permission.
[24] Research conducted in connection with the *Doing Business* series demonstrates a strong link between the severity of business regulation and the size of the informal sector. World Bank (2004a).
[25] World Bank (2004a).
[26] Loayza, Oviedo, and Servén (2005).
[27] Dollar and Kraay (2002). Moreover, Kraay (2004) shows that for periods averaging around 10 years, differences in country growth rates account for fully 90% of cross-country differences in the rate of poverty reduction.

[28] Lopez (2006) suggests that a new pattern may have emerged in the 1990s, with inequality increasing in countries that achieve especially rapid growth. See also World Bank (2004b). 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."

[29] World Bank (2004b).

[30] Lucas and Timmer (2005).

[31] USAID and Woodrow Wilson Center for International Scholars (2006).

[32] Collier (2007).

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

[34] To be more precise, eligibility for MCA is based on policy performance as reflected in seventeen indicators in three major areas – "ruling justly," "promoting economic freedom," and "investing in people." MCA eligibility requires that a country score above the median on at least three of the six ruling justly indicators, three of the five investing in people indicators, and three of the six economic freedom indicators. In addition, it must score above the median on the indicator for controlling corruption.

[35] Once declared eligible for MCA, countries negotiate with MCC to formulate and agree upon a compact – typically a sharply focused, five-year program with total funding of $65 to $700 million. By October 2007, compacts had been reached with sixteen countries, while another ten eligible countries had made varying degrees of progress toward a compact.

[36] 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 Colombia, 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.

[37] Exceptions to the presumption in favor of allowing market forces to reign freely are well-recognized, including cases of natural monopoly and monopoly power exercised by a dominant firm; problems of asymmetric information, especially prevalent in financial markets; and externalities such as pollution. Such exceptions often call for a public policy response, though in many cases the underlying public purpose can be achieved more effectively, and with less danger of corruption, by means other than creating a regulatory body with wide powers of discretion.

[38] USAID's broader approach to fighting corruption is described in USAID's *Anticorruption Strategy* (2005a).

[39] USAID (2004), *Agriculture Strategy: Linking Producers to Markets*.

[40] USAID (2003), *Strategy: Building Trade Capacity in the Developing World*.

[41] Beck, Levine, and Loayza (2000); Caprio and Honohan (2001).

[42] Direct financing often crowds out potential local investment and 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. There is often adequate liquidity in developing country financial institutions, but it is not put to work supporting local economic growth.

[43] USAID (2005b), *Education Strategy: Improving Lives through Learning*.

[44] 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.

[45] De Soto (1989).

[46] McClelland (1996). The international research centers are organized under the Consultative Group for International Agricultural Research.

[47] As documented at length in note 17 and the analyses cited there, there is considerable diversity in interpreting the evidence on this point.

[48] Bloom, Canning, and Jamison (2004).

[49] USAID (2007), "A Guide to Economic Growth in Post-Conflict Countries." draft.

[50] Lewarne and Snelbecker (2004).
[51] Lewarne and Snelbecker, previously cited.
[52] Fox and Timmer (2005).
[53] Crosswell (2000) finds that among the four major users of development resources – the Africa, Asia/Near East, Latin America/Caribbean, and Global Bureaus – overall development funding in constant dollars dropped between 26% and 42% from 1992 to 1999, but economic growth funding fell much further, between 65% and 79%. Thus, the share of EG resources in the development programs of these four bureaus dropped precipitously, from 43% in 1992 to just under 20% in 1999. Within EG, agriculture funding fell somewhat less than for other EG programs.

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