DRAFT FOR PUBLIC COMMENT

USAID
FROM THE AMERICAN PEOPLE

ECONOMIC GROWTH POLICY

Contents

Executive Summary

In 2008, the United States Agency for International Development (USAID) produced *Securing the Future: A Strategy for Economic Growth*,[1] which has successfully guided the Agency's thinking on issues related to growth for more than a decade. This policy paper builds on the findings and recommendations of that earlier document. It begins with a review of recent insights on economic development and then identifies priorities, approaches, and principles for USAID programming to help partner countries accelerate inclusive, sustained, and resilient economic growth.

Economic growth is the key factor in human development. It is necessary for sustained poverty alleviation, job creation, improved living standards, and better access to education and health resources. Growth in developing countries and emerging markets economically and politically benefits the United States. Central to reducing dependency, income per capita is one of the most important indicators associated with reductions in foreign assistance. All technical sectors where USAID works, including humanitarian assistance, depend on market development, which both spurs and depends on economic growth. USAID has played a major role in supporting the recent gains in reducing poverty and improving food security, but much more needs to be done, especially given emerging trends such as digitally enhanced trade, migration, and climate shocks.

The factors of production (natural resources, labor, and capital) are the building blocks of an economy, but they require public and private investment to turn them into human capital and technology. Enterprises—the basic units of production—require well-functioning markets and sound policies that together provide public goods, incentives, and competition to enable continued investments. Sustained private investment leads to increased productivity, and firm-level productivity is the driver of economic growth. Active policies for inclusion and sound environmental management are also necessary for sustainability and resilience.

Constraints to growth are unique in each country and have deep roots in geography and history that influence culture, which shapes local institutions in turn. Market systems analysis, growth diagnostics, political economy analysis, and other tools help USAID better understand these constraints and the opportunities to address them. USAID will accelerate the development process by identifying and addressing the two major types of constraints to growth—market failures and governance failures. Given this Agency's experience and comparative advantage in addressing these constraints through our host-country relationships and private-sector engagement, we demonstrate our strength as a partner.

To help developing countries achieve inclusive, sustained, and resilient growth, USAID will strengthen its partnerships with international and local public, private, and non-governmental organizations and focus its work in three areas: (1) supporting the development of well-functioning markets by first identifying and then helping correct market failures to increase firm-level productivity; (2) strengthening policies, institutions, and public goods by first identifying and then helping correct governance failures to improve incentives and competition; and (3) improving access to productive opportunities for low-income people and disadvantaged groups,

[1] USAID, *Securing the Future: A Strategy for Economic Growth*.

including women, youth, and ethnic minorities, to improve the inclusivity, sustainability, and resilience of growth.

To enhance the efficiency and effectiveness of its programs, USAID will (1) support the development of markets that are commercially sustainable and institutions that are self-financing, so countries can move toward the goal of no longer requiring development assistance; (2) demand systemic or catalytic impact from its programs and ensure its work has impact at the firm level; and (3) provide evidence of “additionality,” meaning partners should be able to demonstrate that they cannot solve problems on their own, and provide evidence of cost-effectiveness so we can better evaluate our assistance and ensure value from U.S. taxpayer resources.

Section I: Economic Growth Transforms Societies and Benefits the United States

USAID promotes economic growth in developing countries in accordance with the 2017 National Security Strategy of the United States, which states:

> We can play a catalytic role in promoting private-sector-led economic growth, helping aspiring partners become future trading and security partners. … We encourage those who want to join our community of like-minded democratic states and improve the condition of their peoples. By modernizing U.S. instruments of diplomacy and development, we will catalyze conditions to help them achieve that goal. These aspiring partners include states that are fragile, recovering from conflict, and seeking a path forward to sustainable security and economic growth. Stable, prosperous, and friendly states enhance American security and boost U.S. economic opportunities.[2]

USAID believes the purpose of foreign aid is to create the conditions that will end the need for its existence.[3] Growth in per capita income is central to reducing foreign assistance. As a country's per capita income rises, development assistance declines and is gradually replaced by private and domestic resources as tax and financial systems grow and mature, thus building countries' self-reliance.[4]

This policy therefore advances USAID's and the broader U.S. Government's commitment to promoting inclusive, sustained, and resilient economic growth in developing countries. The purpose is to offer a concise summary of recent ideas and trends in development economics, link to and integrate with other USAID policies and guidance, offer a model for approaching and addressing economic growth programming, summarize best practices in selected sectors, and commit to several principles for the impact of our programming.

A. Economic Growth Drives Poverty Reduction and Is Essential for Human Development

The impact of small differences in economic growth rates is magnified over long periods due to compounding. For example, a country with per capita income growth of just over 7 percent (which several developing countries have achieved) can double average per capita income in 10 years and increase it by nearly sevenfold in 15 years. Periods of inclusive *growth accelerations*[5] result in massive development gains. Most examples of rapid and sustained economic growth have succeeded in greatly reducing poverty rates and have resulted in other major gains in

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[2] United States, *National Security Strategy*, 4, 37–38.

[3] USAID, *USAID Policy Framework: Ending the Need for Foreign Assistance*, 16.

[4] For low-income countries transitioning to lower-middle-income countries, Official Development Assistance as a share of total external financial flows falls by 25 percentage points, on average. Lower-middle-income countries transitioning to upper-middle-income countries, the average share of Official Development Assistance drops from 65 percent to 35 percent of total external flows (see Piemonte et al., *Transition Finance*).

[5] Growth accelerations, as defined by Hausmann, Pritchett, and Rodrik (2004) are periods where real GDP growth is greater than 3.5 percent per year and the increase in the rate of growth is 2 percentage points or greater over the previous trend, sustained for a period of at least eight years.

human development and well-being.[6] There is also increasing evidence that higher per capita incomes, made possible by economic growth, significantly improve personal happiness and life satisfaction.[7]

Although economic growth is most often associated with reductions in poverty, the distribution of income resulting from economic growth matters. If growth is not inclusive, sustainability and resilience will be greatly reduced. Inequality between regions and ethnic groups feeds grievances and could lead to instability and violence, lowering economic growth.[8] Political institutions that do not limit the power of politicians, reward social status rather than talent, and are marked by widespread corruption reduce inclusiveness and result in significantly higher *growth volatility*, which can quickly erase previous short-run gains and increase poverty.[9] Recent research by the International Monetary Fund has found that "increased inequality can erode social cohesion, lead to political polarization, and ultimately lower economic growth."[10]

Because the benefits of growth are concentrated geographically in many countries, national averages are not sufficient indicators of regional and local differences. Economic growth also requires responsible stewardship of a country's natural resources to be sustainable and resilient; natural resources such as land, water, fish, and forests often provide the basis for growth. Countries rich in natural resources might use them to boost growth, but resources can similarly be squandered and stoke conflict and corruption.[11] Environmentally sustainable growth is also important to mitigate climate shocks that can lead to internal conflict and high migration rates.[12]

USAID recognizes that the benefits of economic growth go beyond the ability to consume more material goods. The United Nations Development Programme developed a Human Development Index "to emphasize that people and their capabilities should be the ultimate criteria for assessing the development of a country, not economic growth alone."[13] In addition to measures of the standard of living in countries, the index also includes measures related to health, education, political voice, environment, and individual freedom.[14]

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[6] For example, growth accelerations in India in 1993 and 2002 increased per capita income by $3,364, compared to "business as usual" growth rates,(1) halving the official poverty rate from 45 percent of the population in 1994 to 22 percent by 2012.(2) The growth acceleration in Indonesia from 1967 to 1996 increased per capita income by $9,712(3), while poverty fell from more than 70 percent in the mid-1960s to 11 percent in 1996.(4) The growth acceleration that began in 1989 in Vietnam increased per capita income by $6,914(5), while the national poverty rate dropped to less than 10 percent for the first time in 2016, from more than 20 percent in 2010.(6) A more recent growth acceleration beginning in 2007 in Ethiopia reduced extreme poverty by 20 percent from 2011 to 2016.(7)

[7] Lindqvist, Östling, and Cesarini, *Long-Run Effects of Lottery Wealth on Psychological Well-Being*; Sacks, Stevenson, and Wolfers, "The New Stylized Facts about Income and Subjective Well-Being."

[8] Bahgat et al., *Inequality and Armed Conflict: Evidence and Data.*

[9] Acemoglu et al., "Institutional causes, macroeconomic symptoms."

[10] IMF, "IMF's Work on Inequality."

[11] Bannon and Collier (eds.), *Natural Resources and Violent Conflict: Options and Actions.*

[12] Burke, Hsiang, and Miguel, *Climate and Conflict*; Null and Risi, *Navigating Complexity*.

[13] United Nations' Development Programme, "Human Development Index."

[14] Permanyer and Smits, "The Subnational Human Development Index."

All development is human development, which is multidimensional and geographically specific. USAID emphasizes that only inclusive economic growth can provide the means for countries to generate the public and private resources they need to effectively and sustainably address human development challenges on their own.

B. Economic Growth in Developing Countries Is Critical for National Security and Is in Our Shared Interest

Investments in global development progress are vital to national security interests. Low-income countries that fail to grow can pose serious problems for the United States and the world. They are more likely to experience political crises, including failed-state status, violent conflicts, and civil wars.[15] Armed conflicts directly affect the security interests of the United States and our allies by creating instability that terrorist and criminal organizations exploit.[16] As a result, these countries often receive large amounts of U.S. foreign assistance and security assistance on a continuing basis because they are not self-reliant.

USAID's economic growth programming is in the shared national interest because it benefits the U.S. economy and American workers.[17] By supporting economic growth in developing countries, USAID helps create better, stronger, and more resilient markets for U.S. exports. Most of the goods and services the United States exports are income-elastic, meaning that as countries get richer, they buy more U.S. goods. Over the 2007–2017 period, almost two-thirds of the growth in U.S. goods exports was to countries whose governments have been major USAID partners.[18]

USAID programs also help American companies by building reliable and sustainable supply chains for commodities imported from developing countries. As countries develop, they become more attractive for private U.S. investors and better integrate into global supply chains that include major U.S. companies. For example, USAID assistance has helped small-scale coffee producers in Africa, Asia, and Latin America increase the quantity and quality of production, improve marketing, and reduce susceptibility to coffee rust disease. The U.S. specialty coffee processing, wholesale, and retail beverage industry has benefited greatly from USAID's support to developing countries; this industry was valued at more than $44 billion in 2017.[19]

C. Much Has Been Accomplished and Much Remains to Be Done

Global poverty rates have fallen sharply over the last several decades and this has been driven by economic growth in emerging and developing countries. According to the World Bank, the number of people in extreme poverty has fallen from nearly 1.9 billion in 1990 to about 650

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[15] See, for example, Collier and Hoeffler 1998, "Higher per capita income reduces the duration of civil war and the probability of its occurrence. These effects are very powerful." Also Fearon and Laitin 2003; and Hegre and Sambanis 2006.

[16] U.S. Department of State, USAID, and U.S. Department of Defense, *A Framework for Maximizing the Effectiveness of U.S. Government Efforts to Stabilize Conflict-Affected Areas*.

[17] USAID, *Shared Interest: How USAID Enhances U.S. Economic Growth*.

[18] USAID, *Shared Interest: How USAID Enhances U.S. Economic Growth*.

[19] Ward, "U.S. Coffee Market Overview 2017."

million in 2018. This was possible as economic growth reached more and more parts of the world. Global average life expectancy increased by 5.5 years between 2000 and 2016, the fastest increase since the 1960s. Emerging and developing countries also experienced a 42 percent reduction in the prevalence of undernourished people between 1990–92 and 2012–14.[20] These major health and nutrition gains are largely the result of economic growth and development that were inclusive and broad-based.[21] Better health and nutrition further boosts growth by increasing the productivity of the workforce.[22]

USAID's work to reduce poverty and hunger and improve health and education has contributed to these achievements. While much has been accomplished, the number of people living in extreme poverty is expected to rise in Sub-Saharan Africa between 2015 and 2030[23], and global hunger began to rise again starting in 2015, returning to levels from a decade prior.[24] Achieving the Sustainable Development Goals by 2030, to which the U.S. Government has committed, will be very challenging. The global landscape continues to change, and development assistance will need to respond to emerging "megatrends" in order to build on previous gains and prevent further backsliding. Economic growth must remain central to USAID's development strategy.

Box: "Megatrends" in Economic Development

Some clear megatrends in economic development have emerged. First, global inequality fell for the first time since the industrial revolution as the income gap between rich and poor countries narrowed.[25] However, these gains began only in the late 2000s and some of the higher growth rates are likely not sustainable.[26] The external debt of developing countries also continued to climb through the 2010s.[27] USAID can continue to learn from the recent experiences of higher-growth countries and strengthen these enabling conditions elsewhere.

Second, 60 percent of the world's poor will be concentrated in fragile states by 2030.[28] This shift necessitates a rethinking of how to confront the special challenges of these environments. In 2018 , USAID, the Department of State, and the Department of Defense completed a Stabilization Assistance Review [29] to streamline interagency coordination efforts in conflict-

[20] FAO, IFAD, UNICEF, WFP, and WHO, *The State of Food Security and Nutrition in the World 2018*.
[21] Deaton, *The Great Escape: Health, Wealth, and the Origins of Inequality*.
[22] Weil, "Health and Economic Growth."
[23] Wadhwa, "The Number of Extremely Poor People Continues to Rise in Sub-Saharan Africa."
[24] FAO et al., *The State of Food Security and Nutrition in the World 2018.*
[25] World Bank, "Yes, Global Inequality Has Fallen. No, We Shouldn't Be Complacent"; Roy, Kessler, and Subramanian, *Glimpsing the End of Economic History?*
[26] Johnson and Papageorgiou, "What Remains of Cross-Country Convergence?"
[27] World Bank, "Debt Stocks of Developing Countries Rose to $7.8 Trillion in 2018."
[28] D'Alelio, "US Aid to Fragile States: Where Does the Money Go?"
[29] U.S. Department of State, USAID, and U.S. Department of Defense, *A Framework for Maximizing the Effectiveness of U.S. Government Efforts to Stabilize Conflict-Affected Areas*.

affected areas. USAID offers a number of resources related to working in crisis and conflict[30] and is building its capacity for conflict prevention and stabilization.[31]

Third, whereas models of economic growth previously focused on exports of finished goods, production today is increasingly dispersed across integrated global value chains. As a result, intermediate (unfinished) goods now account for about half of global trade in goods.[32] Yet to succeed, global value chain inputs and products need to reach their destination "just in time," presenting new challenges and requiring developing countries to implement deeper reforms that USAID can support.

Fourth, digital platforms such as mobile applications, cloud computing, blockchains,[33] and online payment platforms are expanding market access and enabling small businesses to compete against larger, more established firms. However, governments lacking a policy commitment to a market-driven digital economy that is open, secure, and interoperable may create a digital divide that can actually harm growth. USAID co-drafted the Principles for Digital Development,[34] and the Agency's Digital Strategy[35] will continue to empower end users of digitally enabled services.

Fifth is growing internal migration from rural to urban and peri-urban areas in search of economic opportunity, together with external migration from nations suffering from poverty, violence, and climate shocks. Economic growth and a renewed USAID focus on urbanization, youth employment, and continued efforts to understand what works in reducing community violence and improving disaster risk response are needed to reduce desperation based migration.[36]

The final megatrend to discuss here is the increased demand for scarce natural resources and environmental effects from increased growth and production in the developing world. Examples include the world food price crisis of 2007 and 2008, new environmental threats, and the increased investments in adaptation and resilience required to respond to climate shocks. USAID can support partner governments in sustainable natural resource management, together with adaptation to and readiness for climate and price shocks through environmental safeguards and resilience programming.

Section II: What Drives and Enables Economic Growth?

Economic growth occurs when there are either increases in the quantity of various factors of production (natural resources, labor, and capital) or changes in the quality of those inputs; for

30 USAID, "Working in Crises and Conflict."

31 USAID, "The Bureau for Conflict Prevention and Stabilization (CPS)."

32 United Nations, *Key Statistics and Trends in International Trade*.

33 Nelson, *Primer on Blockchains.*

34 *Principles for Digital Development*, https://digitalprinciples.org.

35 USAID, *Digital Strategy* (forthcoming).

36 USAID, "Urbanization: Meeting the Challenges & Opportunities of an Urban Future"; USAID, "Youth Impact"; Abt and Winship, *What Works in Reducing Community Violence*; and USAID Office of Foreign Disaster Assistance, "USAID/OFDA'S Approach to Disaster Risk Reduction."

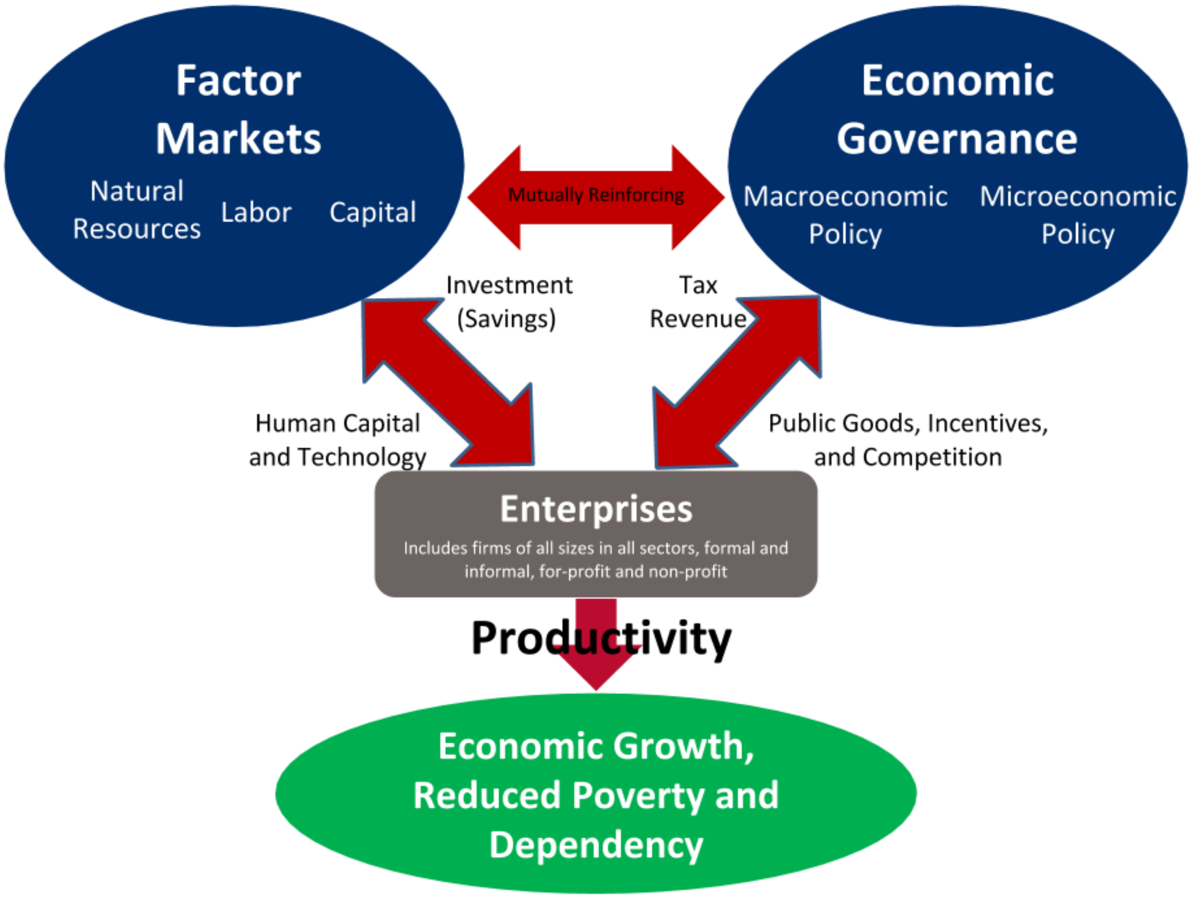
example, through better education and health of the workforce, leading to higher levels of human capital and improved access to and use of new technologies.

Improvement in the quality of the factors of production requires investment, which in turn requires savings. However, a one-time boost in savings rates or improvement in technology through investment increases growth only temporarily. Sustained economic growth requires continued private and public investment.

Enterprises are the basic units of the growth process. To sustain growth, firms need *efficient markets* in order to access labor, capital, inputs, and buyers at relevant prices needed for the production and distribution process. Firms must also face *incentives* that motivate them to make continuing investments, including the ability to make a return on their investment in the knowledge that their businesses are facilitated and protected by effective commercial law. *Competition* is necessary to discipline firms while limiting protections for larger, incumbent enterprises and making it easier for newer, smaller firms to enter the market, which is critical for inclusiveness. *Economic governance* is the framework of policies, laws, and regulations and how they are implemented to produce public goods and the enabling conditions for growth. Public investment in human capital, infrastructure, and technology plays a crucial role in economic governance.

When markets are efficient and enabling conditions are favorable, enterprises are increasingly able to access financing and make investments in human capital and technology that increase their productivity; *firm-level productivity drives economic growth*. Firms' increasing competitiveness generates higher incomes, which the public sector can then mobilize (for example, through taxes and fees) to improve the quality and quantity of public goods and strengthen economic governance. The growth process is therefore endogenous, meaning that each element depends on and mutually reinforces the other, ultimately leading to increased incomes, reduced poverty, and less dependence on foreign assistance. The process does not stop there, however; policies need to be implemented and active measures need to be taken to ensure growth is inclusive and environmentally sound in order for it to be sustainable and resilient.

Framework for Economic Growth



A. Productivity Is the Driver of Economic Growth

The large differences in per capita income across countries mostly reflect differences in labor productivity and use of technology within firms, which allow increases in wages and income that lead to reductions in poverty.[37] Productivity growth can occur within sectors of an economy or be driven by shifts to higher-value sectors that directly affect labor. *Structural transformation* occurs as an economy reduces its dependence on primary production in rural areas (agriculture, forestry, and fisheries) and shifts to manufacturing and service delivery in urban areas. *Employment transformation* refers to the changes in employment opportunities that follow structural transformation, involving a shift from self-employment or household employment into formal wage jobs that offer steadier employment, higher wages, and better access to public services.

[37] Consider that a typical low-skilled worker from a developing country would experience an earnings increase of between $10,000 and $20,000 a year, or an increase of more than 350 percent on average, by moving to the United States. This extraordinary difference is due, in large part, to the much higher levels of productivity in the United States and how much more efficiently U.S. firms combine and organize human capital and technology. (See Pritchett, "The Least You Can Do for Global Poverty Is Better than the Best You Can Do.")

Human capital refers to the knowledge, skills, attitudes, resources, and health that enable people to contribute productively to the economy. Human capital development requires governments to invest in education systems that enable all children and youth to acquire the skills they need to be productive members of society.[38] Higher education institutions should be central actors in development by conducting and applying research, delivering high-quality education, and engaging with communities.

Physical capital is a form of *technology*. In today's economy, mobile technology, computing, enhanced machinery, and Internet-based digital applications are the key drivers of productivity, and hence economic growth. Historically, disparities in access to new technologies drove growth differences between nations, whereas today the access gap has narrowed, but the intensity of use of modern applications has diverged and explains a large share of the development gap.[39, 40]

B. Good Governance Enables Growth

Firms are founded by entrepreneurs. *Entrepreneurship* is the process of introducing or expanding production, developing and implementing innovations in products, or finding better ways to organize production methods, obtain financing, and serve markets. Entrepreneurs exist in all societies, but their capacity and willingness to invest varies considerably with the enabling conditions that allow them to flourish.

Entrepreneurs and firms cannot succeed on their own; they require shared productive resources, or *public goods* (which the public sector typically provides) to make continuing investments. Public and private investments in infrastructure and social capital reduce transaction costs, production costs, and barriers to investment. The level and array of public goods in a country are determined by the government's macroeconomic and microeconomic policies[41] and how they are implemented.

There is little doubt that improvements in policy through best-practice reforms are strongly related to improvements in growth rates across countries.[42] Yet, while some countries have sound policies on paper, local institutions and practices determine their effectiveness and are

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38 USAID, *USAID Education Policy*.

39 Comin and Mestieri, "If Technology Has Arrived Everywhere, Why Has Income Diverged?"

40 Some observers worry that workers undertaking routine tasks are vulnerable to replacement by recent advances in technology that will result in large-scale economic disruptions through unemployment and social unrest. Yet, technology provides opportunities to create new jobs, increase productivity, and deliver public goods. Through innovation, technology generates new sectors and new tasks, and hence new jobs. (See World Bank, *World Development Report 2018*.)

41 *Macroeconomic* policies address monetary and fiscal management issues (taxing and spending) and should reduce business risks and uncertainty through the maintenance of price stability, support for trade and investment, provision of physical infrastructure, and helping meet shared social goals through effective and transparent budgeting. *Microeconomic* policies address economic efficiency through commercial laws and regulations and should maintain an enabling environment to invest, while helping achieve shared social goals. Together, macroeconomic and microeconomic policies and institutions create incentives for sustainable and inclusive economic growth by increasing producers', investors', and consumers' confidence and ensuring competition.

42 Easterly, *In Search of Reforms for Growth*.

shaped by the quality of governance. Similar laws and policies can result in different outcomes, depending on the manner and political context in which they are implemented. Local context should dictate how to apply economic principles, as understanding these specific circumstances can be as important as identifying best practices.[43]

Box: Democracy and Growth

Recent research demonstrates that democratization can increase economic growth significantly by improving governance. On average, countries switching to democratic rule witnessed 20 percent more gross domestic product (GDP) growth over a 25-year period than authoritarian states.[44] Democracies promote growth by encouraging economic reforms, reducing corruption and other business barriers, investing more in education and health, and providing better infrastructure and public services. Democracy also promotes inclusiveness, which promotes peace and reduces social conflicts that undermine economic growth.[45]

Better governance and a more favorable legal and regulatory environment can increase economic growth by improving the enabling conditions and investment prospects for firms. At the same time, economic growth can help drive the reform process by mobilizing domestic resources for further public sector investments in development. As countries get richer, their economies become more complex and effective government institutions tend to become more needed. Economic growth can also influence the quality of policy by empowering individuals and firms to demand more effective and accountable government.

Section III: How the Growth Process Can Get Stuck, and USAID's Role

USAID partner countries face unique challenges to growth that include recent external wars or internal conflicts, high vulnerability to climate shocks, organized crime, corruption, the prevalence of acute and chronic diseases, and high illiteracy. The sources of these constraints typically have deep roots in history, geography, natural resource endowments, and climate that together affect culture, which shapes norms and institutions in turn. Yet, there is no predestination; other countries have faced and overcome similar challenges. There are no insurmountable obstacles to growth when the necessary incentives are in place. Economic growth is always possible, but can be hindered by market and governance failures.

Market failures occur when the potential returns to investment are high but cannot be captured by entrepreneurs and firms due to high risks, high transactions costs, or missing complementary

[43] For example, global indexes that rank country performance and combine various measures of policy and institutional quality can be informative, but it is important to remember that a country's low ranking on a specific indicator does not necessarily mean that indicator is a relevant (or "binding") constraint to growth. Often, low rankings on these indexes are simply a symptom, rather than a cause, of underdevelopment, and comparing performance on specific indicators between countries might not make sense.

[44] Acemoglu, Naidu, Restrepo, and Robinson, *Democracy Does Cause Growth.*

[45] Reiter, "Is Democracy a Cause of Peace?"

investments.[46] *Governance failures* occur when opportunities for private sector investment are not realized due to an unfavorable policy and regulatory environment, when policies distort markets, when there is inadequate public investment in infrastructure and human capital, or when there is a political environment marked by corruption and rent-seeking.[47]

Before funding interventions, USAID should first identify the specific market and government failures that need to be corrected to address the constraints the private sector is facing. Unless USAID efforts focus on correcting specific failures, foreign assistance can distort markets and increase partner governments' dependency.[48]

USAID has roadmaps,[49] diagnostic tools,[50] and other approaches to assess the market and governance failures in the countries where we work. To identify market failures, we must first understand the market structure in specific sectors and the relationship to broader *market systems*,[51] or how inputs and intermediate and final goods and services link to the larger economy, and how interventions modify the incentives and behavior of businesses and other market players. USAID can then focus on market-based solutions to the identified constraints, starting with effective private sector engagement.[52] With these approaches, USAID will help develop markets that are commercially viable, sustainable, and scalable so they will no longer require foreign assistance or subsidies from partner governments.

Given the political nature of most governance failures, identifying and addressing them requires thinking and working politically.[53] *Lack of capacity* of local partners to implement reform is often a key constraint. Capacity constraints should be addressed with technical assistance and interventions that improve access to and use of technologies that reduce the cost of reform. However, *lack of political commitment* is often the binding constraint to reforms. Although building political will is challenging, identifying opportunities and champions within existing systems offers potential for positive change.

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[46] This is because larger-scale private investment requires many complementary inputs and trust between firms. As production becomes increasingly complex, if one factor and/or part of the value chain is missing or weak, then investments are not made (Kremer 1993, The "O-Ring Theory of Economic Development"). In some cases, domestic markets may be "thin" (underdeveloped) and there may be physical barriers to trade of products and services that limit the extent of the market.

[47] Some developing countries lack effective political competition or have designed incentives and expenditures to benefit political supporters, rather than the population as a whole. Often, governments underinvest in the education and health of the workforce, thereby missing an opportunity to create a virtuous cycle between physical and human capital and growth and poverty reduction. Poorly designed government policies and regulations make it difficult or too costly to start or invest in a business, dulling incentives. Weak public sector institutions make it difficult to reduce corruption and anticompetitive practices that benefit the few at the expense of competition.

[48] See, for example, Easterly, *The Elusive Quest for Growth*; Easterly, *TheWhite Man's Burden*; and Deaton, *The Great Escape*.

[49] USAID, "The Journey to Self-Reliance: Roadmaps."

[50] USAID, "Growth Diagnostics."

[51] Campbell, "A Framework for Inclusive Market System Development."

[52] USAID, *Private-Sector Engagement Policy*.

[53] Menocal et al., *Thinking and Working Politically through Applied Political Economy Analysis*.

Box: USAID's Comparative Advantages as a Partner in Advancing Economic Growth

- *Inclusive Approach and Capacity-Development Expertise:* USAID provides technical assistance through grants, rather than loans, and works with public and private sector partners to increase their capacity to finance their own development. This includes our ability to assist vulnerable populations to engage and integrate with the formal economy.

- *Partnerships with the U.S. Private Sector:* USAID partners with U.S. firms that have access to the best technology and business solutions in the world to support an enterprise-driven development approach.

- *Strong In-Country Presence:* USAID forms direct relationships with a broad set of local stakeholders to promote efficient, effective, and inclusive approaches to increasing economic growth and development.

- *Tapping into the Whole U.S. Government:* As the lead U.S. Government development agency, USAID accesses the technical expertise of other U.S. Government colleagues and is a key player in whole-of-government initiatives (such as Prosper Africa, Power Africa, and Feed the Future) that expand the impact of development assistance.

- *Adaptable Contracting Mechanisms:* USAID has adopted new activity design and contracting mechanisms to increase its ability to respond quickly to changing priorities and increase engagement with the private sector in the United States and developing countries.

USAID will share these advantages with our host-country stakeholders so they recognize the resources USAID brings to the table. Our comparative advantages demonstrate our values and help us form balanced partnerships with host-country governments, ultimately helping them achieve their development goals.

Section IV: Application of Best Practices for Inclusive, Sustained, and Resilient Growth

To help partner countries achieve inclusive, sustained, and resilient growth, USAID will:

- *Support the development of well-functioning markets* by identifying and helping correct market failures to increase firm-level productivity;

- *Strengthen policies, institutions, and public goods* by identifying and helping correct governance failures to improve incentives and competition; and

- *Enhance access to productive opportunities* for low-income people and disadvantaged groups, including women, youth, and ethnic minorities, to improve the inclusivity, sustainability, and resilience of growth.

When binding market and governance failures have been addressed, the private sector can lead the economic growth process and reduce poverty. USAID provides sector-specific support to help unleash this potential.

A. Developing Well-Functioning Markets

1. Increasing Agricultural Productivity and Food Security

In most countries, the development process begins with increases in agricultural productivity that expand food supplies for urbanizing populations and can provide foreign exchange for imports. Higher agricultural incomes boost the demand for non-farm goods and services and support the structural transformation of the economy to greater reliance on industry and services.

Low-income economies are largely agrarian; 65 percent of low-income working adults earn their living through agriculture.[54] Modernization of agriculture frees labor for more productive uses and leads to more formal sector employment in higher-paying jobs. Higher agricultural productivity increases farm-household incomes and reduces food prices for the whole population. The resulting increases in disposable income stimulate demand for non-farm goods and services and enable further urbanization. Urbanization[55]stimulates the economic growth process by improving access to education, increasing exposure to new ideas, making infrastructure more cost-effective, expanding the size and scope of markets, and increasing economies of scale.

Feed the Future technical guidance states that the key to agricultural growth is expanding linkages among producers, transporters, processors, and other agribusinesses.[56] In many countries, yields must increase to meet the growing demand for food as population and incomes grow. However, gains in yield can only support economic growth when the market system functions well. A value chain approach that connects small-scale farmers and other primary producers with input suppliers, processors, and more profitable markets has proven effective in overcoming market failures. Research and development institutions that develop or adapt and disseminate technologies to increase the productivity of large- and small-scale producers are vitally important.

USAID will build on experiences and learning to date[57] and follow a three-pronged approach to increasing agricultural incomes and food security: (1) providing economic interventions to increase production, income, employment, and growth in rural economies; (2) supporting resilience by applying environmentally sustainable technologies that reduce or mitigate climate risks in agriculture and promote savings and income diversification; and (3) improving health through increased consumption of nutritious foods that boost workers' productivity.

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[54] World Bank, "Agriculture and Food."

[55] USAID, "Sustainable Urbanization for Global Progress and Security."

[56] Feed the Future, "GFSS Technical Guidance Objective 1."

[57] Feed the Future, "Guidance and Tools for Global Food Security Programs."

2. Supporting Private Enterprises

The private sector creates nine out of ten jobs in the developing world and provides the critical pathway to self-reliance.[58] Yet, based on evidence, only a small number of transformational small and medium enterprises (SMEs) grow rapidly and thus have the ability to drive employment and economic growth.[59] Firm-level productivity varies greatly, and better managed firms are generally more productive, grow faster, and are less likely to shut down.[60] Large disparities persist in firms' access to and use of technology, capital equipment, and business know-how. Partnerships with the international and local private sector, where there is a strong alignment between business interests and our development objectives, is an effective strategy for addressing challenges across all development sectors because it supports building markets.[61]

USAID engagement with the private sector is guided by its Private-Sector Engagement Policy,[62] and numerous resources[63] make these partnerships possible. The private sector in developing countries often has game-changing ideas, but faces frequent constraints in implementing these solutions. In some circumstances, innovative grant competitions can untap this potential and introduce local firms to best practices and technology and innovations that enhance firm-level productivity and increase sales, employment, and backward linkages with suppliers.[64]

Firm-level productivity can also be improved by facilitating access to local business consultants who offer relevant management solutions. Yet, subsidizing these services for local firms can pick winners, distort markets, and foster dependency. USAID will therefore focus on strengthening the market for business development services by demonstrating results and increasing local firms' willingness to pay to enable the phasing out of subsidies so these services can become fully commercial and sustainable.

3. Unlocking Private Capital

Private capital accounts for about 90 percent of financial flows to developing countries, and these flows have been relatively stable over the past 10 years—unlike foreign assistance, which has declined by almost half as a share of developing-country GDP since 2006.[65] The path through which investment generates development impact includes viability (projects must be commercially viable), sustainability (longer-term impact and resilience, because money is on the line), and scalability (increased ability to meet new markets) of businesses and projects. Developing-country demand for investment will grow, and continued increases in private capital flows will be one of the most important factors in meeting development goals. However, current investment levels are still insufficient to address development challenges. Private investment is

[58] USAID, *Private-Sector Engagement Policy*.
[59] USAID, *Theories of Change: High-Growth Small and Medium Enterprise Development*.
[60] Van Reenen, "Management and the Wealth of Nations."
[61] USAID, "USAID Partners: Private Sector Engagement."
[62] USAID, *Private-Sector Engagement Policy*.
[63] USAID PSE Resource Guide for USAID Staff
[64] USAID, "Development Innovation Ventures."
[65] Lee and Sami, *Trends in Private Capital Flows to Low-Income Countries*.

constrained by weak financial intermediation, unfavorable enabling environments, high transaction costs, and risks and uncertainty. Access to equity-based financing and early-stage investment is largely absent in many developing countries, preventing entrepreneurs from realizing their potential, growing their start-ups, and hiring workers.

The rapid growth of private capital in emerging economies, global leadership of U.S. capital markets, and new business models and technology for financing have created unprecedented opportunities for USAID to help mobilize private finance for development.[66] USAID and its U.S. Government partners have a deep understanding of the country and sector context, as well as access to many tools and resources that can improve the risk–return profile of private sector investments. USAID will work with the new U.S. International Development Finance Corporation to facilitate links to financing and provide credit enhancements and risk mitigation tools, such as loan guarantees and insurance, against expropriation and political risks.

USAID can also provide seed capital or support investment funds that could kick-start venture capital or private equity finance. It can partner with business incubators and accelerators that provide essential technical assistance to start-up and early-stage enterprises.[67] USAID can also provide transaction support to connect investors to opportunities, promote policy and regulatory reforms, and partner with development banks and government investment promotion agencies. These types of support will lead to new private investment deals that would not have occurred otherwise by unlocking private capital for development.[68]

4. Building Trade Capacity

As the 2019 U.S. Trade Policy Agenda reiterates, "International trade can play a major role in the promotion of economic growth and the alleviation of global poverty."[69] In similar fashion, a joint report of the World Trade Organization (WTO) and the World Bank suggests "a sustained effort to deepen economic integration and further lower trade costs is essential for ending poverty."[70] International trade can increase efficiency through competition and economies of scale, and participation in international markets helps developing country firms access improved technologies, reach more profitable markets, and create better paying formal sector jobs. Although previously a hotly debated issue, a consistent finding is that trade reforms have a positive impact on economic growth.[71]

USAID supports trade capacity building to help partner countries improve customs procedures that increase transparency and reduce clearance times and risks, meet international standards, and address technical barriers to trade.[72] Issues related to intellectual property rights, working conditions and remuneration, and the environment are central to trade agreements. On top of

[66] Deloitte and USAID, *Mobilizing Private Finance for Development*.
[67] USAID, "PACE Initiative."
[68] USAID, *Unlocking Capital for Development*.
[69] Office of the United States Trade Representative, *Trade Policy Agenda and 2018 Annual Report of the President*.
[70] Bartley Johns et al., "The Role of Trade in Ending Poverty."
[71] Irwin, *Does Trade Reform Promote Economic Growth? A Review of Recent Evidence*.
[72] USAID, *Policy for Trade Capacity Building*

traditional trade in goods, e-commerce and accelerating the adoption of online applications that facilitate trade[73] are now essential and a particularly effective method for integrating SMEs in global value chains.

USAID's trade capacity-building assistance usually involves partnerships with other U.S. Government entities, international organizations, and private sector stakeholders. Trade facilitation and capacity-building are most effective when done through a sequential planning strategy consisting of (1) increasing the political will and knowledge of better and more transparent regulatory practices; (2) procedural simplification; (3) compliance management; and (4) interagency cooperation and coordination.[74] Public financial management issues are critically important, because reductions in tariffs and customs typically mean other domestic taxes will have to offset revenue losses.

Box: USAID Promotes Well-Functioning Markets

- *Increasing Agricultural Productivity and Food Security:* From 2011 to 2018, the whole-of-government Feed the Future Initiative unlocked $3 billion in financing for agriculture and food processing. This investment increased the sales revenues of small-scale producers and SMEs by $12 billion and decreased the number of families suffering from hunger by more than 5.2 million.[75]

- *Supporting Private Enterprise:* From 2008 to 2017, USAID brought the private sector into 2,300 Global Development Alliances and other partnerships, expected to leverage more than $43 billion in non-U.S. government funds toward U.S. objectives.[76]

- *Unlocking Private Capital:* Since 2010, USAID's Africa Trade and Investment Hubs have created more than $600 million in investment opportunities in Africa and 46,000 African jobs.[77] USAID's Global Development Lab has partnered with more than 40 business incubators, accelerators, and seed-funding investors and created public-private partnerships that are leveraging $100 million in investment.[78]

- *Building Trade Capacity:* USAID assists countries with WTO trade facilitation needs assessments that helped them initiate reforms to reduce export and import costs and time.[79] USAID led the establishment of the Global Alliance for Trade Facilitation, a collaboration of international organizations, governments, and businesses interested in implementing the WTO Trade Facilitation Agreement. Full implementation of this agreement could reduce

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[73] Suominen, *Expanding Developing Country Small Businesses' Use of Online Platforms for Trade*.
[74] Holler et al., *A Comprehensive Approach to Trade Facilitation and Capacity Building*.
[75] Feed the Future, "Results."
[76] USAID, *Private-Sector Engagement Policy*.
[77] USAID, "Trade and Investment Hubs."
[78] USAID, "PACE Initiative."
[79] Office of the United States Trade Representative, *Trade Policy Agenda and 2018 Annual Report of the President*.

trade costs by an average of 14.3 percent and create around 20 million jobs, mostly in developing countries.[80]

B. Strengthening Policies, Institutions, and Public Goods

1. Supporting Domestic Resource Mobilization and Public Financial Management

Developing countries often lack the *fiscal space* to increase public investments to optimal levels for economic growth and development. The tax base is often small, and tax collection efforts are often weak. Financing Self Reliance requires adequate public revenues and effective public spending to provide governments with the means to alleviate poverty and deliver public goods and services.[81] Domestic revenue collection systems need to be efficient, effective, transparent, equitable, accepted by the public, and properly enforced. Good domestic revenue collection systems impose relatively low transaction costs on the private sector, do not impair domestic commerce or cross-border transactions, and contribute to improved governance and accountability.

Domestic resource mobilization[82] generates sufficient public revenues through effective tax policies with a broad base of payers, diversified revenue sources, and high levels of compliance. Well-designed and implemented tax policies reduce compliance burdens and minimize distortions in economic decision-making, while generating sufficient revenue for public investment. Sound *public financial management* systems allocate scarce public sector resources based on widely accepted priorities, efficiency, and transparency to contribute to improved governance and accountability. Well-functioning public financial management systems comply with the laws and regulations for timely planning, budgeting, delivering, and accounting of expenditures and monitoring and evaluation of the intended results.

Sound domestic resource mobilization and public financial management systems reduce the likelihood of excessive government debt or inflationary spending. Since 2013, debt levels in the Sub-Saharan Africa region have been on the rise, with the median debt-to-GDP ratio increasing from 31 percent in 2012 to 53 percent in 2017.[83] Economic growth rates tend to be significantly lower for countries with relatively high levels of public debt.[84] Better domestic revenue mobilization and public financial management can help alleviate this problem; these systems are important at the national, subnational, and local levels.

2. Improving Physical and Digital Infrastructure

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80 World Trade Organization, “Trade Facilitation.”
81 USAID, “Fact Sheet: Financing Self-Reliance.”
82 USAID, “Charting a Path toward Self-Reliance.”
83 Coulibaly, Gandhi, and Senbet, “Is Sub-Saharan Africa Facing Another Systemic Sovereign Debt Crisis?”
84 Reinhart and Rogoff, “Growth in a Time of Debt.”

Inadequate infrastructure impairs economic efficiency by increasing firm-level transaction costs. On average, electric power outages cost African countries 1–2 percent of their GDP annually.[85] Expanding the power grid to serve all African households by 2030 would cost $835 billion, far more than the anticipated amount available through public sector financing,[86] and much of the investment required would not be commercially viable.[87]

Public and private sector investment in capital and operation of infrastructure services is necessary to meet development objectives and can enable projects to move forward, while increasing efficiency and sustainability. To enable investment at scale, governments must have the capacity to plan, procure, and regulate assets and services so the system is financially viable and financing risks are reduced. Improving the financial viability of infrastructure sectors, including moving toward cost recovery by building local capacity, is needed to move toward sustainability and self-reliance. The whole-of-government Power Africa Initiative brings together USAID and other U.S. Government entities, technical and legal experts, the private sector, and partner governments to increase the number of people with access to on-grid and off-grid power.[88]

Although traditional infrastructure will remain vital, access to the Internet and digital services are more important than ever. Recent studies confirm that increasing access to broadband Internet services correlates positively with economic growth.[89] By leveraging the digital economy, small businesses can access market information and new technologies to bring their products and services to market faster and increase their competitiveness in world markets. In 2005, just 2 percent of people in Sub-Saharan Africa had Internet access. By 2017, almost a quarter of all Africans were connected to the Internet. Much of this growth was driven by mobile technology. Nevertheless, Internet penetration rates in the least-developed countries were only 15 percent, or about one in seven individuals.[90] Women in developing countries were much less likely than men to have Internet access or own mobile phones.[91]

Interventions that strengthen market-driven digital ecosystems and connect the last 4 billion people, bringing them into the digital age, are essential for economic growth and human development.[92] Digital development[93] will need to address such issues as (1) expanding access to underserved populations; (2) increasing the interoperability, openness, and security of information and communication systems; (3) increasing the capacity of digital service providers;

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85 Lemma et al., *Evidence Review: What Are the Links between Power, Economic Growth and Job Creation?*

86 Castellano, Kendall, Nikomarov, and Swemmer, *Brighter Africa: The Growth Potential of the Sub-Saharan Electricity Sector.*

87 Connecting low-income households in remote areas to the electric grid is unlikely to be commercially viable for utilities, even if the financing were available. Local micro grids, minigrids, or off-grid distributed energy resources (photovoltaics or wind power) are more economical alternatives.

88 USAID, "Power Africa."

89 USAID, *Better Connectivity, Better Programs*; Minges, *Exploring the Relationship between Broadband and Economic Growth.*

90 World Bank, "Digital Development."

91 World Bank, *World Development Report 2016*; USAID, *Digital Strategy* (forthcoming).

92 Schmida et al., *Connecting the Next Four Billion*.

93 USAID, *Digital Strategy* (forthcoming).

(4) helping students and the labor force improve their ability to obtain and use reliable information and other digital services; and (5) strengthening e-governance.

3. Reforming the Commercial Legal and Regulatory Enabling Environment

The quality and enforcement of commercial law and regulations are strongly linked to the rate of business formation and, ultimately, economic growth.[94] The potential impact of improving the policy and regulatory environment is large.[95] Burdensome and frequently changing or unpredictably enforced regulations are costly in the time and money required for compliance; they also facilitate corruption by public officials. It is important for national, subnational, and local governments to follow established administrative procedures that are transparent and include broad stakeholder consultations in issuing policies and regulations and budgeting for public expenditures.

Although many developing countries have implemented major policy and regulatory reforms that have moved them up the ladder in various international rankings, an unfavorable enabling environment for growth has persisted in some of these countries, due to political economy factors that can be difficult to change, such as political patronage systems and corruption. Weak administrative processes and capacity also mean it can take years for reforms to be implemented and achieve results.

An assessment of ongoing and potential policy reform activities requires a detailed examination of existing laws and regulations, institutional capacity, stakeholders' needs and interests, and the political economy of change.[96] USAID will focus on commercial legal reforms that (1) increase transparency and predictability in governance; (2) reduce transaction costs; (3) recognize more forms of collateral; (4) protect intellectual property rights and improve contract enforcement and the effectiveness, efficiency, and accessibility of justice systems and courts; (5) reform foreign investment rules to increase access and reduce risks for foreign businesses; (6) strengthen competition; (7) establish and implement bankruptcy systems that provide incentives for firms to take risks while establishing protections for sources of financing, suppliers, and workers; and (8) strengthen corporate governance, accounting, and reporting.

4. Protecting the Environment

In the early stages of a country's development, environmental impacts and pollution may increase along with economic growth. Air pollution is a major negative externality resulting from growth. Worldwide, air pollution reduces life expectancy more than smoking. It is a leading cause of premature adult and infant mortality in many developing countries and accounts for some 6 million premature deaths annually.[97] However, once a higher level of GDP per capita has been achieved, economic growth may improve environmental quality and natural resource management as the country gains the funds, political will, and technologies it needs for these

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[94] Divanbeigi and Ramalho, *Business Regulations and Growth*.

[95] World Bank, *Regulation and Growth*.

[96] MarketLinks, "5.2.10. The BizCLIR Tool Framework."

[97] EPIC, "New Index Finds Air Pollution Reduces Global Life Expectancy by Nearly 2 Years"; Alexander and Schwandt, *The Impact of Car Pollution on Infant and Child Health*.

improvements.[98] The economic importance of tourism has also grown over the last decade and is an engine for job creation, SME growth, and foreign exchange earnings. In many developing countries, tourism is heavily based on natural resources—wildlife as well as scenic landscapes and waterscapes.[99]

Environment and natural resource management is a cross-cutting issue[100] in development that requires cross-sectoral investment and promotion of environmental considerations.[101] USAID recognizes that sustainable and resilient growth depends on environmental safeguards and effective and equitable management of natural resources. Many developing countries need to strengthen governance structures, capacity, inclusivity, and transparency of environment and natural resource management at the national, subnational, and local levels. USAID will continue to help partner countries (1) improve land tenure policies[102] and natural resource use rights that provide incentives for responsible management; (2) reduce deforestation and forest degradation, particularly in tropical forests,[103] and promote natural forest and landscape restoration; (3) protect biodiversity,[104] while creating opportunities for ecotourism and other conservation enterprises; (4) reduce pollution; and (5) increase resilience to climate shocks.

5. Supporting Resilience

It is not just the rate of economic growth that matters, but the *volatility* of the growth rate. One major difference between developed and developing countries is that the latter often experience more severe macroeconomic downturns, a fact that makes it hard to sustain development momentum and has a negative impact on long-run growth overall.[105] Recurring economic or environmental shocks drive many of the same communities into crisis in any given year, erasing previous gains. Low-income people and marginalized groups are most vulnerable to the negative economic impact of macroeconomic downturns, often resulting in hunger.

Although most guidance has focused on supporting the resilience of households and communities, a market systems perspective on resilience[106] emphasizes that population well-being is highly dependent on the sustained functioning of markets, including through shocks and stresses. Economic diversification is central to reducing volatility. USAID's support for trade capacity-building, the private sector, and finance and investment can play an important role, as

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[98] https://epi.envirocenter.yale.edu/2018/report/category/hlt. "One of the consistent lessons of the Environment Performance Index (EPI) is that achieving sustainability goals requires the material prosperity to invest in the infrastructure necessary to protect human health and ecosystems." (Yale University, *2018 Environmental Performance Index (EPI) Report*).

[99] Twining-Ward et al., *Supporting Sustainable Livelihoods through Wildlife Tourism*.

[100] USAID, "Environmental and Natural Resource Management Framework."

[101] USAID's environmental procedures are established in the Code of Federal Regulations (22 CFR 216), as authorized by Section 117 of the Foreign Assistance Act (USAID, "22 CFR 216 Agency Environmental Procedures," "The Foreign Assistance Act of 1961, as Amended").

[102] USAID, "Why Land Rights Matter."

[103] USAID, "Fact Sheet: Peruvian Forest Sector."

[104] USAID, "USAID Biodiversity Conservation Gateway Key Documents."

[105] Lin and Kim, "The Link between Economic Growth and Growth Volatility."

[106] Vroegindewey et al., *Guidance for Assessing Resilience in Market Systems*.

can investments in improved management of the natural resources that are essential for economic growth, such as water, land, and forests. USAID will also continue to help partner governments create the fiscal space and capacity to respond to environmental shocks and natural disasters and improve disaster response preparedness.

At the household level, people are escaping but then falling back into poverty in the face of shocks and stresses, underscoring the broader relevance of USAID resilience programming. Sources of household-level resilience include (1) social capital (the ability to access community support); (2) financial inclusion that builds household assets and savings; (3) gender equity within the family; (4) diversification of livelihoods; (5) sustainability of the natural resource base for development; (6) investments for better adaptation to current weather risks and future climate risks; (7) enabling access to markets, allowing greater opportunity to sell household goods and services; and (8) training to help people adopt positive coping strategies to better adapt.[107]

Box: USAID Strengthens Policies, Institutions, and Public Goods to Increase Economic Growth

- *Supporting Domestic Resource Mobilization:* Between 2011 and 2017, USAID assisted the Government of El Salvador to modernize tax administration to improve taxpayer services, reduce tax fraud and tax evasion, and increase public confidence in the tax system. USAID support yielded an estimated $230 million in new revenues from a USAID investment of $3.6 million--an additional $64 in domestic resources mobilized for every dollar USAID spent.

- *Improving Energy and Infrastructure:* Between 2013 and mid-2019, the whole-of-government Power Africa Initiative had brokered the financial closure of 120 private sector investments in renewable energy in Sub-Saharan Africa, with a total capacity of more than 10,000 megawatts of electric power. Between 2011 and 2019, USAID leveraged more than $192 million from public and private partners to catalyze the enabling environment for inclusive digital infrastructure and services, such as Internet connectivity and digital payments.[108]

- *Reforming the Regulatory and Commercial Legal Environment Reform:* A USAID-funded program in Mexico greatly expanded access to credit for SMEs by establishing a modern secured lending system incorporating new laws and an electronic registry for registering non-real estate assets as collateral. Five years later in 2019, Mexico saw over seven million filings, 68% of which included items such as crops, livestock, fish, sewing machines, and vacuums used by small entrepreneurs. Loans carried an average interest rate of 12% -- well below the average 75% interest rate charged by microfinanciers.

- *Protecting the Environment:* Between 2012 and 2018, USAID's Sustainable Landscapes programs leveraged more than $500 million in investments and partnered with major

[107] USAID and Center for Resilience, *Resilience Evidence Forum Report*.
[108] USAID, *2018 Digital Download*.

corporations to reduce deforestation and forest degradation. USAID helped establish the Tropical Forest Alliance, a public-private partnership with major transnational companies, to reduce tropical deforestation from beef, cacao, palm oil, pulp and paper, and soybean production.[109] USAID also founded the Global Sustainable Tourism Alliance.

- *Supporting Resilience:* USAID and other donors established the Global Resilience Partnership.[110] This public-private partnership works with partner governments, regional institutions, and companies to advance risk and resilience measurement, learning, and cooperation.

C. Enhancing Access to Productive Opportunities

1. Gender Equality and Women's Empowerment

When women are economically empowered, they invest in their families and communities, producing important social welfare effects. However, more than 2.7 billion women are legally restricted from having the same job opportunities as men.[111] Although women comprise more than 40 percent of the agricultural labor force in developing countries, only a small fraction are landholders with formal tenure.[112] Women-owned enterprises make up as little as 10 percent of businesses in Africa and only 3 percent in South Asia.[113] Women also have less access to digital services, which can be a platform for training, employment, and financial services.[114] In 2018, more than 1.7 billion women in low- and middle-income countries still did not own mobile phones and were 26 percent less likely to use mobile Internet than men.[115] Removing legal and social barriers to women's participation in the labor force could increase GDP in many developing countries by up to 30 percent.[116]

Applying a gender lens is almost always needed when designing and monitoring activities, especially those with the purpose of increasing labor-force participation and economic advancement.[117] Women are less likely to benefit when interventions fail to consider gender, because their constraints and opportunities differ from facing men.[118] Economic empowerment of women starts with increasing financial self-reliance through access to private and secure commercial banking services. Financial institutions may need to compensate for implicit gender bias in their outreach and service provision by offering different products, changing marketing

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[109] Tropical Forest Alliance 2020, "Objectives."
[110] Global Resilience Partnership, "About Us."
[111] World Bank, *Women, Business and the Law 2019: A Decade of Reform.*
[112] World Bank, *Women, Business and the Law 2019: A Decade of Reform.* https://openknowledge.worldbank.org/bitstream/handle/10986/31327/WBL2019.pdf
[113] Calardo, "How USAID is Supporting Women Entrepreneurs."
[114] Dlott, "Reaching Universal Financial Access is Impossible Without Women."
[115] White House, "Women Prospering in the Workforce."
[116] Aguirre et al., *Empowering the Third Billion Women and the World of Work in 2012*.
[117] USAID, "Women Prospering in the Workforce."
[118] World Economic Forum, *The Global Gender Gap Report 2018: Insight Report*.

approaches, and providing incentives for staff to serve women clients. Most women-owned SMEs in the developing world have financial needs beyond microfinance, but their assets do not qualify them for larger commercial loans. New financial innovations are needed that solve this problem. This will require the expansion of digital banking services that enhance women's access to credit and more effectively spread risks.

In addition to formal services, support from peer groups is an important source of encouragement for women taking the risks of starting and managing a business or entering a new field of employment. Such networks also increase access to markets and services.[119] Identifying and advocating for changes in policy and regulatory barriers to increasing women's participation in the economy at the national, subnational, and local levels is the longer-term goal, and will require bottom up, demand-driven reform.

2. Microenterprise Development

In developing economies, informal microenterprises account for about one-third of GDP and 70 percent of employment, and more than half of the total is from self-employment.[120] Often, self-employment in a microenterprise is the result of a lack of formal sector jobs available for low-income people, particularly among youth. On average, an informal enterprise in a developing economy is only one-quarter as productive as the average firm in the formal sector.[121] Informal enterprises also have short lifespans because they confront high competition and business risk, compounded by household risk (such as injury or illness). Because modern, private sector firms tend to produce the most formal, highest-paying jobs, the most effective strategy is to focus on growing employment in this sector. Nevertheless, the reality is that until a country reaches upper-income status, most of its labor force will not obtain a formal wage job.[122] Support for microenterprises remains necessary and is important for development -- not only for reducing poverty and increasing resilience, but also for strengthening markets.

USAID assistance to the mircoenterprise sector will address the systemic constraints that prevent microenterprises from integrating into the formal economy while helping create the conditions that reduce the need for self-employment due to a lack of wage based jobs. Although there are some examples that show training youth on self-employment opportunities can help improve their livelihoods, the surprising result is that simply giving cash grants might work just as well.[123] More importantly, approaches that only end up helping a few firms and a limited number of people with grants and training do not generate the impact that we seek. Based on the evidence, USAID is shifting its microenterprise development approach to address multiple challenges simultaneously.[124] USAID programs will focus geographically, by sector, and/or by gender and build local institutions, such as networks of non-governmental, private sector, and

119 Buvinić, and O'Donnell, "Gender Matters in Economic Empowerment Interventions: A Research Review."

120 Yu and Ohnsorge, "The Challenges of Informality."

121 Yu and Ohnsorge, "The Challenges of Informality."

122 USAID, "Getting Employment to Work for Self-Reliance."

123 Fox and Kaul, "The Evidence Is In" (USAID).

124 USAID, "Microenterprise and Pathways out of Poverty."

governmental entities that can continue to support microenterprises with services beyond USAID assistance.

3. Increasing Employment

As countries develop, workers shift from informal to formal sector employment. Only about 20 percent of employment in low-income countries is in the formal sector, compared to 55 percent in middle-income countries.[125] In emerging markets, most formal jobs are generated by SMEs, which create 7 out of 10 jobs.[126] Economic development is not only about creating jobs, but about jobs becoming better, safer, higher paying, and more inclusive. Even when there are relatively good opportunities for formal sector employment, some segments of the labor force might not benefit at the same rate and could require training and other support, such as career counseling or mentoring. There is increasing evidence on what works and what does not work in increasing formal employment in developing countries.[127]

USAID recognizes that developing-country economies will increasingly demand workers with higher levels of human capital, including socio-emotional skills. Yet, training is a supply-side intervention that is helpful only when demand is present and when the training equips youth or other workers with the skills they need to fill job vacancies that would otherwise go unfilled. It is important to remember that many job-creation and training interventions do not measure job *displacement* effects—the replacement of older workers in existing jobs by younger workers—that do not create new jobs.[128] Critically for sustainability, assistance should not simply pay for training by subsidizing vocational education providers, because this creates aid dependency. Rather, assistance should build markets for vocational training in partnership with local businesses. Such assistance should emphasize cost recovery through fee generation from employers and students.

Demand side interventions should facilitate the removal of systemic policy barriers to productivity, competition, trade, and foreign direct investment as described above. The demand for employment can also be increased by helping younger businesses start up or expand by supporting access to financing and technical assistance that are better tailored to their needs. USAID will support the development of supportive networks for start-up enterprises that allow early-stage businesses to realize their potential.

4. Access to Financial Services and Financial Inclusion

Financial inclusion contributes most to economic growth when there is a favorable enabling environment that fosters competition, innovation, and consumer protection.[129] Financial inclusion involves more than just access to credit. It includes the ability to access and use a

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[125] World Bank, "Pathways to Better Jobs in IDA Countries."
[126] World Bank, "Small and Medium Enterprise Finance."
[127] USAID, "Getting Employment to Work for Self-Reliance."
[128] Fox and Kaul, "The Evidence Is In" (Peace Child International).
[129] Sahay et al., *Financial Inclusion: Can It Meet Multiple Macroeconomic Goals?*

range of financial services[130] effectively to improve financial well-being and resilience to external shocks. Increased access to finance results in higher employment growth, especially for microenterprises and SMEs.[131] However, almost 70 percent of SMEs do not use external financing from financial institutions due to the high transactions costs (including collateral requirements) and risk premiums.[132] These enterprises may also need assistance in developing loan applications that banks would accept.

Worldwide, 1.7 billion adults still do not have banking services, but two-thirds own a mobile phone. Although bank account ownership has surged in some developing countries, progress has been slower elsewhere. Access to savings—the least costly financial service to provide and use—is the most important financial service for low-income individuals and households. Savings fosters self-reliance and provides an entry point to other financial services.[133] There is a nine percentage-point gap in savings account ownership between men and women in developing economies, a gap that has remained unchanged since 2011.[134]

USAID will reduce the number of unbanked globally by supporting the enabling environment and ecosystem of market actors to address barriers to access financial services, particularly through digital technology. Digital finance[135] (or, more broadly, "FinTech") can foster greater efficiency and transparency, resilience, and empowerment across a variety of contexts, whether in agriculture, health, education, energy, or governance. Financial inclusion programs, whether FinTech-focused private sector engagement[136] or more broadly oriented,[137] should first understand market systems, define market gaps, scope out the key market actors (for example, commercial banks, mobile network operators, regulatory authorities, consumers), and then select the engagement model that can address the identified constraints. In designing interventions, programs should account for the systemic issues that often contribute to exclusion. Often, support for basic financial literacy training through local financial institutions can significantly improve how the poorest people manage their money. Ultimately, programs should look to demonstrate that even the poorest (the "bottom of the pyramid") are an important source of client growth for commercial banks and that financial inclusion is profitable.[138]

Box: USAID Increases Access to Productive Opportunities

Gender Equality and Women's Empowerment: Between 2011 and 2018, Feed the Future helped 2.6 million women and their businesses gain access to financing and support, unlocking more

[130] USAID, "Microenterprise and Pathways out of Poverty."
[131] Ayyagari et al., *Access to Finance and Job Growth: Firm-Level Evidence across Developing Countries*.
[132] World Bank Group, *Improving Access to Finance for SMEs*.
[133] USAID, "Microenterprise and Pathways out of Poverty."
[134] World Bank, "Financial Inclusion on the Rise, but Gaps Remain, Global Findex Database Shows."
[135] Digital finance, or FinTech, refers to financial services enabled by or delivered through digital technologies such as mobile phones or the Internet. These services can be offered by bank or nonbank institutions. Digital finance services include payments, credit, insurance, savings, and financial advisory tools.
[136] Nelson, *FinTech Partnerships Playbook*.
[137] USAID, "FinTech Partnerships Checklist: Identifying and Strengthening the Right Digital Finance Partner."
[138] Burjorjee and Scola, "A Market Systems Approach to Financial Inclusion Guidelines for Funders."

than $630 million in agricultural loans. USAID also enabled more than 8.2 million women to apply improved technologies and practices to lift themselves out of hunger and poverty.[139]

Microenterprise Development: In 2017 alone, USAID's microenterprise development assistance improved the livelihoods of almost 5 million very poor people worldwide.[140]

Employment and Entrepreneur Support: USAID helps develop public-private partnerships that test new strategies to support businesses in overcoming barriers to growth. USAID's Partnering to Accelerate Entrepreneurship Initiative catalyzes private sector investment for early-stage enterprises and has worked with more than 40 business incubators and accelerators and seed-stage impact investors. These partnerships are leveraging $145 million in combined public and private investments.

Access to Financial Services: Between 1999 and 2018, USAID's Development Credit Authority helped make $5.5 billion in bank financing available for businesses in 80 developing countries.[141] In 2019, USAID co-founded the Alliance for eTrade Development,[142] which includes multiple major U.S. businesses, such as Cargill, Etsy, MasterCard, PayPal, and Visa. The Alliance advances digital finance–enabled market development and expands developing-country small businesses' use of online financial platforms for trade.

Section V: Principles for Program Impact

USAID supports sustained, broad-based, and resilient economic growth that is essential for poverty alleviation and human well-being and serves the U.S. national interest. USAID assistance is too small to have a direct impact on growth rates in assisted countries, but it can accelerate the development process through programs tailored to help partner countries address market and governance failures that inhibit local firms' ability to increase their productivity. To do this, USAID follows three core principles in its economic growth programming.

A. Programs Will Build Markets and Institutions that Are Self-Financing

In all economic sectors, USAID programming will identify and address specific market and governance failures that are the most important constraints to economic growth. Equipping relevant market actors to solve their own problems should be the programmatic approach. The Agency will design activities to be locally owned and create institutions able to generate their own sources of revenue to eliminate or reduce the need for continuing development assistance. Each activity will be designed with a strategy of local ownership and graduation from assistance—not necessarily full graduation of the partner country, but of targeted sectors and subsectors. Well-functioning markets are self-financing because markets are driven by the private sector; when they are competitive, they are efficient and do not require subsidies. Local

[139] Feed the Future, "2019 Feed the Future Progress Snapshot: Turning Potential into Progress."
[140] USAID, "2017 Microenterprise Results Report."
[141] USAID, "Development Credit Authority: Putting Local Wealth to Work."
[142] Suominen, *Expanding Developing Country Small Businesses' Use of Online Platforms for Trade*.

ownership requires USAID and its implementers to systematically and strategically plan for how their assistance can be phased out. If we focus our efforts on self-financing, we will escape from the mentality of "design, implement, and then design a follow-on activity."

B. Programs Will Demand Systemic or Catalytic Impact

USAID's goal is growth that affects thousands of firms and millions of people. Building markets, improving policies and governance, and creating opportunities for low-income people accomplishes this objective to be transformative, rather than benefiting just some firms and households. Although economic growth hinges on firm-level productivity, that does not mean USAID must work at the firm-level, but rather that the Agency must ensure its work has impact at the firm level. Where systemic impact is not possible, catalytic impact is essential. Demonstration activities will be limited to those that can be scaled up, widely replicated, or lead to changes in policy, regulation, or institutions that can have significant impacts on the economy. USAID will also increase its use of pay-for-results approaches,[143] where practical, to boost incentives for achieving development outcomes rather than funding inputs.

C. Programs Will Consider Additionality and Cost-Effectiveness

Evidence of additionality of impact should be included when designing and evaluating economic growth programs. *Additionality* means results are unlikely to occur in the absence of USAID support because the private sector and/or partner government cannot solve problems on their own. Agency staff and partners should identify specific constraints preventing the achievement of desired outcomes, assess why these constraints have not been overcome, and explain why USAID assistance is likely to be effective.

USAID also recognizes the priority to demonstrate the value of its programs compared to their cost to taxpayers. We will therefore increase the use of cost-effectiveness analysis in designing and evaluating activities to denominate our results and make programs and activities more comparable. Cost-benefit analysis[144] can strengthen a program's cost-effectiveness through an analysis of the impact on beneficiaries, donors, and other stakeholders, as well as project sustainability. *Cash-benchmarking*[145] is a type of cost-effectiveness analysis that compares a program's financial impacts on beneficiaries to the alternative of cash grants equal to the intervention costs.

D. Programs will Emphasize Adaptive Management and Learning

Achieving broad-based, sustained, and resilient economic growth is difficult, and USAID will use *collaborating, learning, and adapting*[146] approaches to help ensure the selection and implementation of the most promising and effective approaches. USAID will continue and enhance collaboration with the Department of State, the U.S. Development Finance Corporation,

[143] Camp and Fernandez, *Pay for Results in Development: A Primer for Practitioners.*

[144] USAID, "Cost-Benefit Analysis."

[145] Placeholder for endnote citation.

[146] Learning Lab, "Understanding CLA."

and other U.S. Government agencies, as well as other development assistance organizations that share common goals and approaches. USAID will also scale up engagement with the private sector in partner countries, the United States, and other developed countries to leverage their knowledge and resources to meet shared objectives. USAID will expand its use of alternative approaches to procurement, including co-creation[147] that involves local organizations, the private sector, traditional implementing partners, local experts, and partner country officials in the design process to increase local ownership, expand available resources and expertise, and reduce risks.

USAID will enhance its learning by ensuring evaluations challenge the underlying theory of change and assumptions that were the foundation of the design, while emphasizing trade-offs in the use of resources. Use of impact evaluations,[148] although not always feasible or appropriate, should be increased, because they are an important tool for learning about the extent and intensity of project effects and the degree to which those effects can be said to have been caused by a specific intervention. USAID will also increase the use of performance indicators that reflect higher-level results and impact, including improved metrics for market development, economic governance, and self-reliance. Finally, USAID will use digital media to expand its knowledge dissemination efforts based on evaluation efforts and lessons learned in the field, demonstrating its technical leadership.

Conclusion

In summary, USAID will scale up the gains from its economic growth programs by emphasizing the potential for systemic and catalytic impact through correcting critical market and governance failures, while focusing on additionality, cost-effectiveness, and ultimately reducing dependency in the economies of the partner countries where we work. USAID will support its country and regional Missions to implement this policy through continuing analysis by our technical officers on the topics covered here, the generation of supplemental learning materials and guidance, implementing partner consultations, and direct field support. Together with adequate funding and technical staff, USAID can accelerate the impact of its programs and help many more people secure a better future.

[147] USAID, "Program Cycle Discussion Note: Co-Creation Additional Help (External Version)."
[148] USAID, "Impact Evaluation Decision."

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Endnotes