

Reforming Policies and Institutions to Foster Economic Growth

Economic growth has lifted hundreds of millions of people out of poverty in the last 60 years. How have successful economies done this? The quality of policies and institutions clearly matter. But the art of policymaking involves a process to determine the appropriate priorities and approaches to reform for each country and time frame.

How has China succeeded in lifting hundreds of millions of its citizens out of poverty in just a quarter century? How did Chile become the most prosperous nation in Latin America, and Mauritius achieve the highest standard of living in Africa? How did Indonesia reduce the incidence of severe poverty to 17 percent by 2004, when poverty was pervasive 30 years earlier?

The simple answer: through economic growth. A growing economy creates pathways for people to escape poverty, achieve food security, improve well-being, and reduce conflict risks. Growth also augments the resources that governments need to expand and improve public services and social welfare systems. And without growth, there is just not enough income or wealth in poor countries to lift the average citizen out of poverty.

But this answer is too simple to be useful. The operational questions go further: How do countries achieve rapid and broad-based growth? And how can international donors best assist? This paper addresses these questions by outlining major insights from empirical evidence and conceptual models on the determinants of growth, with an emphasis on the new consensus on the need for country-specific approaches, country

ownership, and an inclusive process to gain legitimacy for implementing and sustaining reforms.

NO SINGLE RECIPE FOR GROWTH

Given the enormous advantages of rapid growth (see Briefing Notes 2 and 3) and the wealth of experience from almost 200 countries over many decades, one would think that the recipe for growth should be well known by now. Not so. Decades of empirical analysis have not identified a particular set of indicators reflecting policies or reforms that explain differences in growth performance across countries. Instead, various studies produce inconsistent findings on the importance of particular policies for long-term growth. The evidence also suggests that sustaining economic growth over an extended period is especially difficult, as many countries have faltered after enjoying episodes of rapid growth. Furthermore, experience has discredited prescriptions for growth that once were viewed as standard wisdom (Box 1).

One possible conclusion from this evidence is that we do not know enough about the determinants of growth to devise effective policies to promote rapid growth (Easterly 2009). And yet everyone knows of cases where reforms have triggered

This briefing note is part of a series produced for the EGAT Bureau at USAID as a contribution to the recurrent debate on development priorities. Each note in the Programming for Growth series examines a topic relating to the value and effectiveness of USAID's economic growth programs. All the titles in the series are listed on the last page of this note.

BOX I

Seeking the Recipe for Growth

Early models of growth focused on the quantity and quality of labor and capital and gains in productivity. Other models highlighted the need for saving to finance investment, and foreign exchange earnings to import key inputs to production. These models did not provide much operational guidance on specific policy actions. As a result, many practitioners in the 1960s and 1970s promoted government-directed industrial policies, later vilified as “bureaucrats choosing winners.”

By the late 1980s, many development professionals embraced the “Washington consensus,” which extolled macroeconomic stability, market liberalization (“getting prices right”), privatization

of state enterprises, and security of property rights (see table below). Over the next decade, many countries in sub-Saharan Africa and Latin America implemented structural reforms along these lines, but with mixed results.

A widely cited study by Hausmann, et al. (2004) examined long-term growth performance in more than one hundred countries, found that fewer than 15 percent of the observed “growth accelerations”^a were associated with major economic reforms (as measured by available international indicators). Conversely, only 18 percent of the identifiable liberalization episodes generated a growth acceleration.

Hausmann et al. also found that policy regimes in some of the most successful countries, including China, were highly unorthodox. For example, a reduction in trade barriers was a cornerstone of the prevailing consensus, yet some of the best performers maintained high tariffs on many imports.

As these stylized facts were becoming clear, a parallel insight emerged emphasizing the quality of political, legal, and economic institutions. This led to an “augmented Washington Consensus,” which added institutional and governance reforms to the former list (see table below). Even with institutional indicators included, however, statistical analyses still fail to find robust results on the determinants of growth.

| ORIGINAL WASHINGTON CONSENSUS | AUGMENTED CONSENSUS (PREVIOUS 10 ITEMS PLUS...) |
|---|---|
| 1. Fiscal discipline | 11. Corporate governance |
| 2. Reorientation of public expenditures | 12. Anticorruption |
| 3. Tax reform | 13. Flexible labor markets |
| 4. Interest rate liberalization | 14. Adherence to WTO disciplines |
| 5. Unified and competitive exchange rates and standards | 15. Adherence to international financial codes |
| 6. Trade liberalization | 16. Prudent capital-account opening |
| 7. Openness to direct foreign investment | 17. Nonintermediate exchange rate regimes |
| 8. Privatization | 18. Independent central banks and inflation targeting |
| 9. Deregulation | 19. Social safety nets |
| 10. Secure property rights | 20. Targeted poverty reduction |

Source: Rodrik 2005

^aHausmann et al. (2004) identify growth accelerations using two main criteria: (1) that the growth rate increased by at least 2 percentage points and (2) that it averaged 3.5 percent per annum or more for at least eight years.

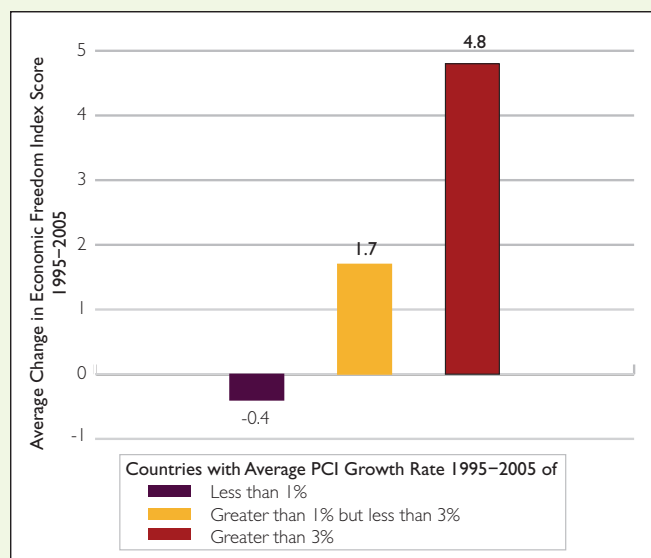
a strong growth response, including in Korea, China, Mauritius, Chile, and Indonesia—as well as cases where policy reversals led to economic crises, most notably in Zimbabwe. This suggests a different interpretation: that the evidence simply tells us that no single recipe can be applied mechanically to different contexts, that various policies can achieve similar results, and that best practices in one setting do not necessarily succeed in other

settings.¹ The lesson for policymakers is that “[s]ustained growth depends less on whether policies conform to some ideal than on whether they identify binding constraints accurately and address them effectively” (Zagha and Nankani 2005, 80). Each country’s economic structure, political currents, culture and history matter in determining the appropriate prescriptions and the sequencing of reforms.

Lacking a detailed blueprint for reform, the development literature still provides valuable guidance on how countries can go about promoting more rapid growth. There is broad agreement, for example, that major obstacles to growth include weak economic institutions and inappropriate policies that hobble transactions, discourage investments, and impede private sector development. It follows that strategic policy reforms and institutional innovations to overcome barriers to private investment are often essential for improving growth performance. Figure 1 provides illustrative evidence about the importance of reforms, showing that growth performance among developing countries from 1995 to 2005 was strongly associated with the extent of improvement in a country's score on the Heritage Foundation's Economic Freedom Index.

FIGURE 1

Improvements in Economic Freedom are Strongly Associated with Faster Growth



Note: Index levels range from 0 to 100 (“repressed” to “free”).

Source: Authors’ calculations; data from the Heritage Foundation and the World Bank.

BOX 2

Policies to Promote Investment

Policies to motivate investment must either improve the returns or reduce the risks involved in a commitment of private resources. Investment returns can be enhanced by policies aimed at

- Improving and expanding infrastructure: transportation, telecommunications, energy, water;
- Maintaining macroeconomic stability;
- Investing in education and health services;
- Improving knowledge of market opportunities and appropriate technologies;
- Pursuing financial market reforms that expand access to and reduce the cost of financing;
- Reducing barriers to trade to reduce input costs and improve access to regional and global markets;
- Reducing red-tape through deregulation, simplification of procedures, and civil service reform;
- Maintaining an efficient and predictable tax system with moderate tax rates and professional tax administration; and
- Establishing laws and institutions to control corruption (which is a heavy implicit tax on business).

Governments can also stimulate investment by reducing risk and uncertainty through policies aimed at

- Maintaining macroeconomic stability (again), with low inflation, a sustainable budget profile, a competitive real exchange rate, and a sound banking system;
- Strengthening institutions to protect property rights, enforce contracts, and control crime;
- Eliminating as far as possible bureaucratic discretion in implementing laws and regulations that affect investments and business operations;
- Guaranteeing that foreign investors can repatriate capital and profits;
- Improving the dependability of infrastructure services; and
- Minimizing political risk by respecting human rights, establishing transparent and accountable governance, and developing effective processes for dispute resolution.

POLICIES AND INSTITUTIONS AS DETERMINANTS OF GROWTH

To see why policies and institutions are so important, consider the sources of growth in a simple conceptual framework. To increase per capita income (PCI), countries need to increase per capita production, which requires boosting productivity per worker.² As widely acknowledged, “productivity growth takes place at the level of the firm” (USAID 2008, 5), as a result of new investments, new technologies cost-saving innovations, and education and training for the labor force, among other things. These actions at the firm level are heavily affected, however, by the prevailing policy regime and the quality of institutions for economic governance.

More specifically, decisions to invest or innovate are generally motivated by expected returns, relative to the risk and uncertainty involved in the commitment of private resources. Box 2 provides a run-down on how government actions affect these underlying determinants of investment.

Furthermore, the quality of investment is just as important as the quantity. Hence, measures to promote private sector development should be designed to stimulate *efficient* and competitive investment (Box 3). Policies that foster investments that depend on subsidies or protection usually work at cross purposes to the ultimate goal of sustainable development, even if they elicit a positive investment response in the short run.

In 2008 the international Commission on Growth and Development, consisting of 19 world leaders, mainly from developing countries, completed two years of work on *The Growth Report: Strategies for Sustained Growth and Inclusive Development*. A major part of the report was an assessment of every economy that sustained an average GDP growth rate of 7 percent or more for at least 25 years since 1950. At the beginning of this period, such rapid and sustained growth would have been regarded as miraculous. But 13 economies achieved it,³ and in doing so “spare[d] people *en masse* from poverty and drudgery” (Spence 2008, 1).

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High-growth economies followed a variety of approaches, confirming the view that solutions are context-specific but have shared points of resemblance.

BOX 3

Policies to Improve Productivity

Economic principles suggest that the following policies can contribute to enhancing productivity as a central feature of growth dynamics:

- Allowing resource allocation decisions to be determined primarily through market mechanisms, to harness the power of personal initiative and self-interest
- Investing in human capital, including scientific, technical, and managerial education
- Enhancing specialization and economies of scale by improving transport and communications infrastructure and facilitating production for the export market
- Strengthening competition by reducing trade barriers and eliminating legal and administrative barriers to business entry and exit
- Creating a policy environment to attract direct foreign investment as a source of technical and managerial innovation
- Facilitating the introduction, adaptation, and development of new technologies
- Reducing economic distortions by establishing an efficient tax system based on even-handed treatment of alternative investments
- Maintaining positive inflation-adjusted interest rates, so that the price system channels financial resources to efficient investments.

the Growth Report also found that they shared five “striking points of resemblance” (21). The most important commonality is that all 13 countries had credible, capable governments that were highly committed to development. In addition, all of them exploited the global economy; maintained macroeconomic stability; achieved high rates of saving and investment; and largely let markets allocate resources (Spence 2008, 21).

Committed, credible, and capable governments. Dedicated and effective leadership is required to sustain long-term efforts to attract investment, create jobs, strengthen competition and facilitate resource mobility, while addressing potentially destabilizing social vulnerabilities. Political leadership for growth also requires that the governments had

to “communicate their goals to the public, and convince people that the future rewards are worth the effort, thrift, and economic upheaval” (Spence 2008, 3). For this purpose words are not enough; the governments also pursued policies and institutional reforms to ensure a broad distribution of benefits from infrastructure and social spending, provide some form of a social safety net to protect workers as obsolete jobs end, and create an environment in which citizens have opportunities to accumulate assets and improve living standards through private initiative.

Exploiting the global economy. In every economy that sustained high growth, leaders recognized the importance of and took advantage of the global economy as a source of knowledge, competition, and markets to spur productivity growth. This outward orientation was particularly important in smaller countries where reliance on domestic markets would limit scale economies, specialization, and competition.

Macroeconomic stability. Every high-growth government managed fiscal and monetary policies prudently, keeping public spending under control, maintaining relatively low inflation, and avoiding costly financial sector failures. These policies not only created a more attractive business environment, but also reduced vulnerability of the economy by providing the governments with space to respond effectively to shocks.

Saving and investment. High rates of saving and investment are another feature common to the high-growth economies. The Growth Commission calls this “future orientation,” which entails deferring current consumption in favor of providing for future gains, in both the public and private sectors. Although the specifics differed in detail from one country to the next, they generally involved heavy investments in infrastructure, health and education, protection of property rights and contract enforcement, along with prudential financial regulation and macroeconomic stability.

Market allocations. Governments in all of the high-growth economies understood the importance of markets in promoting efficiency and providing incentives for resource mobility and

structural transformation. As a result, they adopted reforms that largely allowed markets signals to allocate resources—though not necessarily across the board.

Beyond these observations about high-growth commonalities, the Growth Report also highlights the importance of reforms and interventions in other areas, namely:

- Technology transfer
- Competition
- Labor mobility
- Export promotion and industrial policy
- Exchange rates
- Capital flows
- Financial sector development
- Urbanization and rural investment
- Equity and equality of opportunity
- Regional development
- Environment and energy
- Effective government
- Quality of debate.

This list represents a set of issues for consideration; it is not meant as a reincarnation of the recipe approach embodied in

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the Washington Consensus (though many elements are the same). What the Growth Report calls the “art of policy making” involves a process to determine the appropriate set of priorities and approaches for reform and institutional development for a given country and time frame. This is the essence of the “growth diagnostics” framework developed by Hausmann, Rodrik and Valesco (2004), which sets out a systematic method for assessing country-specific constraints to growth and priorities for reform. The bottom line, though, is that the quality, design, and effectiveness of policies

and institutions clearly matter as determinants of private sector development and economic growth.

IMPLICATIONS AND OPPORTUNITIES

Development professionals have learned a great deal about humility from prior efforts to devise standard solutions to the problem of fostering broad-based growth in developing countries. As a result, the new consensus highlights the process of shaping interventions to country conditions rather than recommending a priori measures. And yet we do know a great deal about the fundamental requirements to support private sector development, including the importance of strengthening economic institutions, ensuring macroeconomic stability, relying on markets to allocate resources, reforming the business environment, opening to trade and investment, and developing sound and efficient financial institutions.

For host countries, economic transformation invariably confronts established interests with new ideas, challenges, and opportunities. As new firms, products and technologies appear, old ones become obsolete. The transformation process entails the movement of people, the need for new skills, and a realignment of economic and political power—all of which can strain a country's political institutions. Success therefore demands political leadership with “patience, a long planning horizon, and an unwavering focus on the goal of inclusive growth” (Spence 2008, 3), along with the ability to convince major constituents that the reforms are in society's best interest. Measures to promote inclusiveness and empowerment, and efforts to carry out economic growth reforms, are mutually reinforcing. The former create buy-in and legitimacy for successive stages of reform, which, in turn, spur further growth that helps to pay for social policies.

This synergy carries three messages about the process of economic reform. First, governments can enhance the legitimacy and effectiveness of the reforms by becoming more responsive and accountable organizations, giving affected parties a greater stake in a successful outcome. This may be approached through consultation (sincere involvement of stakeholders in a policy debate), transparency (such as “freedom of information” and public reporting), and subsidiarity (transferring to lower levels of government responsibilities that do not involve scale economies).

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Second, in implementing reforms governments should seek to mitigate adverse effects of change, for example by providing basic public services, skills training, and unemployment insurance, where possible. Where governments cannot afford to provide social protection, it is important to calibrate reforms to maintain a balance between job creation and job destruction (Spence 2008, 44).

Third, political support for reform can be strengthened with measures that promote inclusiveness through economic empowerment of disadvantaged groups, including microenterprises in the informal sector, and poor women in particular. Examples include improving institutions that establish and protect property rights, improving the regulatory framework for microenterprise and microfinance, enforcing occupational safety and health regulations, and improving matrimonial inheritance rights.

On the donors' side there are analogous implications. Just as host governments need to empower constituents in order to deepen support for reform, donors, too, need to empower the

host governments (and local constituencies) to own the design and implementation of economic growth interventions.

Economic growth programs are most successful when the country's leaders and stakeholders champion the interventions. USAID and other donors do seek extensive local inputs and partnership in identifying and designing projects. But ensuring ownership requires listening

more carefully to the recipient and developing programs that the country's leaders and stakeholders want to succeed at least as much as the donors do. In addition, better coordination and greater coherence is also needed among donors (HELP Commission 2007).

The MCC's participatory process of compact formulation is one model for country ownership, but it is applicable mainly in working with a reasonably capable and responsible partner government. The great challenge arises in dealing with governments that do not instill confidence. In the short run this often requires scaling back direct support to the government and focusing on nongovernment organizations and private sector groups, including strengthening their capacity for policy analysis and advocacy of reforms. As opportunities arise, however, atten-

tion has to shift to strengthening government systems to drive reforms through a transparent and accountable process. The objective, in the end, is to promote effective economic governance as a foundation for growth.

Second, given the absence of a universal formula for spurring growth, donors need to study the constraints and opportunities particular to each situation, taking into account the partner country's unique history, culture, economic structure and resources. To customize interventions, donors need flexibility in defining priorities and a willingness to test alternative approaches. This operational model plays squarely into USAID's strength on the ground in each country, and its expertise in delivering flexible support for economic growth in a variety of technical areas.

In conclusion, economic growth is essential for achieving deep reductions in poverty and transformational improvements in social welfare. Economic growth requires rising productivity, driven by private initiative. This, in turn, requires the adoption of policies and institutions that support and facilitate doing

business, and the provision of social services to deliver broad benefits and strengthen political buy-in for reforms. Above all, capable governments and committed leaders are required to identify key constraints and address them effectively.

Well-designed donor programs can play an important role in supporting the reforms and transformations that are needed to foster rapid and broad-based growth. As always, though, the proof of the pudding is in the eating: To what extent, then, have USAID's economic growth (EG) programs actually been effective in promoting broad-based growth? Other Programming for Growth Briefing Notes answer this question by examining evidence from a variety of EG programs. The main conclusion is that many EG programs have indeed delivered impressive development outcomes. But USAID needs to adopt more systematic and rigorous approaches to program evaluation and data collection in order to strengthen institutional learning and feedback for improving program design.

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BRIEFING NOTES CAN BE READ IN ANY SEQUENCE.

Zagha, Roberto and Gobind Nankani. 2005. *Economic growth in the 1990s: learning from a decade of reform*. Washington, D.C.: World Bank.

NOTES

1. For example, national education exams and school autonomy worked well in Finland (Spence 2009), but proved to be a disaster in Nigeria; import substitution worked well for 20 years in Brazil but was a drag on growth in India. In an econometric study of 26 transition countries, Zinnes, Eilat, and Sachs (2001) found that even for institutional reforms such as privatization, the results drastically differed depending on a country's institutional environment, such as the enforcement of property rights.
2. This is a convenient simplification that is largely true but not strictly accurate. Per capita income can also rise as a result of improved prices for export products, as in a commodity boom, or from a demographic transition that increases the ratio of workers to population. These qualifications do not change the basic point about the importance of productivity.
3. The 13 economies are Botswana, Brazil, China, Hong Kong, China, Indonesia, Japan, the Republic of Korea, Malaysia, Malta, Oman, Singapore, Taiwan, China, and Thailand. The commission points out that India and Vietnam are on track to replicate this performance.

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