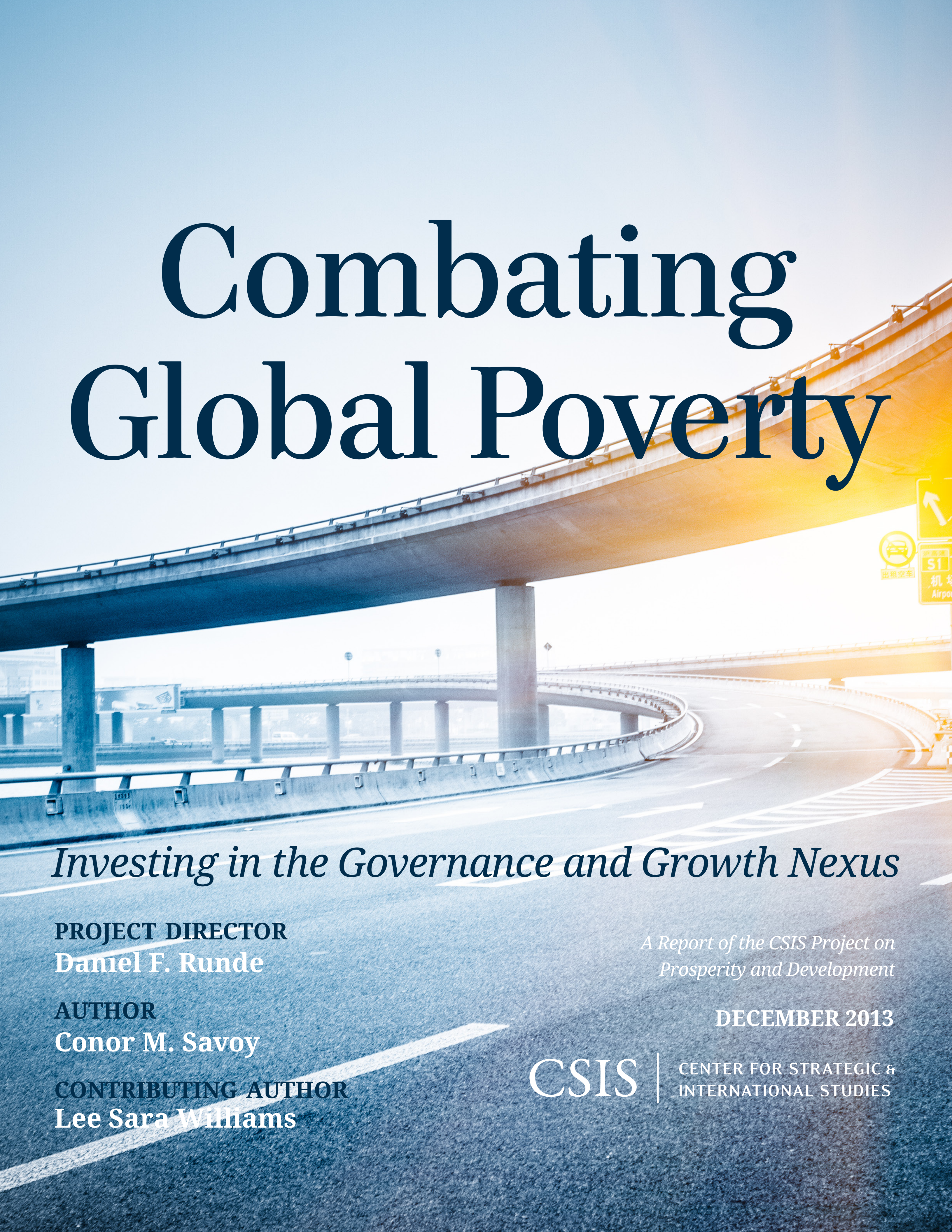

Combating Global Poverty

Investing in the Governance and Growth Nexus

PROJECT DIRECTOR
Daniel F. Runde

AUTHOR
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A Report of the CSIS Project on Prosperity and Development

DECEMBER 2013

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Contents

Acknowledgments iv

Executive Summary vi

1. Introduction 1
2. Governance and Growth Nexus 5
3. U.S. Support for Governance and Growth 15
4. Case Studies 24
    - Tanzania 25
    - Peru 37
    - Indonesia 47
5. Conclusions and Recommendations 58

About the Project Director and Author 62

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off-the-record, not for attribution basis. Needless to say, we spoke with a wide variety of individuals who work in these areas; their insights and comments contributed immensely to our understanding of the issues.

Executive Summary

Foreign aid donors face a changed development landscape that necessitates a new approach to programming resources. In the last 20 years, countries across the developing world democratized, began to improve their governance, and experienced substantial economic growth. Yet, significant challenges remain that must be tackled, many of which fall within the governance and growth nexus. These issues—government effectiveness, rule of law, regulatory policies related to the business and investment climate, and barriers to entry to the formal economy—are the preeminent challenges to expanding broad-based economic growth and continuing to reduce global poverty. The United States needs to shift its focus away from meeting basic human needs toward broader institutional development if it is to increase support for the governance and growth nexus. U.S. foreign aid is overwhelmingly directed toward global health and the delivery of other public goods. This must change.

There is growing evidence that good governance, particularly democratic governance, leads to better development outcomes and improved economic growth. There are numerous studies and analyses indicating this link. These studies resulted from a growing sense in the development community in the 1980s that weak governance was undermining broader efforts. In 1989 the World Bank wrote that "underlying the litany of Africa's development problems is a crisis of governance." Other evidence includes Daniel Kaufmann's work with the World Bank's Worldwide Governance Indicators, Steven Radelet's *Emerging Africa: How 17 Countries Are Leading the Way*, and the recent work by Thomas Carothers and Diana de Gramont. Further, the U.S. government has long supported the idea that good governance and economic growth are linked in speeches and policy documents, but implementing agencies have done little to actually change the way they deliver foreign aid.

There is a window of opportunity for donors to increase their attention to the governance and growth nexus. First, there is a growing body of evidence that supports the idea that improved governance leads to better development outcomes. Second, there is alignment on the importance of governance among a number of actors including the United States, the United Kingdom, the Group of Eight (G8), and others. Third, traditional bilateral donors are under increasing budget pressure due to the lingering effects of the global financial crisis of 2008–2009. Large-scale aid programs designed to support the delivery of basic human needs—for example, public health and basic education—will be increasingly difficult to justify. Finally, many developing countries have seen dramatic increases in domestic resources available either through improved tax collection and financial management, or the commodity resource boom of the last decade. Directing these steadily increasing resources toward basic human needs can free donor resources for other structural priorities. This will also strengthen local governments, which will gain greater legitimacy by delivering goods and services that many expect their government to provide.

In order for the United States to improve its ability to target the governance and growth nexus, it should take the following steps:

1. Increase focus at the country level on governance and growth by integrating it into the U.S. Agency for International Development's (USAID) country development cooperation strategy process as well as its Partnership for Growth initiative.
2. Tackle the politics of governance and growth reform by moving beyond simply engaging in technocratic solutions to improve governance or economic performance.
3. Shift funds and resources to increase support for governance and growth nexus programming; this will require reducing the level of support for programs such as global health in a number of countries.
4. Improve internal and external communication, by creating a coordinating body that would involve the assistant administrators of the two relevant USAID bureaus: Bureau for Democracy, Human Rights, and Governance and the Bureau for Economic Growth, Environment, and Education.
5. Focus the governance and growth nexus on a select number of countries that would benefit most from this work.

To continue sustained growth in the United States' important partners in the developing world, the development community and donor country implementing agencies must look beyond short-term concerns to the second half of the 21st century. To do this, policy should shift to focus on long-term institutional and structural investments in good governance, to lay the groundwork for and support growing self-sufficiency in the provision of basic human needs.

1 Introduction

The global landscape has changed considerably in the last two decades, especially in the developing world. There are significantly more democracies and overall governance has strengthened. Although the main economic story has focused on the BRIC nations, economic growth has accelerated across the developing world with 50 countries averaging 5 percent or better growth since 2000. Further, there is a growing sense that to move developing countries to the next level, donors must increase their focus on governance and growth issues. David Cameron, prime minister of the United Kingdom, captured this in his “golden thread” of governance op-ed published in the *Wall Street Journal*. Cameron wrote, “We also need to tackle the causes of poverty, not just the symptoms. And that means a radical new approach to supporting what I call ‘the golden thread’ of conditions that enable open economies and open societies to thrive: the rule of law, the absence of conflict and corruption, and the presence of property rights and strong institutions.”[1] Although funding for governance and economic growth is a part of U.S. foreign aid, it remains a relatively low priority in spite of rhetorical pronouncements to the contrary. There is significant reason, however, to reverse this trend and return to a focus on governance to ensure broad-based economic growth across the developing world. To do so though will require a shift in how the United States allocates its people, time, and money in delivering foreign assistance.[2]

Beginning in the 1970s the United States steadily shifted the focus of its foreign assistance on meeting basic human needs—public health, basic education, and food security—of the developing world; programs aimed for poverty reduction. This represented a marked shift from the early years of foreign aid when the United States concentrated on improving public administration, infrastructure development, and macroeconomic policy. This support for basic human needs has ebbed and flowed across different presidential administrations, but has intensified over the last 15 years as a series of presidential initiatives have targeted public health spending, basic education, and agricultural development. Governance, in its current form, emerged as a development focus in the 1990s.[3] Within the development context, governance and economic growth encompass a variety of areas. This

1. David Cameron, “Combating Poverty at Its Roots,” *Wall Street Journal*, November 1, 2012, http://online.wsj.com/news/articles/SB10001424052970204712904578090571423009066.

2. James Michel, “Trends in the Practice of Development Cooperation: Strengthening Governance and the Rule of Law,” Center for Strategic and International Studies, August 2013; http://csis.org/files/publication/130904_Michel_TrendsDevelCoop_WEB.pdf.

3. Thomas Carothers and Diane de Gramont, “Aiding Governance in Developing Countries: Progress Amid Uncertainties,” Carnegie Endowment for International Peace, November 2011, 1.

paper is principally concerned with the governance and growth nexus, which we define as having four critical areas:

1. government capacity/effectiveness
2. rule of law
3. regulatory policies related to the investment and business climate
4. barriers to entry

These four areas also include a variety of additional topics. For too long, donors have approached these issues from a technical and best practice model by remaining above the political fray. But these are fundamentally political issues. To achieve lasting growth through this nexus, aid donors must move beyond the technical and begin to tackle the political issues that prevent real reform from occurring.[4]

There is a window of opportunity for donors to increase their attention to the governance and growth nexus. There are a number of reasons for this. First, there is a growing body of evidence that supports the idea that improved governance leads to better development outcomes. Second, there is alignment on the importance of governance between a number of actors ranging from the United States, the United Kingdom, the Group of Eight (G8), and others. Third, traditional bilateral donors are under increasing budget pressure due to the lingering effects of the global financial crisis of 2008–2009. Large-scale aid programs designed to support the delivery of basic human needs—for example, public health and basic education—will be increasingly difficult to justify. Finally, many developing countries have seen dramatic increases in domestic resources available either through improved tax collection and financial management, or through the commodity resource boom of the last decade. Directing these steadily increasing resources toward basic human needs can free donor resources for other structural priorities. This will also have the effect of strengthening local governments, who will gain greater legitimacy by delivering goods and services that many expect their government to provide.

This paper will touch on the issue of democracy, but not directly address it. There is a traditional perception that democracy cannot exist without a minimum level of economic development. However, contemporary research has confirmed a more interdependent relationship between the fields. One issue that this paper seeks to address is the tendency among donors to view programs aimed at building democracy (i.e., the political process, strengthening of parliaments, elections, etc.) as the same as programs improving governance. Elections offer transparency and accountability, but in the absence of rule of law or strong institutions to implement regulations, growth will likely not expand. To be sure, democracy and strengthening the democratic process is part of the puzzle, but donors often focus on these areas to the detriment of the governance issues that most impact growth.

4. See Thomas Carothers and Diane de Gramont, *Development Aid Confronts Politics: The Almost Revolution* (Washington, DC: Carnegie Endowment for International Peace, 2013).

The authors would, therefore, stipulate up front that the governance issues discussed in this paper are best addressed within a democratic framework. From an accountability and transparency perspective (both of which strengthen governance) democracy is the best form of government. Although some believe that good governance can occur absent democracy, ultimately the negatives will overpower any benefits.[5] A well-functioning democracy helps to combat the exclusive economic order that occurs in nondemocratic societies.

Democracy facilitates development in part through advancements in economic integration. Societies that have clear rules, established property rights, and strong legal systems—including courts and dispute mechanisms that are efficient, transparent, and follow the law—attract investment. Democratic countries are less likely to nationalize entire industries or expropriate investment, thus giving investors confidence that their investments are secure. Economies attract investment when governments effectively provide personal security. They do this by delivering public goods such as health care, education, infrastructure, and security, and have mechanisms such as a free press to reduce corruption, allow a free competition of ideas, and indirectly push good policy outcomes. In other words, to attract capital, countries need an appealing, enabling environment: stability, rule of law, and infrastructural institutions, all best achieved through democratic growth. More prosperous countries achieved their wealth, in large part, by utilizing the wealth of others—gaining access to that wealth by facilitating and attracting trade and investment from abroad—and this remains a key ingredient for many countries' development today.

The U.S. government has long recognized the link between democratic governance and broad-based economic growth. The 2010 National Security Strategy states:

> The United States supports the expansion of democracy and human rights abroad because governments that respect these values are more just, peaceful, and legitimate. We also do so because their success abroad fosters an environment that supports America's national interests. Political systems that protect universal rights are ultimately more stable, successful, and secure.[6]

This sentiment is further supported in the 2010 *Quadrennial Diplomacy and Development Review* (QDDR), which sought to strengthen the United States' civilian power. The QDDR notes, "Economic growth is the single most powerful force for eradicating poverty and expanding opportunity. It transforms countries from development recipients into development partners."[7] These sentiments echo earlier rhetoric from the Bush administration,

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5. The political scientist Francis Fukuyama, in his "What Is Governance" paper, states quite clearly, "The current orthodoxy in the development community is that democracy and good governance are mutually supportive. *I would argue that this is more of a theory than an empirically demonstrated fact*, and that we cannot empirically demonstrate the connection if we define one to include the other." [emphasis added] Fukuyama goes on to add, "*An authoritarian regime can be well governed, just as a democracy can be mal-administrated*." [emphasis added] Fukuyama, "What Is Governance?," *Working Paper 314*, Center for Global Development, January 2013, 4.

6. The White House, *National Security Strategy of the United States*, May 2010, 37.

7. U.S. Department of State, *Quadrennial Diplomacy and Development Review* (Washington, DC: Government Printing Office, 2010), 87.

which made economic growth and democratic governance core goals in the 2002 and 2006 National Security Strategies. Indeed democratic governance, for example, has been a core principal of every National Security Strategy since 1990.[8]

In spite of the strong rhetorical bipartisan support for the link between governance and growth from multiple presidential administrations, these fields have yet to be merged in policy and practice. Few, if any, significant shifts in resource allocation toward these fields have occurred under the last two administrations. The Bush administration sought to tap into improved governance and growth in a number of developing countries by creating the Millennium Challenge Corporation (MCC) in 2004. Although the hope was that this new organization could cement these positive trends, it has largely focused on physical infrastructure development. In the broader development community, there are a number of formal and informal barriers that have resulted in a failure to develop connections and avenues of communication in response to renewed thinking about the importance of governance to growth. Some of this disconnect is due to the communities' typically divergent educational and professional backgrounds (economic growth is an area populated by economists, while democracy and governance is a field of political scientists and "recovering" lawyers), and even discrepancies within members' vocabularies resulting from decades of institutional separation.

To overcome institutional and informal challenges, the discussion on the governance and growth nexus must be elevated within the development community as a whole. U.S. policymakers must establish policies and procedures to incentivize and facilitate greater communication and coordination. These practicable, operable policies and practices must account for informal barriers and address the whole picture: policy, programming and budgeting, personnel allocation, and implementation. Given the contemporary global context—such as U.S foreign assistance budget constraints, the continued global struggle for democracy, and what is now known about the link between governance and economic growth—the United States must determine which initiatives it wants to protect and prioritize, and where. Ultimately, this prioritization must account for policies and programming focused on the governance and growth nexus.

This paper focuses on the need for greater U.S. attention to the nexus of growth and governance. The authors spent a year conducting case studies in three developing countries that are considered to be performing well in terms of governance and economic growth. Chapter 2 examines the growth and governance nexus with a particular focus on the emerging body of literature that links democratic governance with strong economic growth, as well as the strategic context. Chapter 3 reviews U.S. foreign assistance spending and programming on democracy and governance as well as economic growth. Chapter 4 consists of three country case studies (Tanzania, Peru, and Indonesia). The last chapter offers conclusions and recommendations.

8. U.S. Agency for International Development, *USAID Strategy on Democracy, Human Rights, and Governance*, June 2013, 9.

2 | Governance and Growth Nexus

This chapter addresses the nexus between governance and growth. Before defining this further, it is important to have a broad definition of governance and economic growth. *Governance is the mechanism by which a country's economic, political, and social authority is apportioned and exercised, and the quality of governance determines the quality of the institutions available to citizens to express their opinions, exercise their rights, and fulfill their obligations.* Good governance is characterized by a democratic government with an inclusive and meaningful competition for political power, a high level of political participation among citizens, and political and civic freedom.[9] *Economic growth covers both an internal improvement of a population's economic circumstances and the expansion of a country's capacity to produce goods and services.*

Over the last two decades, donors and the broader development community have come to recognize the role that good governance—in particular democratic governance—can play in facilitating greater economic growth. This is broadly endorsed by U.S. development agencies through their policy documents, in particular in the global development strategy released by the Obama administration through Presidential Policy Directive-6 (PPD-6). The PPD-6 states that the United States will "foster the next generation of emerging markets by enhancing our focus on broad-based economic growth and democratic governance."[10] The State Department's 2010 *Quadrennial Diplomacy and Development Review*, as well as the U.S. Agency for International Development (USAID) 2008 economic growth strategy and its recently released strategy on democracy, human rights, and governance support this goal. USAID's 2008 economic growth strategy states:

> Economic growth enables countries to reduce and eventually eliminate extreme poverty. It is the surest way for countries to generate resources they need to address illiteracy, poor health, and other development challenges on their own, and thus to emerge from dependence on foreign aid.[11]

U.S. foreign policy and foreign assistance programming often seek primarily to prompt economic growth in underperforming countries or improve discrete governance functions.

9. See Daniel Kaufman, Aart Kraay, and Pablo Zoido-Lobaton, *Governance Matters*, World Bank Policy Research Working Paper 2196, October 1999, 1.

10. The White House, "Presidential Policy Directive-6: Global Development Strategy," September 22, 2010, http://www.whitehouse.gov/the-press-office/2010/09/22/fact-sheet-us-global-development-policy.

11. U.S. Agency for International Development, *Securing the Future: A Strategy for Economic Growth*, April 2008, 3.

Actually it is a more complex relationship that requires governance and growth activities. This is broadly understood by many in the development community, but implementation of this concept remains weak, particularly by the United States. In practice, governance and growth are generally delinked; in some cases, governance is estranged from the development agenda as a whole. The causes of this division include communities relying on their developed areas of expertise, the discrepancies between the personalities of governance experts and economic growth experts, and even a divergence in vocabulary. USAID runs its governance and growth programs through discrete sections of programming and with separately allocated funds. This has resulted in two different strategies and approaches, even though there are very clear linkages between the two areas.

For decades, the United States and other Western bilateral donors have supported broad democracy promotion and governance goals around the world as a cornerstone of foreign policy. This became especially important for the United States in the years immediately following the Cold War as it sought to support the spread of democracy to the former communist countries in Central and Eastern Europe. This also involved a significant economic reform package as the former Warsaw Pact countries not only dismantled authoritarian political states, but also their command socialist economies. Aid and technical assistance lead to the creation of functioning financial markets, stock exchanges, property rights, rule of law, political parties, free and open elections, and many other activities. The so-called "color revolutions" in former Soviet states (Rose in Georgia, Orange in Ukraine, and Tulip in Kyrgyzstan) of the early 2000s and the Arab Spring in early 2011 demonstrated the enduring desire of people to live under freedom and democracy, despite varying outcomes. Much of the popular anger that emerged during these events focused on the lack of transparency and accountability, poor delivery of government services, and a lack of economic opportunity. At the same time, there is a sense in Washington that U.S. democracy and governance programming needs a renewed review and focus. Policymakers need to look at the big picture to identify areas of success and weakness, and effective partners to inform a new strategic vision for this critical work for human freedom and prosperity.

Governance and Growth: Evidence of Interdependence

There are numerous studies and analyses indicating that improved governance—preferably democratic—leads to greater economic growth. These grew out of a growing sense in the development community in the 1980s that weak governance was undermining broader efforts. In 1989, for example, the World Bank wrote that "underlying the litany of Africa's development problems is a crisis of governance."[12] In 1999, under the direction of Daniel Kaufmann, the World Bank launched an aggregate index that sought to capture the

12. Quoted in Carothers and de Gramont, "Aiding Governance in Developing Countries," 19; originally found in World Bank, *Sub-Saharan Africa: From Crisis to Sustainable Growth* (Washington, DC: World Bank, November 1989), 60.

role that governance played in enabling better development outcomes. The World Bank's worldwide governance indicators (WGIs) examine six areas: (1) voice and accountability; (2) political stability and absence of violence; (3) government effectiveness; (4) regulatory quality; (5) rule of law; and (6) control of corruption. Kaufmann and his team found that:

> with new empirical evidence that governance matters, in the sense that *there is a strong causal relationship from good governance to better development outcomes* such as higher per capita incomes, lower infant mortality, and higher literacy. [Emphasis added.][13]

In a 2009 paper Kaufmann and his co-authors highlighted what they had observed over a decade of updating the WGIs. Several of these conclusions are worth discussing. With ten years of data, the WGIs showed that: "1) where there is commitment to reform, improvements in governance can and do occur; 2) significant improvements in governance can and do occur; and 3) yet, on average, there is no evidence of a significant improvement in the quality of governance around the world over the past decade."[14]

There are three studies from the last ten years that highlight the role that governance plays in facilitating greater growth. In particular, these studies also note that democratic governance plays an important role in this process. This adds momentum to a movement that counters at least 40 years of consensus that governments must first economically develop their countries in order to establish a middle class, after which they can afford the "luxury of democracy." The first study, *The Democracy Advantage: How Democracies Promote Prosperity and Peace*, was written by Mort Halperin, Joseph Siegle, and Michael Weinstein. The study examined 50 democratic and undemocratic countries and found overwhelming evidence that democracy supports development and reduces the likelihood of violent conflict, noting the recent comparative success of democracies, like the Baltic States, Costa Rica, and Ghana, over authoritarian Uzbekistan, Syria, and Zimbabwe. The report provided evidence of the following:

- Effective democracies minimize the polarizing effects of interest groups, tend to reflect a broader range of interests, and help to ensure that citizens maintain the power to eject ineffective leaders.
- Systems reflecting more traditional "democratic values" are associated with more robust and stable economic growth.
- Economic success in authoritarian systems is often the result of success within an isolated sector.
- Democracies perform better than most authoritarian governments and, at a minimum, meet or surpass the growth rates and deficit reductions of dictatorships.

13. Kaufman et al., *Governance Matters*, 1.

14. Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi, "Governance Matters 2009: Learning from over a decade of the Worldwide Governance Indicators," June 29, 2009, http://www.brookings.edu/research/opinions/2009/06/29-governance-indicators-kaufmann.

Although the report's authors exercise due caution in drawing conclusions from these divergent examples, they find the scale of evidence offers a significant indication that democracy can in fact facilitate, rather than impede, economic development.[15]

Daron Acemoglu and James A. Robinson's *Why Nations Fail* is an important contribution to the literature on why some countries are rich and some are poor. They argue that countries, such as Egypt, are poor because "it [Egypt] has been ruled by a narrow elite that have organized society for their own benefit at the expense of the vast mass of people. Political power has been narrowly concentrated, and has been used to create great wealth for those who possess it."[16] They argue that, in contrast, countries such as the United States and Great Britain grew prosperous because they created inclusive economic and political institutions that sought to benefit society as a whole, most often around a critical juncture such as the Glorious Revolution of 1688 in the case of Great Britain. The authors dismiss the idea that culture, geography, and other common explanations for the gap between rich and poor countries, by providing examples such as Botswana, which has bucked broader regional trends through the creation of inclusive institutions. About Botswana, Acemoglu and Robinson write, "Inclusive political institutions bred political stability and supported inclusive economic institutions . . . inclusive economic institutions increased the viability and durability of inclusive political institutions."[17]

In 2010 Steven Radelet, the former chief economist at USAID, examined 17 sub-Saharan African countries in *Emerging Africa: How 17 Countries Are Leading the Way*. The 17 countries—out of 54 in the region—were the best economic performers from the mid-1990s to 2008, exhibiting improvements such as decreases in conflict, more responsive governance, and reductions in overall poverty levels. They averaged more than 3 percent growth over this period—in contrast with overall African growth rates during that period of around zero percent. In examining the considerable discrepancies in the level of progress within the region, Radelet noted several key differences; for example, most of the 17 emerging players were democracies, and none were oil exporters. One of the five key drivers of a country's overall development success identified by this research was the presence of a more democratic and accountable government. The other four drivers of success included: (1) improvements in economic policy; (2) the proliferation of new technologies, such as mobile phones; (3) a new generation of technocrats, business leaders, and political leaders—often trained in the West; and (4) significant reductions in debt burdens.[18]

This is not to suggest that all accept that there is a link between improved democratic governance and greater economic growth. As Thomas Carothers and Diana de Gramont

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15. Morton H. Halperin, Joseph T. Siegle, and Michael M. Weinstein, *The Democracy Advantage: How Democracies Promote Prosperity and Peace* (New York: Routledge, 2010).

16. Daron Acemoglu and James A. Robinson, *Why Nations Fail: The Origins of Power, Prosperity, and Poverty* (New York: Crown Business, 2012), 3.

17. Ibid., 413.

18. Steven Radelet, *Emerging Africa: How 17 Countries Are Leading the Way* (Washington, DC: Center for Global Development, 2010).

pointed out in their 2011 article, "Aiding Governance in Developing Countries," there are examples of countries that have seen strong economic growth in the absence of democratic good governance.[19] This includes countries such as China, South Korea, Singapore, and Vietnam. For example, South Korea experienced strong economic growth in the 1970s and 1980s when it was under military rule and lacked clear rule of law. And yet, even in these instances, the rise of good governance in South Korea was associated with the introduction of democracy in the 1980s and 1990s and led to even greater economic growth. For many, of course, China is seen as the obvious counterweight to the Western model of governance and growth. It is now the second largest economy in the world, yet it remains firmly under one-party rule. It would be premature to write the Chinese Communist Party's obituary, but there are cracks showing, many of which are associated with a lack of good governance. Rule of law is weak, corruption is high, and there is a sense that there is a growing barrier to entry for many who are not connected to the elite.[20]

At the same time, the success of democracies depends largely on the people's satisfaction with the government's economic performance—if a population's economic circumstances have not improved, or worse, have declined, they are less likely to sustain democratic aspirations. A growing body of quantitative research indicates a strong association between poor economic performance and democratic failure.[21] For example, Botswana's democratic government's comparatively efficient handling of the country's natural resources is often associated with its democratic success and vice versa. In comparison, Russia's failure to facilitate a wide distribution of economic benefits since Vladimir Putin came to power in 2000 is widely thought to have resulted in its people's apathy and failure to address its faltering democratic performance. A recent study by Milan Svolik indicates that a voting populace suffering from widespread political apathy due to a recent history of unresponsive, corrupt governance is more likely to revert to authoritarianism, rather than simply replacing leadership within the context of normal democratic processes.[22] Similarly, a populace accustomed to a closed market is more likely to be suspicious of profit-seeking actors, and more likely to dismiss the concept of a free market entirely than to identify any bad behavior as an isolated occurrence. In other words, poor economic performance in a new democracy may make it more likely to lead to democratic breakdown, whereas a historically democratic country typically addresses poor performance within the electoral process.

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19. Carothers and de Gramont, "Aiding Governance in Developing Countries," 20.

20. Larry Diamond, "Chinese Communism and the Seventy Year Itch," *The Atlantic*, October 29, 2013, http://www.theatlantic.com/china/archive/2013/10/chinese-communism-and-the-70-year-itch/280960/.

21. See, for example, Michael Bernhard, Timothy Nordstrom, and Christopher Reenock, "Economic Performance, Institutional Intermediation, and Democratic Survival," *Journal of Politics* 63(3):775–803 (2001); José Antonio Cheibub, *Presidentialism, Parliamentarism, and Democracy* (New York: Cambridge University Press, 2007); Adam Przeworski, Michael E. Alvarez, Jose Antonio Cheibub, and Fernando Limongi, *Democracy and Development: Political Institutions and Well-Being in the World*, 1950–1990 (New York: Cambridge University Press, 2000); Milan Svolik, "Authoritarian Reversals and Democratic Consolidation," *American Political Science Review* 102(2):153–168 (2008); Steven Haggard and Robert R. Kaufman, *The Political Economy of Democratic Transitions* (Princeton, NJ: Princeton University Press, 1995).

22. Milan Svolik, *Learning to Love Democracy: Electoral Accountability, Government Performance, and the Success of Democracy* 35 (October 2010).

The Governance and Growth Nexus

Governance and growth directly impact one another, but most importantly the nexus leads to broad-based economic growth. The four areas—government effectiveness, rule of law, critical regulatory policies, and barriers to entry—cut across both governance and growth. Indeed, even within these nexus issues there is significant overlap. It is, however, important to note that just as donors need to see governance and growth as intrinsically linked, there are not clear divisions between the four areas that form the nexus. Government effectiveness impacts the rule of law. Rule of law and government effectiveness impacts the promulgation and enforcement of critical regulatory policies. All these areas influence barriers to entry to the formal economy. Seeing the governance and growth nexus as an integrated development challenge is critical to cementing the immense gains of the past 20 years.

Government effectiveness. The institutional capacity of government to effectively and efficiently deliver social goods to its people is critical to growth. In particular, institutions that provide incentives to enforce formal and informal rules are necessary.[23] Dani Rodrick notes,

> Desirable institutions provide security of property rights, enforce contracts, stimulate entrepreneurship, foster integration in the world economy, maintain macroeconomic stability, manage risk-taking by financial intermediaries, supply social insurance and safety nets, and enhance voice and accountability.[24]

Donors have tended to focus on technical assistance programs to improve government systems and the human capacity of the civil service to implement rules and regulations. This is useful, but more needs to be done to strengthen institutions in developing countries.

Rule of law. Rule of law is seen as "the presence or absence of specific, observable criteria of the law or the legal system." This includes "a formally independent and impartial judiciary; laws that are public; the absence of laws that apply only to particular individuals or classes; the absence of retroactive laws; and provisions for judicial review of government action."[25] From the governance and growth nexus perspective, rule of law is primarily focused on the strength of legal institutions related to the business and investment climate. In particular, donors need to focus on the commercial court system, commercial code, contract enforcement, and ability to resolve insolvency.

Critical regulatory policies. There are a group of regulatory policies related to property rights, contract enforcement, investment, and starting a business that support the

23. Douglass C. North, "The Foundations of New Institutional Economics," Lecture, Center for International Private Enterprise, http://developmentinstitute.org/north/north_script_en.pdf, 3–4.
24. Dani Rodrick, "Second-Best Institutions," NBER Working Paper 14050, June 2008, 1.
25. Matthew Stephenson, "Rule of Law as a Goal of Development Policy," The World Bank, 2005, http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTLAWJUSTINST/0,,contentMDK:20763583~menuPK:1989584~pagePK:210058~piPK:210062~theSitePK:1974062~isCURL:Y,00.html.

governance and growth nexus. Properly structured and enforced regulations then reinforce the overall rule of law in a particular country. Of course, reform of regulations cannot occur within a bubble. An oft-cited criticism of the Washington Consensus of the 1980s and 1990s is that it pursued policy and regulatory reform without regard to the strength of local institutions. In particular, there was a lack of capacity to implement the regulatory reforms. As Carothers and de Gramont note, "The weak states prevalent in the developing world were poorly prepared for designing, enacting, and above all implementing the many technically complex, administratively demanding policy measures that the market model required."[26] Although progress has been made, sadly this remains largely the case.

Barriers to entry. In many countries, the barriers to entry to the formal economy remain extremely high, leading to the creation of large informal sectors that provide little opportunity for long-term economic growth. Large-scale informal economies all contribute to higher poverty, weak rule of law, poor resource allocation, and a variety of other development challenges. Common barriers to entry include the fees and requirements for registering a business; fees and requirements for land titling; permits and licenses; excessive taxes; regulatory burden; the existence of cartels and monopolies; and barriers to exit.[27]

The Strategic Context

Since the United States made the decision to switch its development focus toward basic human needs 40 years ago, the global strategic context has changed dramatically, opening a window for a greater focus on the governance and growth nexus. In particular, there is a group of emerging middle and lower-middle income countries that can increasingly pay for their own development. As a result, the United States has the opportunity to shift resources to better support programs and projects aimed at governance and growth.

The end of the Cold War ushered in a period of democratic growth across the world. In 1991 less than half the world's countries were considered electoral democracies. By the end of the first decade of the 21st century that numbers was over 60 percent. This third wave of democratization ended the communist regimes in Eastern and Central Europe, swept away the military juntas of Latin America, and many of the kleptocracies of sub-Saharan Africa. Certainly many of the countries that transitioned to democracy did so on their own terms and may have the trappings of Western democracy, but significant regional and cultural variances exist. Stubborn autocratic holdouts remain, including Cuba, Saudi Arabia, North Korea, and China. Further, there has been some backsliding with prominent military coups in Mali in 2011 and Pakistan in 1999, as well as illiberal democracies in parts of Latin America, sub-Saharan Africa, and elsewhere. But what seems to be equally true is the resilience of some democracies in the face of the continued existence of authoritarian regimes or backsliding by neighbors.

26. Carothers and de Gramont, *Development Aid Confronts Politics*, 58.
27. Kim Eric Bettcher and Nafisul Islam, *Reducing Economic Informality by Opening Access to Opportunity*, Center for International Private Enterprise, June 2009, 3.

More recently, two major events shaped the global spread of democracy and good governance, both of which were aimed at the broader Middle East. First, the Bush administration specifically listed democratic government as a key factor that would lead to the defeat of extremism and terrorism. This was first enunciated in the National Security Strategy of 2002 and built upon in President George W. Bush's second inaugural address when he proclaimed a "freedom agenda" that sought to bring democracy to the remaining holdouts. Although some believed that Bush's rhetoric used to support this initiative was radically at odds with the mainstream of American foreign policy, it was largely a direct descendent of the Wilsonian stream of thought that saw self-determination and democracy as key objectives for the United States. The deviation largely came from its connection with the twin wars in Iraq and Afghanistan that involved large-scale nation-building efforts that were part of integrated counterinsurgency campaigns. For many, the tremendous expenditure of resources called into question the wisdom of democracy promotion. In spite of the unresolved experience in Afghanistan and Iraq, there were a series of color revolutions during this time in former Soviet states (Rose in Georgia, Orange in Ukraine, and Tulip in Kyrgyzstan) that suggested other routes for democracy promotion that did not require the commitment of American military power.

The second event was the Arab Spring that began in 2011 when a Tunisian fruit vendor set himself on fire to protest the economic and political repression present in his country. This single act led to massive protests throughout Tunisia—largely seen as a Western-oriented, politically stable, investment-friendly country—that ultimately led to the ouster of Zine al Abidine Ben Ali who had ruled for 24 years. Events in Tunisia then triggered protests across the Middle East and North Africa with large-scale protests and uprisings in Egypt, Libya, Jordan, Syria, Morocco, Yemen, and other countries. Protests in Egypt ultimately overthrew Hosni Mubarak who had ruled since 1981. Protests in Libya turned to full-scale civil war, as rebels with the support of an international coalition removed and killed Muammar Qaddafi, who had ruled since 1969. Large demonstrations against Bashar al-Assad's regime in Syria quickly descended into full-scale civil war, which continues to rage as of this writing. In Egypt, Libya, and Tunisia the political situation remains unstable as a series of forces, largely divided between liberal Western-leaning secularists and Islamists, jockey for power. The people in all three countries remain a potent force that is not afraid to take to the streets to demand accountability and change.

The Arab Spring occurred against the backdrop of a new presidential administration. Although the Obama administration rhetorically supports democracy and good governance through its national security strategy, QDDR, and global development strategy, there is a general sense that the United States has not done enough. In his April 2009 speech in Cairo, President Barack Obama endorsed the principle that democracies are more peaceful and responsive to the will of their people. This came at a time of debate in the United States over how to respond to the Green Revolution in Iran following a disputed presidential election in that country. But in spite of this endorsement the Obama administration was slow to respond to the Arab Spring when it began. Of course, it should be noted that the balance of conventional wisdom in the United States was that Mubarak in Egypt should be supported because of the stability his regime provided in the region. What is clear in the situation of Egypt is that the instability that occurred under Mubarak and subsequently is largely due to anger over economic opportunity. Nonetheless, the resource support for governance and growth efforts simply has not matched the rhetoric of the president or the U.S. policy documents released since 2009.

Coupled with the spread of democracy in the last 20 years has been the rise of free market capitalism, whether in its Western form or its more managed state capitalism cousin. The ideological division between capitalism and communism that occurred during the Cold War is largely a thing of the past. Globalization has reduced trade and economic barriers across the world. What is clear, especially in light of the Arab Spring and other recent protests, is that much of the developing world's economy remains captured by elites who seek to block the benefits from accruing to the majority of citizens. This is not meant to be an exhaustive overview of the economic history of the last 20 years, but there are significant trends that are worth highlighting due to their impact on the growth and governance discussion. In particular, the rise of new economic powerhouses such as China and India has led to a massive reduction in global poverty. Importantly, these two nations have achieved poverty reduction through growth, structural reforms to their economies, and strong institutions. Beyond China and India (and the other BRIC nations), there is a group of emerging nations in Latin America, Southeast Asia, and sub-Saharan Africa that have weathered the global financial crisis and seen far better growth than advanced economies in recent years.

Looking Ahead

In spite of the immense progress that has been made in democracy, good governance, and economic growth since the end of the Cold War, numerous challenges remain. This requires a recommitment of bilateral donors, especially the United States, to support critical reforms to ensure that the gains of the last 20 years are not erased by crises. In particular, there are three lingering strategic challenges: (1) good governance in many areas remains elusive, democracy or otherwise; (2) a need to address the implementation gap; and (3) poverty reduction is needed to balance growth. These strategic issues can begin to be addressed by focusing more resources on the governance and growth nexus.

Good governance remains elusive. Although many countries have made impressive strides in the field of governance and are increasingly democratic, significant governance challenges remain. This also appears to be a major barrier to greater growth in a number of countries. The World Bank's *Doing Business* reporting has been an admirable success in providing a ranking of how countries are improving their overall business regulatory environment. Further, it has spurred a large number of regulatory reforms, at last count 2,000 worldwide since it launched in 2003. World Bank analysis of ten years' worth of data suggests that the indicators that measure the strength of legal institutions—broadly related to the rule of law—have made the least progress since the first report. This includes enforcing contracts, resolving insolvency, and protecting investors.[28] Although the *Doing Business* reports focus on the regulatory environment for small and medium sized enterprises, these indicators point to larger governance problems. Part of this inertia is due to the fact that these are tough governance challenges that often require donors to tackle entrenched political positions in a particular country. Reforming regulations is generally an easy proposition, but getting the bureaucracy to enforce them and protect investors' rights is a tougher proposition. Such progress will require that donors become more comfortable in addressing the fundamental political and economic structures that exist in developing countries.[29]

Addressing the Implementation gap. Many countries have adopted good laws and regulations that often represent best practice in whatever particular area they affect; however, these are frequently not implemented. As one study notes, "When laws and regulations are not properly adopted, such discrepancy creates an implementation gap—the difference between laws on the books and how they function in practice."[30] This gap is important, because it undermines a government's credibility, increases corruption, and creates further barriers to business. This situation then further hampers greater economic growth. In particular, this negatively impacts the investment climate; if investors face a situation where a government does not implement its laws fairly or predictably, then they will have less confidence that their investment will be safe. The implementation gap is closely related to the governance and growth nexus and must be tackled as part of this.

Poverty reduction is needed to balance growth. Perhaps one of the most pressing challenges from a development standpoint is the need for poverty reduction to balance growth. Although many of the best performing developing countries have seen impressive gross domestic product (GDP) growth figures over the last decade, this has not necessarily translated into broad-based poverty reduction. In many countries this is manifested as a rural versus urban divide, coastal versus interior divide, or marginalized groups (such as an ethnic minority) versus the majority.

28. World Bank, *Doing Business Report 2013* (Washington, DC, 2013), 8.
29. Carothers and de Gramont, "Aiding Governance in Developing Countries," 5.
30. Maiko Nakagaki, "Closing the Implementation Gap," Center for International Private Enterprise, June 15, 2013, 2.

3 U.S. Support for Governance and Growth

Donor support for democracy and governance (DG) and economic growth (EG) is traditionally divided within the bureaucracy. This is particularly true of the United States, which has large programs in both areas and has been a traditional funder of both DG and EG. This chapter will provide an overview of U.S. government programs for governance and growth. In addition, it will review U.S. Agency for International Development (USAID) strategies for both economic growth and democracy and governance. Finally, it will conclude with a review of the Millennium Challenge Corporation (MCC) and the recently launched Partnership for Growth, which is an effort to tackle governance and growth as one.

Although there are some 20 agencies and departments involved in dispensing U.S. foreign aid, the vast majority of DG and EG money is dispensed by the USAID and the MCC. The vast majority of this money is allocated to two State Department/USAID sub-accounts, labeled "Economic Development" and "Governing Justly and Democratically." In fiscal year 2014 (FY14), the Obama administration requested $3.3 billion for economic growth and $2.8 billion for democracy and governance work. Both of these accounts represent relatively small percentages of the overall U.S. foreign aid budget, approximately 12 percent and 8 percent, respectively. There has been an uptick in governance and growth funding, but much of this is driven by a renewed focus on food security, and increased spending in Afghanistan and Pakistan.

Although the United States does allocate nearly one-fifth of its foreign aid to either DG or EG work, much of it is spent on specific presidential initiatives or countries. For example, Feed the Future, the food security initiative, accounts for nearly $1.5 billion per year in economic growth spending. This is an increase of approximately $1 billion from the end of the Bush administration. Further, much of the money that is allocated in the governance and growth categories is part of the large aid packages that the United States has annually appropriated for Afghanistan and Pakistan as part of the nation-building effort in those two countries. This has artificially inflated both sub-accounts and it remains to be seen what will happen as the United States draws down its military presence in Afghanistan. Given the current budget situation, it would seem unlikely that the money will be preserved to fund other governance and growth priorities around the world. Table 3.1 outlines the total assistance budget for FY06 to FY14 provided by the U.S. State Department and

Table 3.1. Total State Department/USAID Assistance ($US million)

FY06	*FY07*	*FY08*	*FY09*	*FY10*	*FY11*	*FY12*	*FY13*	*FY14*
20,339.3	23,794.9	26,690.8	32,711.5	36,859.6	31,596.0	33,917.6	33,749.1	31,113.1

Note: FY, fiscal year; USAID, U.S. Agency for International Development.
Source: Curt Tarnoff, "Foreign Aid: An Introduction to U.S. Programs and Policy," *CRS Report for Congress*, April 20, 2012, 5, http://www.foreignassistance.gov.

Table 3.2. Promoting Economic Growth and Prosperity ($US million)

Sub-Account	*FY06*	*FY07*	*FY08*	*FY09*	*FY10*	*FY11*	*FY12*	*FY13*	*FY14*
Macroeconomic Growth	474.1	591.5	590.1	335.9	287.3	418.8	342.7	421.3	295.1
Trade and Investment	416.7	331.6	204.1	216.7	264.6	185.2	184.4	201.4	160.5
Financial Sector	280.2	176.8	198.2	142.4	125.4	92.7	80.6	70.5	100.5
Infrastructure	755.9	723.9	945.8	1,017.3	1,101.0	1,258.0	930.0	1,025.6	788.8
Agriculture	567.0	538.1	474.3	1,081.1	1,685.8	1,389.1	1,400.6	1,467.1	1,275.6
Private-Sector Competitiveness	530.5	385.4	388.1	563.9	670.1	506.8	506.9	531.2	546.4
Economic Opportunity	132.7	127.0	155.1	237.3	241.4	158.8	193.7	189.7	153.8
Total	3,157.1	2,874.4	2,954.8	3,596.7	3,751.5	3,280.3	2,967.9	3,906.8	3,320.7

Note: FY, fiscal year.
Source: Curt Tarnoff, "Foreign Aid: An Introduction to U.S. Programs and Policy," *CRS Report for Congress*, April 20, 2012, 5, http://www.foreignassistance.gov.

USAID. Table 3.2 outlines the budgeted amounts specifically for promoting economic growth and prosperity for FY06 to FY14. Funds in the sub-accounts are earmarked for specific purposes as described below.

- **Macroeconomic Growth:** Establish a stable and predictable macroeconomic environment that encourages the private sector to make productivity and growth-enhancing investments. A solid macroeconomic foundation for growth consists of stable fiscal and monetary policies and institutions, and the ability of the government to utilize these tools, in concert, to manipulate the economy. *In FY14, $190 million (64 percent) of this account was allocated to one country, Jordan.*

- **Trade and Investment:** Support the institution of international agreements and trade facilitation techniques that allow countries to exchange goods and services and make financial investments without fear of loss. This is done through supporting public-sector and private-sector efforts to participate effectively in international trade and investment agreements and institutions, implement international agreements, adjust to changing trade conditions, and take full advantage of trade and investment to generate economic growth and reduce poverty. *In FY14, the largest single recipient country is Afghanistan, which is budgeted to received $30.6 million or 19 percent of total funding.*

- **Financial Sector:** Supports the establishment of a sound, private, well-functioning, equitable financial sector that fulfills critical roles in a market economy, most importantly financial intermediation—the efficient generation and allocation of savings to their most productive use. *In FY14, Egypt is budgeted to receive $64.5 million or 64 percent of total funding.*

- **Infrastructure:** Supports the creation, improvement, and sustainability of physical infrastructure and related services in both urban and rural areas, to enhance the economic environment and improve economic productivity, including for women. The main infrastructures are energy, including electric power transmission lines and distribution networks, oil and gas terminals, refineries, storage facilities, and pipelines; telecom and transport, including roads, airports, railways, and ports. *In FY14, infrastructure funding for Pakistan and Afghanistan account for almost 67 percent of total aid funding ($364.7 million for Pakistan and $161 million for Afghanistan).*

- **Agriculture:** Supports agricultural endeavors. Agriculture is the science and practice of food, feed, and fiber production (including forestry, wildlife, fisheries, aquaculture and floriculture) and its relationships to natural resources, processing, marketing, distribution, utilization (including nutrition), and trade. *The majority of this money is now programmed to support the Feed the Future (FTF) food security initiative; in FY14, this amounts to over $1 billion.*[31]

- **Private-Sector Competitiveness:** Supports efforts to improve policies, laws, regulations, and administrative practices that affect the private sector's ability to compete nationally and internationally. All the sectors include not only the adoption and implementation of policies, but also their oversight by elected officials, nongovernmental organizations (NGOs), and the private sector. *In FY14, $118 million (over 21 percent) was allocated to Afghanistan.*

- **Economic Opportunity:** Supports efforts aimed at helping poor households (especially female-headed households as they are often the most disadvantaged) connect to the economic opportunities created by growth. It includes both efforts to enhance the current income-earning prospects of poor households, as well as efforts to ensure that they can accumulate and protect productive assets.[32]

Table 3.3 outlines the budgeted amounts specifically for governing justly and democratically for FY06 to FY14. Funds in the sub-accounts are earmarked for specific purposes as described below.

- **Rule of Law and Human Rights:** Upholds the rule of law principle under which all persons institutions and entities, public and private, including the state itself, are accountable to laws publicly promulgated, equally enforced, and independently

31. "Feed the Future Initiative," http://www.foreignassistance.gov/web/Initiative_FTF_2012.aspx?FY=2012.
32. Descriptions of sub-sectors under the economic development sub-account are drawn from the data now available at http://www.foreignassistance.gov.

Table 3.3. Governing Justly and Democratically ($US million)

	FY06	*FY07*	*FY08*	*FY09*	*FY10*	*FY11*	*FY12*	*FY13*	*FY14*
Rule of Law and Human Rights	437.5	532.0	612.4	699.3	1,077.4	758.4	950.4	1,106.1	909.5
Good Governance	637.6	763.2	761.9	1,088.4	1,621.6	973.6	905.5	1,002.3	1,206.6
Political Competition	203.3	305.4	295.2	432.7	320.9	231.3	233.7	236.8	210.1
Civil Society	479.8	540.8	593.3	481.7	636.8	553.6	506.5	493.8	493.1
Total	1,758.1	2,141.3	2,258.5	2,262.8	3,656.7	2,516.9	2,596.3	2,839.1	2,819.2

Note: Discrepancies in totals are due to rounding. FY, fiscal year.
Source: Curt Tarnoff, "Foreign Aid: An Introduction to U.S. Programs and Policy," *CRS Report for Congress*, April 20, 2012, 5, http://www.foreignassistance.gov.

adjudicated, and which are consistent with international human rights law. It also requires measures to ensure adherence to the principles of supremacy of law, equality before the law, accountability to the law, fairness in the application of the law, separation of powers, participation in decisionmaking, legal certainty, avoidance of arbitrariness, and procedural and legal transparency. *In FY14, $328.1 million was requested to support rule of law and human rights programs in Afghanistan.*

- **Good Governance:** Supports avenues for meaningful public participation and oversight, as well as for substantive separation of powers through institutional checks and balances. Transparency and integrity are also vital to government effectiveness and political stability. *In FY14, $696.0 million was requested for Afghanistan. The next largest planned recipient was Pakistan at $60.0 million.*

- **Political Competition (including consensus building):** Supports peaceful political competition and negotiation of disputes through a democratic and representative political process. It creates and supports vehicles for people to debate public priorities, air alternative solutions, win support for proposed remedies, and provide input to decisions that affect their lives. *In FY14, $47.0 million was requested for political competition programs in Afghanistan.*

- **Civil Society:** Provides mediums (media, civil society organizations, advocacy groups/associations) through which citizens can freely organize, advocate, and communicate with their government and with each other; strengthen a democratic political culture that values citizen and civic engagement, tolerance, and respect for human rights; empower citizens to participate in decisionmaking on matters affecting them; and mobilize constituencies to advocate for political reform, good governance, and strengthened democratic institutions and processes. *In FY14, $60.3 million was requested for Afghanistan and $47.0 million for Pakistan to support civil society.*[33]

33. Descriptions of sub-accounts for the governing justly and democratically account are drawn from http://www.foreignassistance.gov.

Millennium Challenge Corporation

After USAID, the next largest pool of U.S. aid dollars directed toward DG and EG work is through the Millennium Challenge Corporation (MCC). Created in 2004 during the Bush administration, the MCC seeks to pursue economic growth and poverty reduction in well performing countries with a large dollar, multiyear compact. Countries are selected from either low-income countries (amongst the poorest 75 countries) or from lower-middle income countries (below $4,035 per capita income). The MCC then uses a series of indicators within three broad categories to determine countries eligible for a compact: ruling justly, investing in people, and encouraging economic freedom. Once selected, the MCC then conducts an analysis to identify binding constraints to growth in the country in order to develop a series of compact projects that address these constraints. Not surprisingly, given the fact that lack of physical infrastructure is a major constraint in the developing world, a majority of MCC money is directed toward infrastructure projects.

In FY13 the MCC spent $904.5 million on its compacts. Of this, $500 million (55.2 percent) was spent on economic development programs. The next largest category was health, which accounted for 18.9 percent of MCC spending. The majority of economic development money, $335.8 million or 67.1 percent was spent on infrastructure projects. The rest of the economic development money in FY13 was allocated toward agriculture, macroeconomic foundation for growth, private-sector competitiveness, and financial sector projects.[34] The MCC's allocation of resources is in marked contrast to USAID and the State Department, which in FY14 plans to spend nearly 30 percent of its resources on public health programs and another 26 percent on security assistance. This is not to suggest, as some have, that the MCC is the solution. Far from it; it is a relatively small piece of the overall U.S. foreign aid budget and works in a small subset of countries, but because of its requirements MCC compacts cannot be extended to all countries that are recipients of U.S. foreign aid. *It does, however, suggest that the United States should reconsider how it spends its assistance, especially in countries that are seen as good performers.*

Review of 2008 Economic Growth Strategy

USAID's most recent strategy for economic growth, released in 2008, seeks to help countries achieve "rapid, sustained, and broad-based" growth.[35] In its strategy, USAID writes, "Burdensome and corruption-prone systems of regulation, weak property rights, and other microeconomic manifestations of poor economic governance are emerging as the binding constraints to growth in a wide range of countries."[36] Importantly, this strategy also notes what this paper argues: USAID's commitment to allocating resources to economic growth activities is limited. Further, it adds that staffing remains a challenge for USAID, in

34. Data from http://www.foreignassistance.gov.
35. USAID, *Securing the Future*, 23.
36. Ibid., 34.

particular finding the correct type of technical personnel to execute economic growth projects. This has changed somewhat through recent hiring, but resource allocation has not changed markedly since the 2008 strategy was published.

To operationalize its strategy, USAID defines “rapid” as growth of at least 2 percent per year; “sustained” is defined as growth over a long-term period; and “broad-based” is defined as including major income groups, ethnic groups, and women. In order to do so, USAID pursues three broad objectives: (1) develop well-functioning markets; (2) enhance access to productive opportunities; and (3) strengthen the international framework of policies, institutions, and public goods that support growth.[37] Within the growth and governance nexus that this paper presents, USAID’s economic growth strategy highlights the areas that are necessary to spurring growth through better governance. USAID’s first objective includes:

- fiscal policy and administrative reform
- monetary policy and capacity-building
- reforming regulatory systems
- strengthening systems to establish and enforce property rights
- developing systems of commercial law

The second objective, enhancing access to productive opportunities, includes:

- inflexible labor markets
- weak and inaccessible judicial systems
- burdensome business regulation.[38]

The 2008 economic growth strategy is broadly in line with the governance and growth nexus described in this paper; however, it remains at its base a strategy focused on economic growth. As much as it touches on issues of governance that impact growth, it remains rooted in a bifurcated bureaucratic system.

Review of 2013 Democracy, Human Rights, and Governance Strategy

In 2013 USAID released its first democracy and governance strategy in 20 years, which prominently incorporated human rights into the broader area. This operationalizes many of the concepts that are embraced in the national security strategy, *Quadrennial Diplomacy and Development Review* (QDDR), and the global development strategy (Presidential Policy Directive-6, PPD-6). This also represented an internal shift, as USAID elevated human

37. Ibid., 23.
38. Ibid., 24–28.

rights to be a central part of the new strategy. The new democracy, human rights, and governance (DRG) strategy is important for three reasons: (1) it directly links good democratic governance as necessary for broad-based economic growth; (2) it emphasizes the importance of the local political and economic context for the success of aid projects; and (3) it argues for the integration of DRG principals into other development issue areas.

Perhaps the most important thing the new DRG strategy does is emphasis how important good democratic governance is for broad-based economic growth. As this report argues, there is a growing body of evidence (much of which is favorably cited in the 2013 DRG strategy) that argues broad-based economic growth is difficult absent democratic governance. Lack of political accountability and lack of transparency breeds corruption, which ultimately stifles economic opportunities and poverty reduction. The DRG strategy states, "Poverty is underpinned by poor and undemocratic governance, weak and corrupt institutions, and entrenched power dynamics that lead to political and economic exclusion."[39] It goes on to add, "Sustainable approaches to address poverty therefore require improvements in DRG to develop responsive government institutions capable of providing basic services and fostering inclusive economic growth."[40]

Second, the DRG strategy emphasizes that the political economic context is important in determining whether a country can implement the reforms necessary to achieve good governance and broad-based economic growth. Tackling the difficult issues that come with governance and economic reform often requires the explicit political support of local governments. Matters related to accountability, transparency, and corruption are inherently political in nature; if the local elite does not support reform then it is unlikely a donor will make headway. Simply examining the political economic context of a country will likely identify many of these issues. The strategy notes that "by considering the political context in their country, Missions can begin to identify the high level DRG strategic issues they will likely face." It concludes,

> Obstacles to economic and social development are not only technical in nature; they are rooted in the political economy of a country. Therefore technical efforts to promote poverty reduction and socioeconomic development must address democracy, human rights, and governance issues, including a lack of citizen participation and poor government accountability."[41]

Finally, USAID argues that DRG needs to be integrated into other development issue areas. The strategy "acknowledges the importance of better integrating economic governance work into relevant DRG programs and activities."[42] This is an important step for USAID to acknowledge, given the fact that many of the governance challenges that linger are related to issues around institutional capacity. Refocusing some of USAID's resources from the public health sector toward strengthening government capacity in these areas would be useful. Often governments have the resources to pay for the social services, but

39. USAID, *USAID Strategy*, 4.
40. Ibid., 4.
41. Ibid., 5.
42. Ibid., 5.

lack the means to deliver them to the people. Strengthening the delivery side—that is, capacity—should be a focus of USAID.

Although far from perfect, the DRG strategy is an important contribution to the broader development agenda. There is a general sense from some in the development community that democracy and governance work, because it touches on political issues, is not "real" development work. This view places more value in work that is directed at meeting basic human needs, such as education, public health, and other projects geared toward the delivery of public goods. What this neglects to take into account is how fragile the gains frequently are within these fields. Without strong, accountable institutions to back them up, these gains can be lost quickly in a crisis. USAID's DRG strategy states quite strongly, "The inability of weak or illegitimate governments to manage conflict or withstand natural and economic shocks can substantially roll back precious development gains. Development is often undermined by the corrosive impact of corruption, elite capture of state benefits, and unaccountable governance."[43] Solving this impasse is critical for the development enterprise.

Partnership for Growth

The Obama administration launched Partnership for Growth (PFG) in 2010 partially to operationalize the president's global development strategy as outlined in PPD-6. PFG is designed to engage governments, the private sector, and civil society to develop new sources of investment, either domestic or foreign. As the U.S. government notes, the core objective is:

> By improving coordination, leveraging private investment, and focusing political commitment throughout both governments, the Partnership for Growth enables partners to achieve better development results.[44]

As an initial test, PFG was extended to four countries: the Philippines, El Salvador, Ghana, and Tanzania. Through a joint analysis, PFG seeks to identify the top constraints to greater growth in each country. It then develops a joint country action plan (JCAP) that outlines a series of potential tools, reforms, technical assistance, and reforms that can be applied over the next five years to address the constraints. PFG, in many ways, gets close to the governance and growth nexus. Applying a comprehensive constraints analysis to the countries is particularly useful because it identifies many of the issues that fall under the nexus. It remains to be seen, however, if this will fundamentally result in a redistribution of U.S. development resources.

THE PHILIPPINES AS A CASE STUDY

Because the United States has a long relationship with the Philippines, it has been a major recipient of U.S. aid since 1946 (approximately $9.5 billion total). The Philippines, like other countries in Southeast Asia, has seen high levels of economic growth over the past several

43. Ibid., 8.
44. U.S. Department of State, "Fact Sheet: Partnership for Growth," November 29, 2011, http://www.state.gov/r/pa/prs/ps/2011/11/177887.htm.

years. It has made impressive gains, but as USAID notes, "Growth remains constrained by ineffective governance (including a poor regulatory environment, rampant corruption, and weak rule of law), elite state capture, inadequate health and social services, decaying infrastructure, degrading environments, frequent natural disasters, and a population growth that outpaces the rate of economic development."[45] USAID has a robust assistance program in the Philippines and the MCC began a compact in 2011. The Philippines was selected as a Partnership for Growth (PFG) country the same year. Since FY09, USAID's annual assistance has grown from $123.7 million to $180 million in the FY14 budget request.[46]

The Philippines is a useful example of what is possible through U.S. foreign assistance. Through a variety of recent analyses processes—country development cooperation strategy (CDCS), MCC constraints analysis, and the Partnership for Growth country diagnostic—the U.S. government has identified a variety of governance challenges as the binding constraints to growth in the Philippines. PFG identified weak governance and a narrow fiscal space as the two most important. Based on this, the PFG JCAP identified the following objectives:

1. Create a more transparent, predictable, and consistent legal and regulatory regime in the Philippines, one that is less encumbered by corruption.
2. Foster a more open and competitive business environment with lower barriers to entry.
3. Strengthen the rule of law that is grounded in an efficient court system capable of delivering timely justice.
4. Support fiscal stability through better revenue administration and expenditure management.[47]

Based on this analysis, the Philippines represent a growth and governance nexus challenge. Unlike other countries where the U.S. government works, the Philippines is one where the United States is tackling the nexus. Through the JCAP and the CDCS, USAID and the MCC have either allocated or reallocated resources to addresses these important governance and growth challenges. This involved a significant shift of resources away from programs targeted specifically at the island of Mindanao (from 60 percent of total USAID funds to 10 percent) toward the rest of the Philippines.[48] Further, the amount directed toward growth and governance issues has also increased during this time. These are good signs and ones that should, in the long term, be applied to other countries that face governance and growth challenges.

45. USAID, *The Philippines: Country Development Cooperation Strategy, 2012–2016*, 2012, 4–5.
46. Data from http://www.foreignassistance.gov.
47. Partnership for Growth, *Philippines-United States Joint Country Action Plan, 2012–2016*, November 2011, iii.
48. USAID, *The Philippines*, 12.

4 Case Studies

To augment existing research, the authors conducted research trips to study the ongoing challenge by donors of linking governance with economic growth in Tanzania, Indonesia, and Peru. The goal was to examine a group of countries that are widely seen as development success stories, but are at different points in their development. All three countries are newly emergent democracies and enjoy a high level of political stability that make them attractive for foreign investment. The authors visited each country and interviewed a series of key stakeholders, including the local U.S. embassy, USAID mission, World Bank, African Development Bank, Asian Development Bank, other bilateral donors, host nation government officials, and other local observers. There are four conclusions that these case studies support.

1. Regardless of where the country is in its development, issues that fall within the governance and growth nexus remain paramount challenges to sustained, broad-based growth. This is true of Tanzania as it attempts to translate its impressive GDP growth into poverty reduction and an increase in GDP per capita. Indonesia is aiming to avoid falling into the "middle income country trap" and continue to develop as an economic and political power at the center of a geostrategic region. And, Peru is looking to move toward countries such as neighboring Chile and be seen as a success in a region that has experienced uneven growth.
2. In all three countries, governance and growth issues are closely intertwined with local political and economic power structures. In all instances, there are local elites who benefit from the existing order and who prevent real reform from occurring. Donors must do a better job of understanding these power structures and find ways to engage in policy dialogues to find solutions that will lead to real and lasting reform.
3. Sub issues within the governance and growth nexus in these countries are closely intertwined; it is impossible to address one without addressing another. This means that in order to improve the land rights in one country, one must also improve the institutional capacity of the government. Tanzania and Indonesia, for example, both struggle with a weak land tenure structure and lack the government capacity to force a systematic solution.
4. Although the United States maintains a robust foreign aid presence in all three countries, money and resources are not directly supporting projects aimed at the governance and growth nexus. U.S. resources in Tanzania, for example, are overwhelming directed toward public health spending (over 90 percent of U.S. foreign

aid per year). This is in spite of significant analysis by the World Bank, multilateral development banks, and the United States itself that consistently identify governance and growth issues as the binding constraints to greater growth in these countries. In terms of resource distribution, Indonesia likely comes closest, but there is still room to improve upon the types of programs that the United States carries out there.

Tanzania

Tanzania has emerged from a one-party, socialist system in the past two decades. It held its first multiparty election in 1995 and has pursued a series of economic reforms that have introduced a high level of macroeconomic stability. Situated in East Africa, Tanzania is widely seen as one of the most politically stable countries in the region and has attracted an increasing amount of foreign direct investment (FDI). In spite of its impressive strides, Tanzania continues to face a series of development challenges that must be addressed for growth to continue. Many of these are closely related to governance and economic growth, including private-sector development, business environment reforms, corruption, transparency, and accountability, and infrastructure development. For these reasons, Tanzania was selected as one of the case studies for this report.

COUNTRY PROFILE

Political

The United Republic of Tanzania gained independence from the United Kingdom in 1961 as Tanganyika under the leadership of Julius Nyerere and the Tanganyika African National Union (TANU) party. Originally a German colony, Tanzania was ruled as German East Africa until the end of World War I. Under the Treaty of Versailles, German East Africa became the British mandate of Tanganyika. Beyond some architecture in Dar es Salaam, there is little that remains of a German legacy in Tanzania. The prevailing colonial legacy is British; Tanzania has English common law and a parliamentary system with a president as head of state. It remains a member in good standing of the Commonwealth of Nations. Unlike other parts of the continent, Tanganyika experienced a relatively peaceful transition to independence. Modern Tanzania was formed through a union with the island of Zanzibar in 1964 following the island's independence from the United Kingdom in 1963.

Nyerere ruled Tanzania from 1961 until 1985 when he stepped down and turned over power to a hand-picked successor. Throughout this period, Tanzania was a one-party state. During Nyerere's rule he introduced the concept of "ujamaa" or African socialism through the Arusha Declaration of 1967. A core principal for Nyerere was the idea that a person becomes a person through the people or community. This led to an emphasis on the village as the organizing force in Tanzanian society and farming collectives as the principal source of economic prosperity for the people. During Nyerere's rule, all land was held by the government in trust for the various villages. The government also nationalized industry and the bureaucracy ballooned to a point that the central government became the country's largest employer.

A common refrain in Tanzania today is that Nyerere succeeded in building a nation, but failed to build an economy. Unlike many of its neighbors, Tanzania enjoys a remarkable level of political stability and has avoided the tribal divisions that Kenya and other neighbors have endured. Nyerere's political party, now known as the Chama Cha Mapinduzi (CCM), remains in power and is now the longest ruling party in sub-Saharan Africa. Beginning in the 1980s Tanzania underwent a period of reform that led to the first multiparty elections in 1995. Jakaya Kikwete, the current president, was reelected to a second term in October 2010 with 61.2 percent of the vote. The opposition candidate gained 26.3 percent. Although this is a comfortable election margin and the CCM enjoys a substantial parliamentary majority (70 percent of all seats), it does represent a shift from earlier years. The opposition is drawing increasing support from the youth in Tanzania, but this has yet to translate to electoral victory. Voter turnout decreased significantly between the 2005 and 2010 elections, dropping from 80 percent to 40 percent. There is a general sense in the country that one is free to criticize the government, but the government fails to respond in a constructive manner.[49]

Despite Tanzania's political stability, there are significant governance challenges that remain. Some stem from the effect that British colonial administration had on the country. Under the British, sovereignty was personal and the state and leader became intertwined into one entity. There is a lingering belief that the leader is a ruler. This is not reflective of good governance, because a ruler is simply deciding what is good for the people by issuing orders.[50] The CCM remains largely unaccountable from a political perspective, which can be attributed to its large margin of victory in recent elections. The opposition party, Chama cha Demokrasia na Maendeleo or CHADEMA (known as the Party of Democracy and Development), has been unable to formulate a coherent alternative vision for the country beyond simply opposing the CCM. Parliament remains largely a rubber stamp for the president's policies, although it has shown some independence as of late by rejecting ministry budgets. The judiciary is not independent and is generally subordinate to the president and CCM. Corruption is a major issue in Tanzania; in 2012 the country ranked 102 out of 176 in Transparency International's corruption perception index.[51] This effects all level of the government from the central on down through the provinces and districts. The judiciary, in particular, is seen as one of the most corrupt institutions in Tanzania.

The capacity of the state remains low. Although there are capable public servants in the government, capacity is uneven across the various ministries. Generally, the Ministry of Finance, the Tanzania Revenue Authority, and other economic and planning agencies are seen as capable and efficient. Donors have identified capacity at various levels as being a challenge for Tanzania to address. In particular, public financial management remains extremely weak, especially for a country that receives a significant amount of budget support from donors. Further, the capacity of the national and local governments to manage land issues remains extremely weak. As a recently completed Organization for

49. Ted Dagne, "Tanzania: Background and Current Conditions," *CRS Report for Congress*, August 31, 2011, 1–2.

50. Anonymous interview, Dar es Salaam, Tanzania, May 20, 2013.

51. Transparency International, *Corruption Perceptions Index 2012,* 3, http://www.transparency.org/cpi2012/in_detail.

Economic Cooperation and Development (OECD) investment report on Tanzania noted, "the overlapping roles of the Ministry of Lands and the Prime Minister's office, Regional Administration and Local Government (PMO-RALG), and weak governance in land administration pose major risks for efficient and fair land rights." The report adds, "Governance in land administration at all levels, but particularly at the local level, remains weak due to limited financial and material resources, weak human capacity, complex procedures, and multiple reporting lines."[52] President Kikwete has sought to address the underlying issues with Tanzanian governance by launching a constitutional reform process that led to a Constitutional Reform Commission in April 2012. The commission is supposed to finish its work by 2014, but nothing will take effect before the 2015 elections.[53]

Economic

After independence Tanzania experienced a period of socialist economic policies that saw nationalized industry and an expansion of the government sector. The country was badly affected by the oil shocks of the 1970s and later experienced a financial crisis in the early 1980s. Beginning in the mid-1980s, the government of Tanzania pursued extensive economic reforms that sought to create a market-based economy. Growth accelerated from 3.5 percent on average in the 1990s to over 7 percent on average in the last decade (see Figure 4.1).[54] The economy remains highly dependent on the agricultural sector, which contributes over 30 percent of GDP per year and employs approximately 80 percent of the workforce. The service sector contributes approximately 47 percent of GDP and the remainder comes from the industrial sector, which provides 23 percent of GDP (dominated by the construction sub-sector).

Generally, Tanzania has pursued stable macroeconomic policies since reforms began in the late 1980s. It has seen its external debt shrink to around 45 percent of GDP largely through the restructuring of old loans and significant loan forgiveness in the late 1990s. Further, during this period Tanzania significantly increased its domestic revenue collection, which grew by 71 percent between 2006–2007 and 2009–2010. Government expenditure has also risen during this time and Tanzania is running deficits of around 5 to 6 percent of GDP per fiscal year.[55] Tax revenues, after growing throughout the 1990s and early 2000s, now stand at approximately 15 percent of GDP. This inability to raise additional revenue, coupled with continued deficit spending (which would be higher if not for the significant amount of aid Tanzania receives), represent a worrying trend that donors need to keep in mind in the coming years.

Over the last two decades Tanzania has opened itself up to international trade. It has seen its exports rise dramatically. Exports now account for approximately 22 percent of

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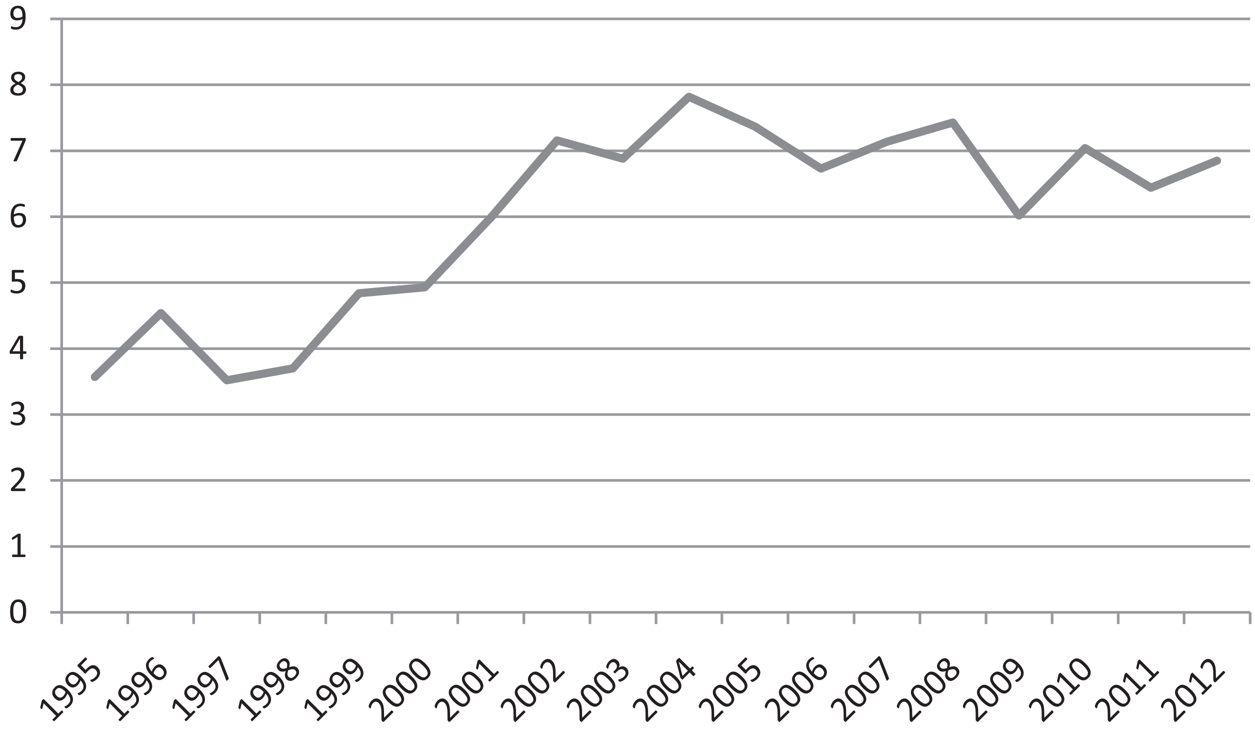
52. OECD, *OECD Investment Policy Review: Tanzania*, August 6, 2013, 23 (hereafter cited as OECD, *Tanzania Investment Policy Review*).

53. Bruce Heilman and William John, "Countries at the Crossroads 2012: Tanzania," Freedom House, 2012, http://www.freedomhouse.org/sites/default/files/Tanzania%20-%20FINAL.pdf, 3.

54. World Bank, *Country Assistance Strategy for the United Republic of Tanzania: Fiscal Year 2012–2015*, May 9, 2011, 2 (hereafter cited as *Tanzania Country Assistance Strategy*).

55. African Development Bank (AfDB), *United Republic of Tanzania: Country Strategy Paper 2011–2015*, June 2011, 3 (hereafter cited as AfDB, *Tanzania Country Strategy Paper*).

Figure 4.1. Tanzania GDP Growth Rate, 1995–2012 (percent)



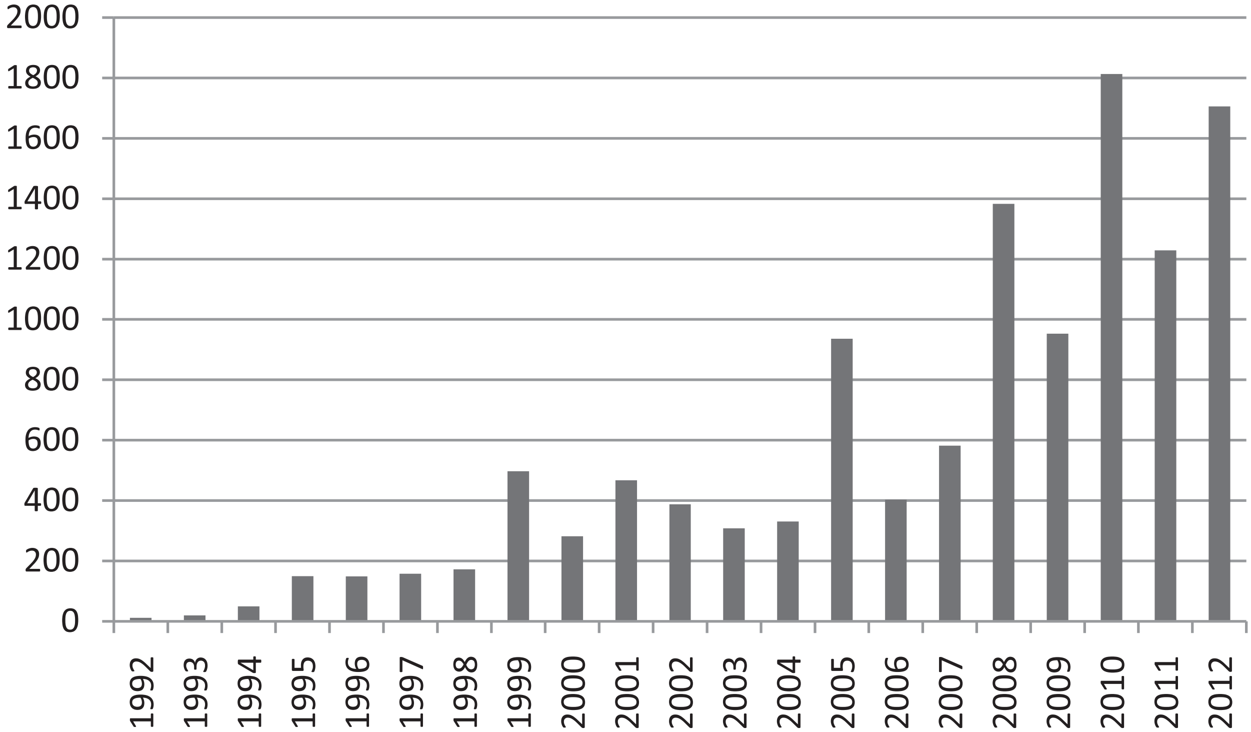
GDP, gross domestic product.
Source: The World Bank: "Databank: Tanzania GDP," (retrieved: November 4, 2013), http://databank.worldbank.org/data/views/reports/tableview.aspx#.

GDP.[56] Agriculture traditionally dominated Tanzania's exports, but has declined in recent years from a total of 66 percent in 1988 to 23 percent in 2012. Commodities make up 56.7 percent of total exports with gold alone accounting for 31.8 percent. Importantly, manufacturing has risen from just 7 percent of exports in 2004 to 29.4 percent in 2012.[57] Tanzania's top export partners in 2011 were Switzerland (19.4 percent), South Africa (18.1 percent), and China (14.3 percent). In contrast, U.S. trade with Tanzania remains relatively low with total imports from Tanzania equaling only $58 million in 2011. Total trade (including U.S. exports to Tanzania) in 2011 came to $316 million, making Tanzania the United States' 136th largest trading partner.[58]

Tanzania is seen as an attractive investment destination because of its political stability and generally favorable investment laws.[59] This represents remarkable growth over the past two decades; in 1992, for example, Tanzania only received $12 million in FDI. In 2012 Tanzania attracted $1.7 billion in FDI, which is a significant increase from the $582 million it received in 2007 (see Figure 4.2). This is in marked contrast to its neighbor, Kenya, which saw its FDI plummet from $729 million in 2007 to $259 million in 2012,

56. OECD, *Tanzania Investment Policy Review*, 15.
57. Ibid., 15; Partnership for Growth, *Tanzania Growth Diagnostic: A Joint Analysis for the Governments of the United Republic of Tanzania and the United States of America,* 2011, 10–11.
58. U.S. Trade Representative, "Tanzania," http://www.ustr.gov/countries-regions/africa/east-africa/tanzania.
59. AfDB, *Tanzania Country Strategy Paper*, 10.

Figure 4.2. Total FDI Inflows to Tanzania, 1992–2012 ($US million)



FDI, foreign direct investment.
Source: UN Conference on Trade and Development, "UNCTADstat: Tanzania FDI," (retrieved: November 4, 2013), http://unctadstat.unctad.org/TableViewer/tableView.aspx.

largely due to the ethnic violence that has rocked Kenya since contested presidential elections in 2007.[60] It is important to remember that much of Tanzania's yearly FDI is directed toward the mining sector. In 2008, for example, 27 percent of FDI went toward mining (again mostly gold). In spite of the Tanzanian government's stated goal to increase investment in the agricultural sector, it only attracted 2 percent of FDI in 2008.[61] The focus on mining will likely only increase as recently discovered on-shore natural gas fields in the south of the country come online in the next 5 to 10 years. Tanzania remains dependent on foreign investment because its own local financial sector is largely underdeveloped. Only around 17 percent of formal businesses in the country reported borrowing from financial institutions and private-sector credit is equivalent to only 16 to 17 percent of GDP.[62]

In spite of increased foreign direct investment and impressive GDP growth over the past decade, Tanzania continues to struggle with a high level of poverty and low human development rankings. This is particularly true in rural areas, which continue to struggle with lack of access to credit, technology, water, and power. Further, the economy suffers

60. UNCTAD, *World Investment Report 2013: Global Value Chains: Investment and Trade for Development* (New York: United Nations, 2013), 214.
61. OECD, *Tanzania Investment Policy Review*, 19.
62. AfDB, *Tanzania Country Strategy Paper*, 6.

from infrastructure bottlenecks in transportation and power, a fiduciary environment that impedes private-sector development, and an underperforming agricultural sector that prevents greater rural poverty reduction.[63] The private sector, in particular, continues to struggle in Tanzania. Beyond the issues outlined above, the business climate in Tanzania is not conducive to broad-based private-sector growth. Since the World Bank issued its first *Doing Business Report* in 2003, Tanzania has ranked at the bottom of countries. This is true across the 11 indicators that the World Bank uses to form the rankings. There is a lingering distrust among some elites in Tanzania toward the private sector that can be attributed to the country's former socialist policies. There is a sense, among some observers, that many are willing to publicly praise the need for a vibrant private sector, but in private they continue to voice doubts about its ability to deliver broad-based growth.[64]

DONORS

Tanzania is what some consider to be a "donor darling," meaning international donors perceive it to be a generally well-functioning country that is making the right reforms to warrant an increased amount of aid. It receives over $2.5 billion per year in aid from OECD bilateral donors, which is an increase from approximately $925 billion in 1999 (see Figure 4.3).[65] This represents 30 percent of the national budget and is critical for Tanzania to fund its delivery of public goods.[66]

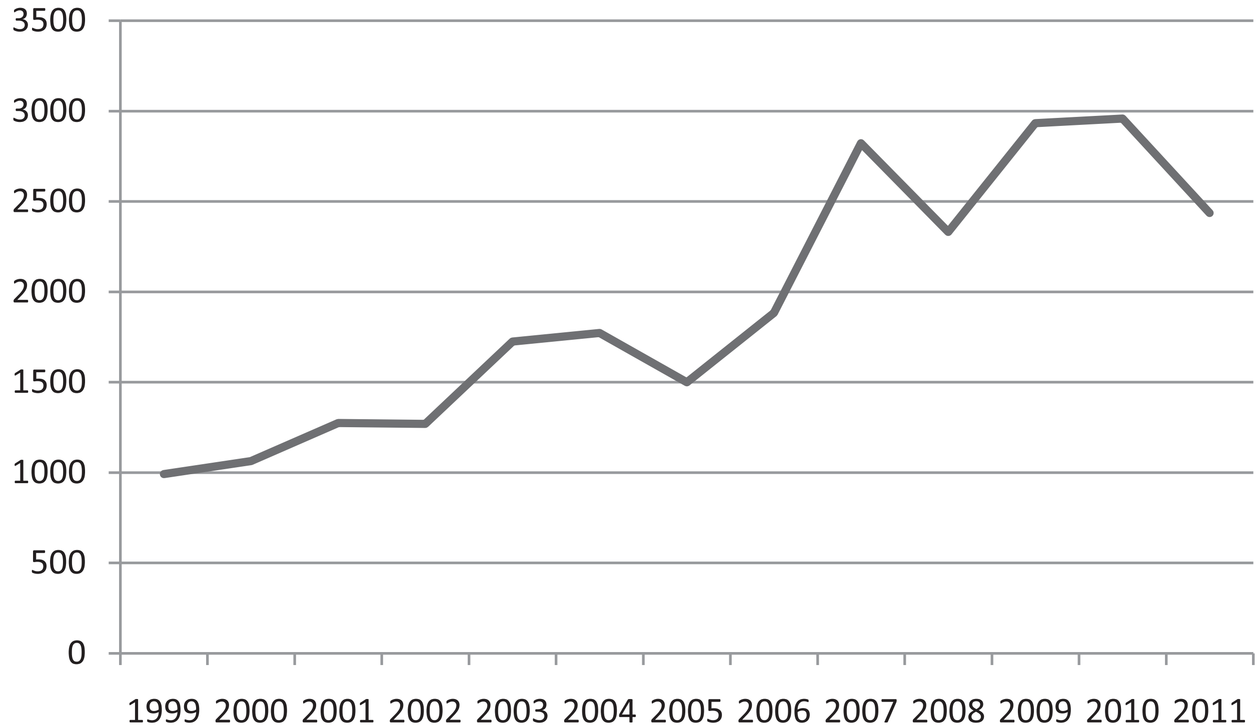
Donors, in general, have aligned their development strategies in Tanzania with its national strategy for growth and poverty reduction, known as by its Kiswahili acronym, MKUKUTA II. Tanzania's national development strategy focuses on three clusters:

1. growth and reduction of poverty
2. improvement of the quality of life and social well-being
3. governance and accountability

One donor trend worth highlighting is the use of general budget support in Tanzania with approximately 30 to 40 percent of total official development assistance (ODA) provided as either general or sector budget support. As an operational review by the African Development Bank (AfDB) in 2011 found, "Budget support is now the Government of Tanzania's (GoT's) preferred aid modality while at the sectoral level there has been a move towards the use of basket funds or sector budget support."[67] Donors, such as the United Kingdom's Department for International Development (DFID), at one point committed up to 80 percent of their aid to Tanzania in the form of budget support. Recently, this has been scaled back

63. AfDB, *Tanzania Country Strategy Paper*, 4.
64. Anonymous interview, Dar es Salaam, May 21, 2013.
65. African Development Bank, *Evaluation of Policy Based Operations in the African Development Bank, 1999–2009: Country Case Study: Tanzania*, March 2011, i.
66. AfDB, *Tanzania Country Strategy Paper*, 11.
67. African Development Bank, *Evaluation of Policy Based Operations*, 3.

Figure 4.3. Total OECD Official Development Assistance Flows to Tanzania, 1999–2011 ($US million)



OECD, Organization for Economic Cooperation and Development.
Source: OECD, "OECD Stats: Bilateral ODA to Tanzania," (retrieved: November 4, 2013), http://stats.oecd.org/qwids/#?x=2&y=6&f=3:51,4:1,1:1,5:3,7:1&q=3:51+4:1+1:1,2+5:3+7:1+2:1,169+6:1999,2000,2001,2002,2003,2004,2005,2006,2007,2008,2009,2010,2011,2012.

over concerns that it is not achieving the goal of capacity building and it is highly prone to "leakages" or corruption.

International

Although there are a multitude of donors in Tanzania besides the United States, three are noteworthy: World Bank, African Development Bank, and DFID. The World Bank and AfDB both have a significant presence in Tanzania. The World Bank under its country assistance strategy has four main goals:

1. Promote inclusive and sustainable, private sector–led growth.
2. Build infrastructure and deliver services.
3. Strengthen human capital and social safety net.
4. Promote accountability and governance.[68]

68. World Bank, *Tanzania Country Assistance Strategy*, 19.

The AfDB is a major donor to Tanzania and its program in the country is one of its largest on the continent. In country since 1971 the AfDB has supported a wide range of projects in the transport sector, multisector, public utilities, agriculture, social sector, and private sector. The current AfDB strategy in Tanzania is centered on two pillars: infrastructure development and building an enabling institutional and business environment.[69] The AfDB focuses on these two pillars in order to align itself with Tanzania's national development strategy, its internal analysis of the country and its needs, alignment with the AfDB's broader bank strategy, and lessons learned from previous work in Tanzania. Commitments in these two categories total approximately $600 million.

Beyond the World Bank and AfDB, the DFID is the country's most significant bilateral donor after the United States. At one point, the DFID provided a significant amount of general and sector budget support to Tanzania, but its 2010 independent country program evaluation noted that "GBS [general budget support] was not the most effective way to deliver results in the current circumstances, and recommended a relative reduction."[70] As the DFID moved away from budget support as an instrument, it has focused on private-sector development and governance challenges in Tanzania. The DFID has three strategic objectives: wealth creation with a particular emphasis on combating rural poverty, reducing the cost of doing business, and reducing trade and transportation costs; delivering the Millennium Development Goals by improving the delivery of basic services; and getting government to work better and helping Tanzanians hold their government to account.[71] Beyond the shift away from budget support, the DFID's operational plan for 2011–2015 represents a commitment to tackling some of the challenging governance and growth nexus issues that Tanzania still has. The DFID plans to allocate £655.8 million over the course of the 2011–2015 operational plan with approximately £167 million committed to governance and growth issues.[72]

United States

The United States provides over $500 million per year in foreign aid to Tanzania, making it one of the largest recipients of U.S. aid in the world. This robust program is administrated largely through the USAID mission, but includes a recently completed Millennium Challenge Corporation (MCC) five-year compact (2008–2013). In addition, Tanzania has benefited from recent initiatives launched by the Obama administration including Feed the Future (FTF) and the Partnership for Growth (PFG). The majority of U.S. aid to Tanzania goes to public health projects, including the President's Emergency Plan for AIDS Relief (PEPFAR) and the President's Malaria Initiative, and food security. Democracy and governance as well as economic growth programs are relatively small in comparison. In FY14 the Obama administration requested $552.5 million in foreign assistance for Tanzania of which $431.7 million was allocated for global health programs (see Table 4.1).

69. Ibid., 13, 15.
70. Department for International Development, *DFID Tanzania: Operational Plan 2011–2015*, June 2013, 4.
71. Ibid., 4.
72. Ibid., 7–8.

Table 4.1. U.S. Foreign Assistance (Excluding MCC Assistance) to Tanzania, FY06–FY14 ($US million)

Mission Category	*FY06*	*FY07*	*FY08*	*FY09*	*FY10*	*FY11*	*FY12*	*FY13*	*FY14*
Peace and Security	2.7	2.4	0.4	0.4	3.7	1.1	1.1	1.0	1.2
Democracy, Human Rights, and Governance	1.4	1.1	0.7	3.2	3.2	8.8	7.0	8.7	14.6
Health	122.3	219.6	335.8	396.0	424.8	430.0	371.7	443.4	431.7
Education and Social Services	5.1	7.0	10.3	46.0	11.0	15.0	11.5	10.8	15.0
Economic Development	2.1	2.2	3.5	4.7	16.5	36.9	71.5	76.9	80.0
Environment	3.9	4.0	5.0	5.0	2.6	10.0	10.0	10.5	10.0
Humanitarian Assistance	13.7	13.7	14.5	9.7	6.1	7.9	7.8	0.0	0.0
Total	151.0	250.0	370.0	465.0	468.0	510.0	481.0	551.0	553.0

Note: Discrepancies in totals are due to rounding. FY, fiscal year; MCC, Millennium Challenge Corporation.
Source: Tanzania mission funding data drawn from http://www.foreignassistance.gov.

As Table 4.1 illustrates, economic development accounts for approximately 14 percent ($80 million) of the FY14 request for Tanzania. This represents a decrease of $12.6 million from the FY13 request of $92.6 million. Agricultural development accounts for 87.5 percent of the FY14 request, and the remaining $10 million is allocated toward infrastructure development. It should be noted that since FY09, economic development funding in Tanzania has grown from $4.7 million to its current requested level. This is a significant increase, but most of this has come with the launch of Feed the Future.[73] Democracy and governance budgeting fared even worse in Tanzania, with the FY14 request being only $14.6 million.

Tanzania is one of four countries[74] selected by the Obama administration as a PFG country. PFG is an attempt to reframe the relationship between developing countries from one of aid dependency to trade, investment, and development. PFG is designed as a joint growth diagnostic between the United States and the recipient country that identifies and ranks constraints to broad-based growth. In the case of Tanzania, the joint U.S. government–government of Tanzania diagnostic identified several key constraints, including:

- lack of key infrastructure, particularly access to reliable electricity and an inadequate rural road network
- lack of access to secure land rights on the part of investors seeking to invest outside the smallholder village-customary system
- lack of other key transportation infrastructure, particularly reliable rail service and a lack of port capacity in Dar es Salaam
- lack of vocational, technical, and professional skills in the private sector

73. Tanzania mission funding data drawn from http://www.foreignassistance.gov.
74. Besides Tanzania, the other Partnership for Growth countries are Ghana, the Philippines, and El Salvador.

- lack of access to finance
- low quality of regulations for business and trade[75]

PFG identified inadequate and unreliable supply of electricity and rural roads that provide inadequate market access to large portions of Tanzania's productive land as the top two binding constraints and the ones that the U.S.-Tanzania joint country action plan (JCAP) would focus on.[76] Beyond simply identifying problems, PFG sought to provide recommended actions that could address these issues. PFG analysis for Tanzania follows.

1. Power
    a. Underinvestment in the energy sector
        i. Establish counter-reflective tariff structure.
        ii. Minimize revenue loss.
        iii. Strengthen legal and regulatory institutions.
    b. Insufficient institutional and technical capacity for robust energy sector planning and management
        i. Improve sector planning.
        ii. Increase key sector institutional capacities.
        iii. Promote private investment in power.
2. Rural roads
    a. Underinvestment in rural roads infrastructure and maintenance
        i. Increase financial allocation for rural roads investment.
        ii. Increase financial allocation for rural roads maintenance.
        iii. Develop a five-year rural roads investment program.
    b. Inadequate institutional and technical capacities for rural road infrastructure and maintenance services
        i. Improve institutional and technical capacities for rural road investment and maintenance services.
        ii. Develop district level capacities for rural roads management.
        iii. Develop the capacity of labor based contractors and local community private enterprises.

Many of the constraints to growth that PFG identified through its growth diagnostic fall within the governance and growth nexus. Although there was a notation in this year's foreign aid budget request that some money directed toward Tanzania would be reallocated based on the outcome of the JCAP, it remains to be seen what impact PFG will have in

75. Partnership for Growth, *Tanzania Growth Diagnostic*, 2–4.
76. Partnership for Growth, *Joint Country Action Plan: Tanzania 2012–2016*, April 23, 2012, 3.

Tanzania.[77] It appears that this is a shift of $10 million to support infrastructure development, which will likely be used to support the rural roads work outlined. The president's recently announced Power Africa initiative is largely in line with PFG's JCAP. Tanzania is one of the countries that will participate in this new initiative.[78]

Besides the extensive USAID program in Tanzania, the MCC recently concluded a five-year compact. The MCC compact with Tanzania was signed in February 2008 and committed $698 million over five years spread across three separate projects. The compact's projects were energy sector ($205.4 million), transportation sector ($366.8 million), and water sector ($64.2 million). There is discussion that the MCC may implement a second compact with Tanzania that will likely focus resources on the power sector; however, this remains unconfirmed at this point.[79]

CONTINUING CHALLENGES

Tanzania has made significant progress in the past two decades and there is reason to believe that its future is bright. However, there are immense challenges that need to be tackled for Tanzania to finally achieve broad-based economic growth. Many of these have been noted in the above discussion about the country's economic and political system, as well as the work that bilateral and multilateral donors are undertaking in the country. It is worth highlighting and expanding on three areas that fall within the governance and growth nexus:

1. government capacity
2. private-sector development/barriers to entry
3. land titling and ownership

These are all intimately connected to governance and the vital role it plays for securing greater economic growth. More importantly, at their heart, these are all issues that require political will in order for reform to take hold. Without political will, implementation aimed at solving these challenges will falter. Donors need to prioritize these issues and engage in a more robust policy dialogue with the government of Tanzania to implement greater reform.

Government Capacity

Tanzania's central, regional, and local government entities are generally seen as lacking the capacity to carry out key duties. Donor analysis supports this conclusion, including the World Bank, AfDB, and USAID. This lack of government capacity then spills over and adversely affects other aspects related to Tanzania's overall investment and business

77. U.S. Department of State/USAID, *Fiscal Year 2014 State and Foreign Operations Budget Request, Volume 2: Foreign Operations*, May 2013, http://www.state.gov/documents/organization/208290.pdf, 49–50.

78. The White House, "Fact Sheet: Power Africa," June 30, 2013, http://www.whitehouse.gov/the-press-office/2013/06/30/fact-sheet-power-africa.

79. Anonymous interview, Dar es Salaam, May 21, 2013.

climate. The OECD's recently completed investment policy review for Tanzania targets capacity as one of the limiting factors in encouraging greater investment in infrastructure. The report notes, "A lack of adequate public management and capacity for infrastructure development . . . is among the central causes of this infrastructure deficit. Public sector capacity in designing and negotiating infrastructure projects remains weak."[80]

Private Sector Development/Barriers to Entry

As noted above, Tanzania does not score well on the World Bank's *Doing Business* reports, ranking 145 out of 185 in 2014.[81] The government of Tanzania did prioritize addressing business climate issues, and released a roadmap in 2010 following discussions with donors reviewing their general budget support. Yet, in the years since, Tanzania has not made much progress in reducing the complexity and time associated with starting a business in the formal economy. The formal sector remains extremely small in Tanzania with only 16 percent of businesses being formally registered. This is directly related to the expensive and complex nature of business regulations and the corruption that exists within the system. Further, there is a sense among many that although Tanzanian officials frequently support private-sector development in public settings, there is in fact a lingering suspicion of the private sector that can be attributed to the country's socialist past.[82]

Land Titling and Ownership

Land remains one of Tanzania's difficult governance and growth challenges. The growth diagnostic conducted by the United States and Tanzania under PFG found that "the primary and most binding constraint in this area [micro-appropriability of returns] is the lack of efficient and timely access to secure land rights."[83] Under Tanzania's laws (1998 Land Act and the 2009 Land Policy), land is held in trust by the president for the people's benefit.[84] These laws create three types of land in Tanzania: village land, reserve land, and general land. The majority of land is village land, but the laws also give the government the right to transfer village land to general land if such an action is deemed in the national interest; this has been interpreted to include investment interests (that is, mining or other extractive activities).[85] Only 3 percent of land is registered in Tanzania and only 7.7 percent of villages have developed a land use plan, which is seen as a step toward greater commercialization of agriculture. There are also bureaucratic challenges; on average it takes 70 days to register property in urban areas of Tanzania.

There is a sense, however, that most donors in country are unwilling to take on a significant program of land reform outside the construction of rural roads for improved

80. OECD, *Tanzania Investment Policy Review*, 23.
81. World Bank and International Finance Corporation, *Doing Business 2014: Understanding Regulations for Small and Medium Size Enterprises* (Washington, DC: International Bank for Reconstruction and Development /World Bank, 2013), 3.
82. Anonymous interview, Dar es Salaam, May 22, 2013.
83. Partnership for Growth, *Tanzania Growth Diagnostic*, 54–55.
84. Heilman and John, "Countries at the Crossroads 2012: Tanzania," 11.
85. Partnership for Growth, *Tanzania Growth Diagnostic*, 59.

farm-to-market access. As one individual from a donor agency noted, Tanzania is an agricultural surplus country in a region of agricultural deficit countries. It has the potential to be a major exporter of agricultural products, but its land tenure policies are a major stumbling block for such a transition.[86] For a country where 80 percent of the people are still employed in agriculture, reforming Tanzania's land titling and ownership system is necessary to achieve broad-based poverty reduction.

Peru

In the past two decades Peru has emerged from violent conflict and instability to become a model of democracy and economic growth in Latin America. Peru has an engaged electorate and has experienced transitions in party multiple times. The country is now classified as an upper middle income country with a growing role on the global stage. Peru's impressive economic and democratic trajectory and its remaining development challenges make it a valuable case study on the interaction among democracy, governance, and economic growth, and the impact on development when one of those areas is neglected.

COUNTRY PROFILE

Political

Once home to the Incan empire, Peru was ruled by Spain for nearly three centuries before declaring independence in 1821. From 1821 to the present, Peru has adopted 13 different constitutions, and of 19 elected governments, only 9 have completed their terms.[87] Peru finalized its sovereign and territorial status when border disputes with neighbors Chile and Ecuador were finally settled by 1999.[88] In 1980 Peru's government emerged from 12 years of military rule only to face widespread turmoil and violence as it struggled to defeat the communist Shining Pat" (Sendero Luminoso) in a protracted guerrilla war.[89] During this period, President Alan Garcia's first term (from 1985 to 1990) is overwhelmingly remembered for the hyperinflation and indebtedness that accompanied overspending and tense international financial relations.[90]

Despite a turbulent history, Peru has recently emerged with relative political stability. In the 1990 election Peruvians sought relief from these counterproductive policies by electing a president who pledged aggressive economic reform and intensified efforts to suppress the Shining Path, Alberto Fujimori. After 12 years of heavy conflict, the Shining

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86. Anonymous interview, Dar es Salaam, May 20, 2013.

87. Maureen Taft-Morales, "Peru in Brief: Political and Economic Conditions and Relations with the United States," *CRS Report for Congress*, June 13, 2013, http://www.fas.org/sgp/crs/row/R42523.pdf.

88. http://www.historyofnations.net/southamerica/peru.html

89. The Shining Path was a radical Maoist insurgency group. Its campaign (beginning in 1980) frequently utilized acts of violence in its pursuit of national control. Peru's 2003 "Truth and Reconciliation Report" reported that approximately 70,000 people were killed by Shining Path guerillas and government forces from 1980–2000. Britannica.com, "Shining-Path" (retrieved June 14, 2013), http://www.britannica.com/EBchecked/topic/540794/Shining-Path

90. Taft-Morales, "Peru in Brief," 1.

Path was largely stifled when its leader was captured and convicted in 1992, though limited clashes with the government continued throughout the 1990s and still occasionally occur.[91] Fujimori's initial widespread popularity among Peruvians gradually gave way to distrust as fear retreated and citizens' priorities evolved.

Although he managed reelection to a second term in 1995, Fujimori's constitutionally questionable election to a third term in 2000 was cut short following widespread allegations of electoral fraud and corruption. He fled the country and submitted his resignation from office within the year.[92] Peru entered a period of increasing stability and growth soon afterward, first with the interim government of Valentin Paniagua, and then maintained through 2006 by President Alejandro Toledo, who signed a free trade agreement with the United States just before leaving office. The 2006 election brought victory to a returned and rebranded Alan Garcia over Ollanta Humala, his nationalist, anti-globalization opponent. Although Peru continued to enjoy impressive economic growth during Garcia's 2006–2011 term, growing public awareness of disparities among residents and between regions led to dissatisfaction within the electorate. This dissatisfaction brought Humala success on his second presidential bid (as a somewhat more moderate candidate) in 2011. The United States—initially wary of Humala's nationalistic far-left platform—engaged as he adopted more moderate, pragmatic policies shortly after entering office.[93]

Despite incredible improvements in stability and function, some aspects of Peru's national political structure are of particular concern. Although U.S. officials considered Humala's shift to be advantageous for Peru's overall welfare and in the interest of its international partners, it has caused friction with the populace. Early on, Humala pushed through legislative measures requiring indigenous "consultation" prior to regional development, and founded the Ministry of Development and Social Inclusion (Midis) to combine and improve social inclusion programs like Head Start and conditional cash transfers. However, many of the nationalistic policy changes the public expected have not been implemented. For example, initial proposals to scale back coca eradication efforts have been replaced with ambitious eradication-maximization policies, which are distinctly unpopular with participants in the profitable coca market.[94] Similarly, development officials in Peru indicated that at least some of the rural population is dissatisfied with Humala's efforts to promote social and economic inclusions.[95] Many of those that elected the president do not believe that he has lived up to the promises made during his campaign,

91. In recent years, the Shining Path has claimed a "moderate resurgence," which has caused only "minor damage" to Peru's military and police. Kathryn Gregory, *Backgrounder: Shining Path, Tupac Amaru (Peru, Leftists)* (Council on Foreign Relations, August 27, 2009), http://www.cfr.org/terrorism/shining-path-tupac-amaru-peru-leftists/p9276; also see BBC News, *Peru's Shining Path Leader Jailed for Life for Terrorism*, June 7, 2013, http://www.bbc.co.uk/news/world-latin-america-22821052.

92. Encyclopedia Britannica, "Alberto Fujimori," http://www.britannica.com/EBchecked/topic/221549/Alberto-Fujimori (retrieved June 28, 2013). In April 2009 Fujimori was convicted of kidnapping and murder by Peruvian courts and sentenced to 25 years in prison. Adriana Leon and Chris Kraul, "Ex-Peru President Fujimori convicted of mass murder, kidnapping," *Los Angeles Times*, April 8, 2009, http://articles.latimes.com/2009/apr/08/world/fg-fujimori8.

93. Anonymous interview, Lima, Peru, February 26, 2013.

94. Anonymous interview, Lima, Peru, February 26, 2013.

95. Anonymous interview, Lima, Peru, February 26, 2013.

creating a split within the Peruvian Nationalist Party and a widespread feeling of political discontent.[96]

Economic

Sweeping economic change and development has accompanied Peru's political transformations, as its recent leaders—whatever their failings—have successfully enacted widespread reform of macroeconomic policies and forged ambitious economic ties with foreign partners, making it one of the foremost economic leaders in the region. In the decade from 2002 to 2012, the Peruvian economy nearly doubled in size and its GDP grew at an average of over 6 percent annually (the highest 10-year average growth in Peru's history). The country weathered the crux of the global financial crisis, suffering a mere 1 percent deceleration in GDP growth in 2009, quickly recovering to reach over 6 percent GDP growth in 2011.[97] Following some minor fluctuations, Peru's inflation rate appears to have settled near the middle of its target band: in 2012 the rate was 2.8 percent.[98] This economic growth and development has brought significant benefits to the populace as well as the broader economy: national poverty rates have been drastically reduced, declining from 58.7 percent in 2004 to 27.8 in 2011.[99] However, Peru's impressive economic improvement has yet to address certain economic issues, and has revealed or exacerbated others.

The country's economic development has been uneven, concentrated primarily around the capital and along the coast, but other areas have not enjoyed the same level of prosperity.

Similarly, as illustrated in Figure 4.4, despite significant reductions in poverty across the board, the discrepancy between urban and rural poverty rates remains significant.

In addition to challenges related to this extreme economic disparity within the country, Peru faces a challenge encountered by many contemporary high-performing emerging economies: the economy's slowing momentum.[100] In-country interviews indicated two sources for this challenge: the inevitable slowdown in growth rates experienced by countries approaching or reaching middle income status and the level of complacency that has taken hold in the country during this period of unprecedented growth and development.[101]

96. Anonymous interview, Lima, Peru, February 27, 2013.

97. International Monetary Fund, "Peru: 2012 Article IV Consultation," February 2013, http://www.imf.org/external/pubs/ft/scr/2013/cr1345.pdf, 5, 10

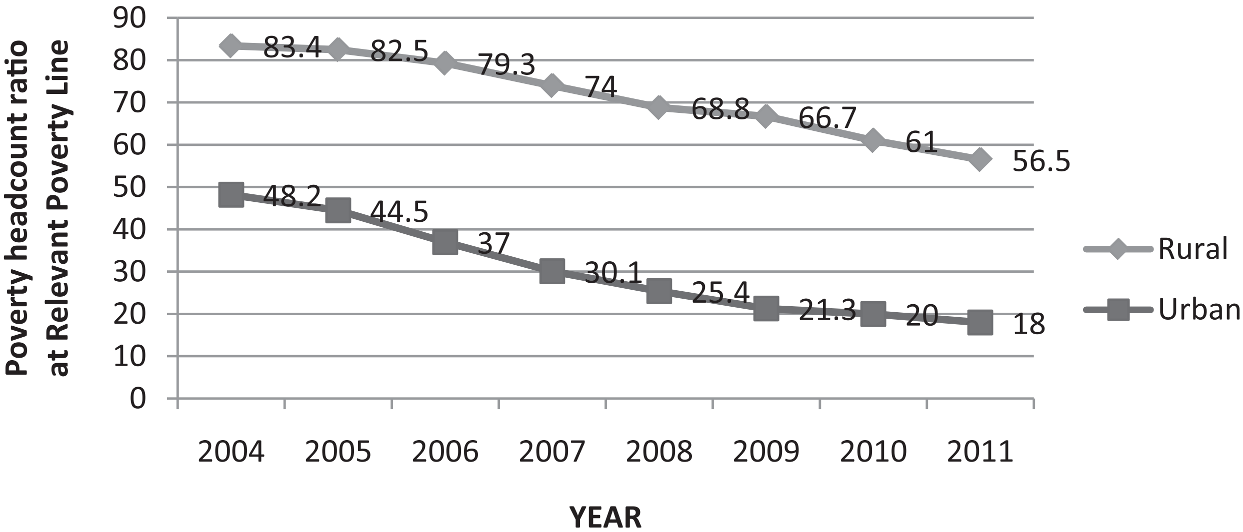
98. Ibid., 10.

99. World Bank, Data (retrieved May 31, 2013), http://data.worldbank.org/indicator/SI.POV.RUHC/countries/PE-XJ-XT?display=default.

100. Statement by Pablo Garcia-Silva, executive director for Peru, and Oscar Hendrick, advisor to executive director, February 13, 2013, cited in *IMF Peru: 2012 Article IV Consultation*, http://www.imf.org/external/pubs/ft/scr/2013/cr1345.pdf,4 (retrieved July 30, 2013).

101. Anonymous interviews, Lima, Peru, February 26, 2013; "Peru's Roaring Economy: Hold on Tight," *The Economist*, February 2, 2013, http://www.economist.com/news/americas/21571162-biggest-threats-latin-americas-economic-star-are-overconfidence-and-complacency-hold.

Figure 4.4. Percentage of the Population in Peru Living Below the Poverty Level



Source: The World Bank: "Data: Percentage of Poverty in Peru," http://data.worldbank.org/country/peru ?display=default%20%5BPoverty%20headcount%20ratio%20at%20rural%20poverty%20line%20%28%25%20of %20rural%20population%29 (retrieved May 31, 2013).

Governance and Democracy

Although only limited quantifiable evidence on the subject is available, Peru's advances in governance and democracy have been significant, though its advancements in governance fall short of its political and economic transformations.[102] For example, in just the last five years, Peru's rank on the World Bank's index measuring the "ease of doing business" within national regulatory regimes has risen from 62 out of 181 in 2009 to 43 out of 185 countries in the 2013 rankings.[103] Additionally, Peru has made an effort to lose its status as one of the two largest cocaine producers in the world. Although the United Nations (UN) reported small increases in areas of Peruvian coca cultivation in its 2013 world drug report,[104] the government eradicated over 14,000 hectares in 2012—a new record[105]—and has pledged to eradicate an additional 22,000 this year.[106] The same UN report stated that there was a total of 62,500 hectares under coca cultivation in the country at the end of 2012, so these removals are significant. Additionally, Humala's victory in pushing through the "indigenous consultation" law was considered a major step forward in the path toward social and economic inclusion.

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102. See generally Fukuyama, *What Is Governance*, which notes the limited nature and scope of empirical measures of governance.

103. World Bank, *Doing Business Report 2009* (Washington, DC: World Bank Group, 2009); World Bank, *Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises* (Washington, DC: World Bank Group, 2013).

104. United Nations Office on Drugs and Crime, 2013, http://www.unodc.org/unodc/secured/wdr/wdr2013 /World_Drug_Report_2013.pdf, 37.

105. Marco Aquino and Terry Wade, "Peru ramps up cocoa eradication in shift by Humala," *Chicago Tribune*, December 20, 2012, http://articles.chicagotribune.com/2012-12-20/business/sns-rt-peru-drugsl1e8nk9nv -20121220_1_coca-eradication-president-ollanta-humala-coca-growers.

106. "Peru's Anti-Drug Chief Says Will Meet Eradication Goal," *Peruvian Times*, May 3, 2013, http://www .peruviantimes.com/03/perus-anti-drug-chief-says-will-meet-eradication-goal/18958/

Despite these improvements, Peru's remaining governance challenges are numerous. Peruvians' support for democracy in general is one of the lowest in Latin America, at 63.6 percent in 2012, outpacing only Bolivia, Guatemala, and Honduras. Peruvians' support for its own political system is even lower at 49.5 percent, placing it 19th out of 26 ranked nations in the Americas.[107] In-country interviews noted that, as Peruvians have become more aware of the existence, nature, and value of democracy and governance, they have increasingly begun to identify it within their government and the public sector, resulting in an initial decrease in confidence even as conditions improve. These experts also offer this theory as explanation for the lack of improvement in Peruvians' perception of corruption in the exercise of public power.[108]

Although all these indicators address only the populace's attitude toward Peruvian governance and democracy, government studies and our interviewees reported that despite progress, corruption remains an issue within the judicial system, law enforcement authorities, and public financial management.[109] In 2009 the government reported that 11,876 public servants had been accused of corruption, and over 1,000 had been found guilty since 2002.[110] Peru has some distance to go in fighting both the corruption within its ranks, and the public's perception of that corruption.[111]

Despite advances like the indigenous consultation law and the creation of the Ministry of Development and Social Inclusion, Peru's lingering and pervasive deficiencies with social and economic inclusion have been a major source of dissatisfaction within the country, and a source of concern for its international partners. Interviewed individuals noted that the economic disparities described above are related to the limited reaches of improved social programs and public goods and services.[112] In May 2013, reports indicated that the Peruvian government intended to weaken the indigenous consultation law, which already limited indigenous communities' power prior to the implementation of new development projects.[113] Interviewees noted that laws and regulations developed to direct mining revenues toward local communities have not had the desired effect. Those communities have found that without the resources to navigate a complex set of administrative rules and

107. As compared, for example, to Argentina at 83.2 and Guyana at 75.1 percent. Americas Barometer, *The Political Culture of Democracy in the Americas, 2012: Towards Equality of Opportunity* (November 2012), 245, 258.

108. Anonymous interview, Lima, Peru, February 27, 2013.

109. Anonymous interview, Lima, Peru, February 27, 2013; http://www.state.gov/j/drl/rls/hrrpt/humanrightsreport/index.htm?year=2012&dlid=204472.

110. "Valsquez: Mas de 11 mil funcionarios publicos fueron procesados por corrupcion desde 2002," *Andiana*, October 30, 2012, http://www.andina.com.pe/Espanol/Noticia.aspx?id=Fih5DDnhOmw=#.UdN2jvm1HEg.

111. "Corruption in Peru: A Widening Web," May 24, 2013,*The Economist*, http://www.economist.com/blogs/americasview/2013/05/corruption-peru. Peru has taken some measures to improve public perceptions; for example, in 1998, Peru initiated a program to hire and develop a female force within its National Police of Peru (PNP) in response to studies indicating that women may be less susceptible to corruption and are often seen as less susceptible to corruption. See Sabrina Karim, "Madame Office: Peru's anti-corruption gamit," *America's Quarterly*, Summer 2011, http://www.americasquarterly.org/node/2802.

112. Anonymous interview, Lima, Peru, February 28, 2013.

113. Mitra Taj and Teresa Cespedes, "Peru rolling back indigenous law in win for mining sector," Reuters, May 1, 2013, http://www.reuters.com/article/2013/05/01/us-peru-mining-indigenous-idUSBRE9400CG20130501

procedures, they have been unable to reinvest their newfound wealth.[114] In addition to financial issues, local communities' environmental concerns regarding the effects of mining, Peru's relatively weak rule of law, and a limited property rights regime have all contributed to social unrest.

The country also faces major governance challenges within its educational system. Despite Peru's comparatively outstanding economic performance in the region, its education system is one of the worst in the region.[115] This limits Peru's domestic capacity and affects the country's attractiveness to multinational companies looking to expand into the area that may be seeking skilled workers.[116] Interviews identified underfunding and Peru's powerful teachers' union resistance to the government's attempts to enforce higher standards as one issue. Additionally, Peru's extreme socioeconomic inequality is evident in the poor quality of educational systems in poorer and more rural areas. All of these governance issues have contributed to the 300 percent increase in social conflicts Peru experience from 2007 to 2012.[117]

DONORS

International

Peru's assistance landscape is broad, with the United States, the Inter-American Development Bank (IDB), the World Bank, Germany's Gesellschaft für Internationale Zusammenarbeit (GIZ), the Canadian International Development Agency (CIDA), Japan's International Cooperation Agency (JICA), the Spanish Agency for International Development Cooperation (AECID), and the European Union all serving as major players in the field. As illustrated in Figure 4.5, donors provide assistance in a wide range of sectors, with the largest proportion dedicated to the development of social infrastructure outside of health and education, including activities addressing narcotics control, employment, housing, and social and welfare services.

A representative of the IDB noted that the scale of its portfolio in Peru is comparable to that of the World Bank; however, the scope of the IDB's investment in Peru is considerably broader. The IDB provides in-depth, on-the-ground support, extensive technical assistance, shared knowledge, and private-sector support with a focus on fiscal support, decentralization (particularly through institution building), and housing and urban development.[118] Like the European Union's contributions, the World Bank's International

114. The SNIP procedures accord with international standards for more developed countries, but rural Peru has limited knowledge on how to effectively accord with those rules. Anonymous interviews, Lima, Peru, February 26–27, 2013.

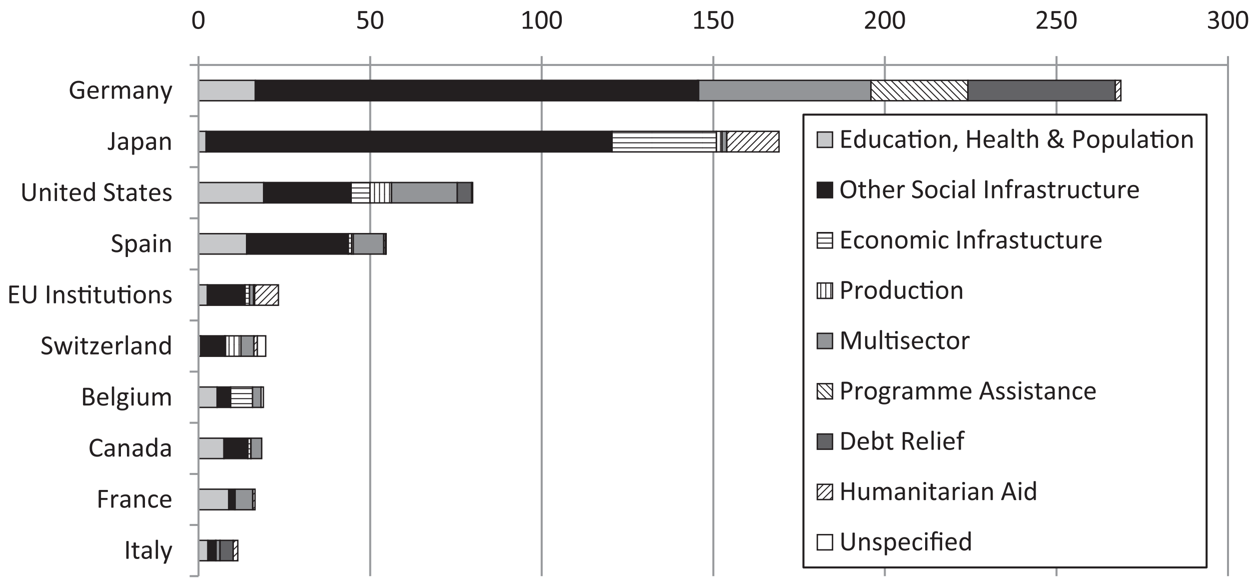
115. "Error Message: A disappointing return from an investment in computing," *The Economist*, April 7, 2012, http://www.economist.com/node/21552202.

116. Joachim Bamrud, "Peru: Latin America's Macro Economic Star," *Latinvex*, April 22, 2013, http://latinvex.com/app/article.aspx?id=662.

117. Alana Wilson, "Peru's social conflict is about more than mining," Fraser Institute, http://www.fraserinstitute.org/uploadedFiles/fraser-ca/Content/research-news/research/articles/perus-social-conflict-is-about-more-than-mining.pdf.

118. Anonymous interview, Lima, Peru, February 26, 2013; Inter-American Development Bank, "Peru Country Strategy 2012–2016," http://www.iadb.org/en/countries/peru/country-strategy,1036.html.

Figure 4.5. Top Ten Donors in Peru: Disbursed Bilateral Official Development Assistance in 2011 ($US million)



Source: OECD, "OECD Stats: Bilateral ODA to Peru," (retrieved: May 31, 2013http://www.oecd.org/dac/stats/aidstatistics-byrecipientandsector.htm.

Finance Corporation (IFC) programs function primarily at a macro level, focusing extensive resources on improvements in the investment climate, sustainable business, access to finance, and promoting public–private partnerships. Although representatives from the IFC note that governance work is not traditionally within its purview, some of its programs in Peru have addressed local governance issues as part of its "responsive, responsible, and accountable" value framework.[119] The Andean Development Corporation provides significant support on infrastructure development, recently approving $435 million in credit to the country to support its response to natural disasters and to finance the development of Peru's natural gas distribution.[120] It does not address institution building more broadly.[121]

Germany, Peru's largest bilateral donor, has been running programs in Peru since 1975.[122] GIZ's work focuses on democracy and governance, water, and environmental issues.[123] One interviewed individual noted that Germany is considering whether to prioritize governance factors within its general development programming, given that its efforts in the mining industry are on the uptick and that authorities are searching for a novel approach to improve decentralization and inclusion in the country. Although German

119. Anonymous interview, Lima, Peru, February 27, 2013.

120. Andina, "CAF Approves $435mn for energy development, natural disaster response," July 9, 2013, http://www.andina.com.pe/Ingles/noticia-caf-approves-435mn-for-energy-development-natural-disaster-response-in-peru-465471.aspx.

121. Ibid.

122. Anonymous interview, Lima, Peru, February 27, 2013; GIZ, "Peru," http://www.giz.de/en/worldwide/400.html.

123. GIZ, "Peru," http://www.giz.de/en/worldwide/400.html.

funding to Peru had increased throughout the last decade, recent reductions in its assistance funds are likely to result in significant cuts to its programs in Peru.[124]

United States

Peru has been a valuable regional ally to the United States. USAID began work in Peru in 1961 and over the past 50 years has provided extensive support to programs addressing poverty, literacy, infrastructure, health, democracy, education, and agricultural issues. From 2008 to 2010 USAID implemented a $35.6 million MCC threshold program that addressed child immunization and corruption in public administration.[125] Additionally, both the Overseas Private Investment Corporation (OPIC) and the U.S. Export-Import Bank have invested in projects in Peru, particularly in the energy sector. Today, a significant portion of Peru's assistance is dedicated to programs combating the drug trade; the Obama administration's FY13 request of $74 million for Peru included $23 million for this purpose.

The United States has a strong interest in Peru's welfare as a strong regional political and economic partner for a variety of reasons. The U.S.-Peru trade promotion agreement (TPA) has been in force for over four years,[126] the United States is the country's largest trading partner, and it looks to Peru to act as its regional ambassador to promote the Trans-Pacific Partnership (TPP).[127] Despite the recent declines illustrated in Figure 4.6, U.S. assistance levels remain strong relative to its level of prosperity and stability. The focus is primarily on projects dedicated to democratic rule, investments in the population, and improvements in physical and social infrastructures.[128] Although many players in Peru's development landscape now put significant resources toward decentralization, USAID's activities addressing this issue are particularly in-depth and geographically broad.[129]

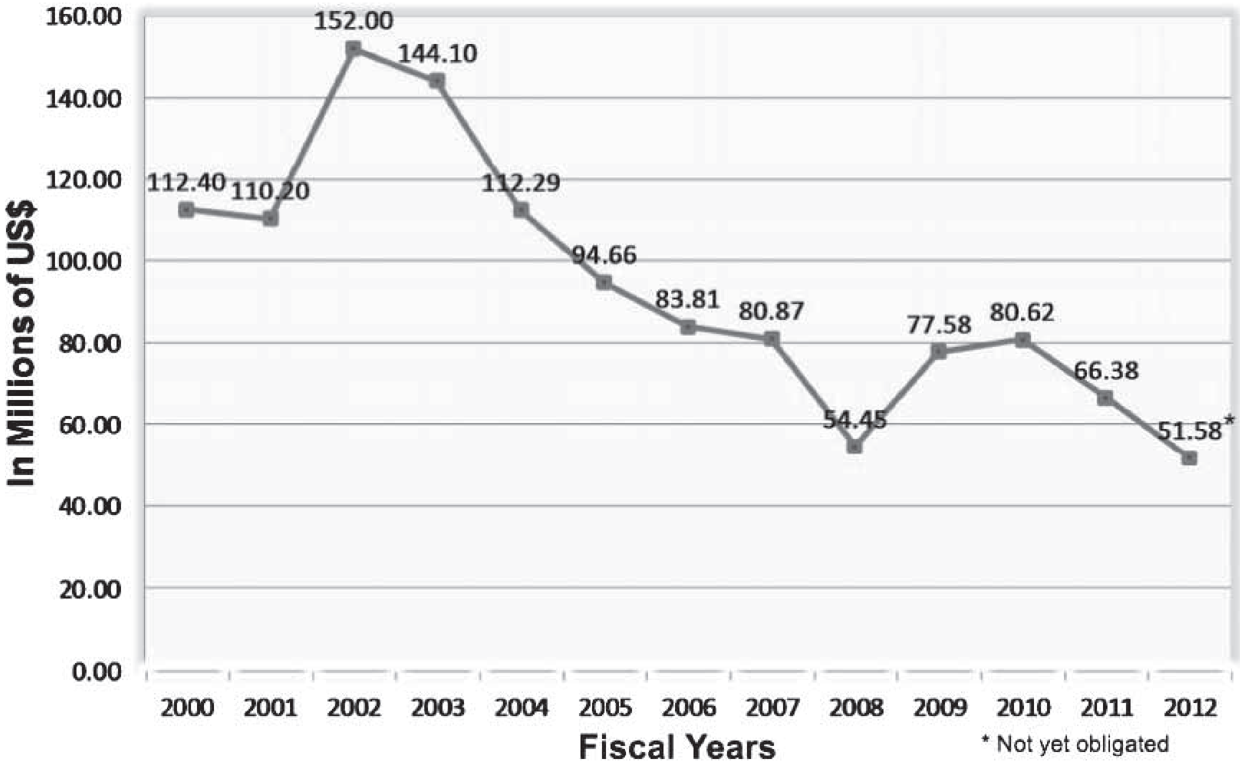
Peru continues to enjoy the benefits of many of USAID's projects, such as past and ongoing efforts to encourage alternative development: the 2007–2012 program supported the cultivation of almost 140,000 hectares of legal alternatives to coca, including over 56,000 hectares of cacao. Despite Peru's value to the United States as a political and economic partner, USAID has scaled down its mission in the country and there is an acknowledgment within the country that the mission will close in the next decade.

CONTINUING CHALLENGES

As Peru's political and economic situations have evolved, so have the development challenges donors face within the country. Expert consultation and independent research revealed

124. Anonymous interview, Lima, Peru, February 27, 2013.
125. MCC, "Peru Threshold Program," http://www.mcc.gov/pages/countries/program/peru-threshold-program.
126. U.S. Trade Representative, "Peru Trade Promotion Agreement," http://www.ustr.gov/trade-agreements/free-trade-agreements/peru-tpa.
127. Anonymous interview, Lima, Peru, February 27, 2013; The White House, "Fact Sheet: U.S.-Peru Economic Relations," June 11, 2013, http://www.whitehouse.gov/the-press-office/2013/06/11/fact-sheet-us-peru-economic-relations.
128. Taft-Morales, "Peru in Brief," 9.
129. Anonymous interview, Lima, Peru, February 27, 2013.

Figure 4.6. Historical USAID Budget in Peru



Note: USAID, U.S. Agency for International Development.
Source: USAID, "Historical Budget for USAID in Peru," http://peru.usaid.gov/historical-budget.

several urgent challenges for Peru and its development partners. The governance and growth nexus remains a challenge for Peru that must be addressed if it is to avoid the middle income trap and continue to grow. In particular, donors need to focus more on improving their governance programs, rule of law, and programs aimed specifically at mining.

Underinvestment in Governance

Donors continue to underappreciate the omnipresent importance of governance across a number of development sectors. Limited resources are devoted to independent governance programs, and the United States frequently addresses governance objectives only in association with its democracy programming. Many donors' programs address governance only as an afterthought or as a by-product of working toward other objectives. In interviews, non-U.S. donor representatives exercised extreme caution in discussing governance objectives and activities, similarly associating governance programming with the United States' "democracy promotion" activities.

Many of Peru's current challenges are strongly related to an underinvestment in governance objectives. In-country interviews indicated that this underappreciation is due to many factors, including: (1) negative associations with historical U.S. democracy promotion; (2) marketing concerns given the slow pace by which governance is improved and benefits from that improvement are felt; and (3) similarly, the thorny nature of developing solutions to governance challenges as opposed to less “conceptual” development objectives.

Mining and Mining Revenues

As in many developing economies, Peru’s natural resources are both a blessing and curse. Although the mining industry is the greatest source of the country’s new wealth, the management of mining projects and the revenue they generate is a constant struggle in Peru. It is also the most prominent cause of public discontent regarding decentralization, environmental degradation, and inadequate economic and social inclusion.

Although the government has made strides to improve mining practices, including the indigenous consultation law and development of regulations to ensure that a significant portion of the public proceeds are directed toward the surrounding community, the mining industry is still seen as a source of tension. Although several donors are working to improve environmental policies and practice within the industry, interviews indicated that some organizations are reticent to invest resources to help Peruvian communities navigate the Economy Ministry’s complex national investment system. Those organizations want to adapt the administrative procedures required to utilize those revenues into a process better suited to the education and abilities of the intended beneficiaries, rather than dedicating limited resources toward enabling some parties to utilize a system they see as in need of reform.[130] Despite this, some training programs within Peru have led to some improvement in the way that mining revenues are utilized.[131]

Rule of Law

Despite real progress within law enforcement and the judicial system, Peru’s efforts to strengthen the rule of law has been outpaced by its development in other areas. The country’s system of recording and enforcing property rights is considered particularly weak. In 2012 Peru scored 40 out of 100 on the Global Property Guide’s property rights index.[132] Despite reforms implemented during the 1990s, much of Peru’s land is not formally or clearly titled to a single owner.[133] Donor’s past programs addressing this issue are believed to have had a significant impact; however, the national and local governments and their partners are perceived as having lost momentum in addressing this issue.[134] Similarly, the public consistently reports mistrust in Peru’s judicial system.[135] Donors continue to invest in improving transparency and reducing corruption in Peru’s legal system, and interviewed individuals

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130. Anonymous interview, Lima, Peru, February 27, 2013; see, for example, World Bank, *Peru: Institutional and Governance Review,* August 24, 2001, http://www1.worldbank.org/publicsector/anticorrupt/FlagshipCourse2003/PeruIGR.pdf, p. 51.

131. Anonymous interview, Lima, Peru, February 27, 2013.

132. Global Property Guide, “Property Rights Index: Peru Compared to Continent,” http://www.globalpropertyguide.com/Latin-America/Peru/property-rights-index.

133. Michael Hendrix, “Land Rights in Peru,” CIPE Development Blog, March 27, 2009, http://www.cipe.org/blog/2009/03/27/land-rights-in-peru/.

134. Anonymous interview, Lima, Peru, February 27, 2013.

135. U.S. Department of State, “Country Reports on Human Rights Practices for 2012: Peru,” 2012, http://www.state.gov/j/drl/rls/hrrpt/humanrightsreport/index.htm?year=2012&dlid=204472#wrapper.

expressed confidence that these investments have effected real improvement. However, Peruvians' growing awareness of corruption means any improvement must be significant and public. Financial pressure in donor countries means limited resources are being dedicated to improving the judicial system; for example, USAID plans to close out its programs addressing judicial transparency and addressing corruption within the courts by 2015.

Indonesia

In 1998 Indonesia's long-time ruler, Suharto, was overthrown in a series of mass protests over dissatisfaction with his increasingly corrupt and authoritarian rule. Since that time, the country has emerged as a strong electoral democracy and undergone two contested presidential elections. In addition, after recovering from the Asian financial crisis of 1997, the country has seen strong economic growth, averaging 6 percent growth per year since 2000. Political and economic reforms since Suharto's downfall have created an environment of general political and economic stability. Indonesia is a founding member of the Association of Southeast Asian Nations (ASEAN) and enjoys a good relationship with the United States. Further, it is an emergent member of the Group of 20 (G20). In spite of its progress, Indonesia is facing an economic slowdown and the possibility that it will alienate the foreign investors needed to sustain progress. Further, there is a sense among Indonesians that they do not need outside advice; they are progressing in their own way. This presents a challenge to donors.

COUNTRY PROFILE

Political

Indonesia was originally colonized by the Dutch beginning in the 17th century, who sought to exploit the country's bountiful natural resources and strategic location for trade with East Asia. In 1942 Japan occupied the then-Dutch East Indies during World War II. Although the Dutch attempted to reestablish their control over Indonesia following the Japanese surrender in 1945, they faced stiff nationalist resistance that ultimately led to the establishment of the modern Republic of Indonesia in 1949. Under its first president, Sukarno, Indonesia pursued a policy of strict neutrality during the early days of the Cold War and became a founding member of the Non-Aligned Movement in 1955.

In 1965 an attempted coup was put down by the Indonesian military; the coup was blamed on the Indonesian Communist Party (PKI) and was used as an excuse to replace Sukarno with a leading general, Suharto. This action led to a large-scale purge of the PKI, which resulted in an unknown number of deaths. Suharto's rule ushered in a period of relative stability built on a strong central government that was supported by the military. Outwardly Indonesia remained neutral but was more anti-communist than during Sukarno's era. Indonesia received diplomatic and economic support from the United States and other Western powers. Foreign investment grew and the country experienced periods of strong economic growth. Suharto remained in power until 1998, when growing discontent with his rule and the Asian financial crisis lead to massive street protests that ultimately ousted him from power. Since then Indonesia has held two democratic presidential elections that were largely seen as free and fair.[136] The current president, Susilo Bambang Yudhoyono, won election in 2004 (defeating Megawati Sukarnoputri of the Indonesian Democratic Party-Struggle and daughter of Sukarno) and reelection in 2009 and is a member of the Democratic Party.

Indonesia's new democracy ushered in a series of reforms that sought to transform the country, particularly by removing the military from politics. The new leadership took away the military's seats in parliament, separated the national police from the military, and installed a civilian defense minister.[137] One critical element of the post-Suharto reforms is decentralization. Power and governing responsibilities have been devolved from the central government to the local level. This means that over 30 percent of the government's budget is now distributed at the local level; service delivery is now largely a subnational government issue. This has helped to allay issues that surrounded centralization of power during the Suharto period, but it has also created a sense of confusion about the different roles of local and central government.[138] This has had the effect of not only decentralizing power, but also decentralizing corruption. Corruption remains an issue that plagues Indonesia, which is ranked 118th out of 176 on Transparency International's corruption perceptions index.

The 2014 year will be crucial for Indonesia as it will hold parliamentary elections in the spring and the presidential election in the summer. President Yudhoyono is constitutionally barred from seeking a third term; at present the competition to be his successor is considered wide open. Likely front runners include Prabowo Subianto, a former general and head of the Gerindra party; Aburizal Bakrie, a businessman and chairman of the Golkar party; Pramono Edhie Wibowo, the brother-in-law of President Yudhoyono and believed to be the choice of the ruling Democratic Party. Finally, there is Joko Widodo, the current governor of Jakarta who is widely seen as having the ability to win, but has not yet declared his candidacy for the presidency.[139] With rising discontent in Indonesia over growing economic inequality, corruption, poor infrastructure, and a sense that the government cannot deliver on its promises, many see Widodo as a welcome outside who could achieve the change needed to tackle these problems.

Indonesia has made great strides since 1998 when Suharto was ousted, but significant remaining governance challenges will impact its future growth prospects. The capacity of both the local and central government remains weak. The top-level officials in ministries and elsewhere are generally seen as competent and capable of executing decisions; however, reform of the civil service remains a challenge. Even with the devolution of power to

136. Bruce Vaughn, "Indonesia: Domestic Politics, Strategic Dynamics, and U.S. Interests," *Congressional Research Service*, January 31, 2011, http://www.fas.org/sgp/crs/row/RL32394.pdf, 8.

137. Ibid., 8; Anonymous interview, Jakarta, Indonesia, July 24, 2013.

138. Anonymous interview with bilateral donor, Jakarta, Indonesia, July 22, 2013.

139. "Let the games begin," *The Economist*, September 7, 2013, http://www.economist.com/news/asia/21584981-parties-search-presidential-candidate-ordinary-indonesians-think-only-jokowi-pictured.

the sub-national level, Indonesia retains a large bureaucracy and numerous ministries that could be reduced.[140] As the 2008 World Bank country strategy for Indonesia noted, "Indonesia faces a challenge in that a large number of government agencies are fragmented and have overlapping authorities. The implementation of the institutional framework governing the division of roles, responsibilities and resources between the national and local governments remains incomplete."[141] Although written in 2008, these challenges remain and were noted in interviews with donors and other local observers in Jakarta. The most recent World Bank country partnership strategy for Indonesia echoed these concerns over institutional capacity to formulate and execute policy. Coordination of policy does not come naturally and is generally executed through ad-hoc steering committees. Further, there is a general lack of transparency in the policy decisionmaking process with little consultation outside of the government.[142]

Economic

The Indonesian economy has performed remarkably well since the Asian financial crisis of 1997–1998. It has averaged 6 percent growth since then, and unlike many advanced economies, it saw growth even at the height of the recent global financial crisis. Growth has steadily increased since the early 2000s and over the last 10 years has averaged between 5 and 6 percent per year, with the exception of 2009 (see Figure 4.7). GDP per capita is now $3,500 and Indonesia is now considered a middle income country. Indonesia is the world's 16th largest economy with a GDP of nearly $1 trillion. Part of this growth can be attributed to Indonesia's rapid industrialization. Industry now accounts for approximately 47 percent of GDP, services account for 42 percent, and agriculture for 11 percent.[143] The local private sector plays a large role in Indonesia's economy, accounting for 60 percent of GDP and 70 percent of employment.[144]

Indonesia's decade of economic success has paid immense dividends from a macroeconomic perspective. The country's debt to GDP ratio has declined from a high of 90 percent in 1999 to 27 percent in 2011. Deficits are now generally in the low single digits; the World Bank projects that Indonesia will run a 2.5 percent deficit in 2013.[145] The Indonesian government's budget reached $100 billion for the first time in 2008; this increase in budget resources has allowed the government to significantly increase discretionary spending. Indonesia's budget is now approaching $200 billion per year.[146] Fuel subsidies, however, remain a challenge. In recent years the Indonesian government has steadily increased the

140. Anonymous interview, Jakarta, Indonesia, July 23, 2013.

141. World Bank, *Investing in Indonesia's Institutions: International Bank for Reconstruction and Development and the International Finance Corporation, Country Partnership Strategy FY09–12 for Republic of Indonesia*, July 22, 2008, 9 (hereafter cited as World Bank, *Indonesia Country Partnership Strategy FY09–12*).

142. Anonymous interview with bilateral donor, Jakarta, Indonesia, July 23, 2013.

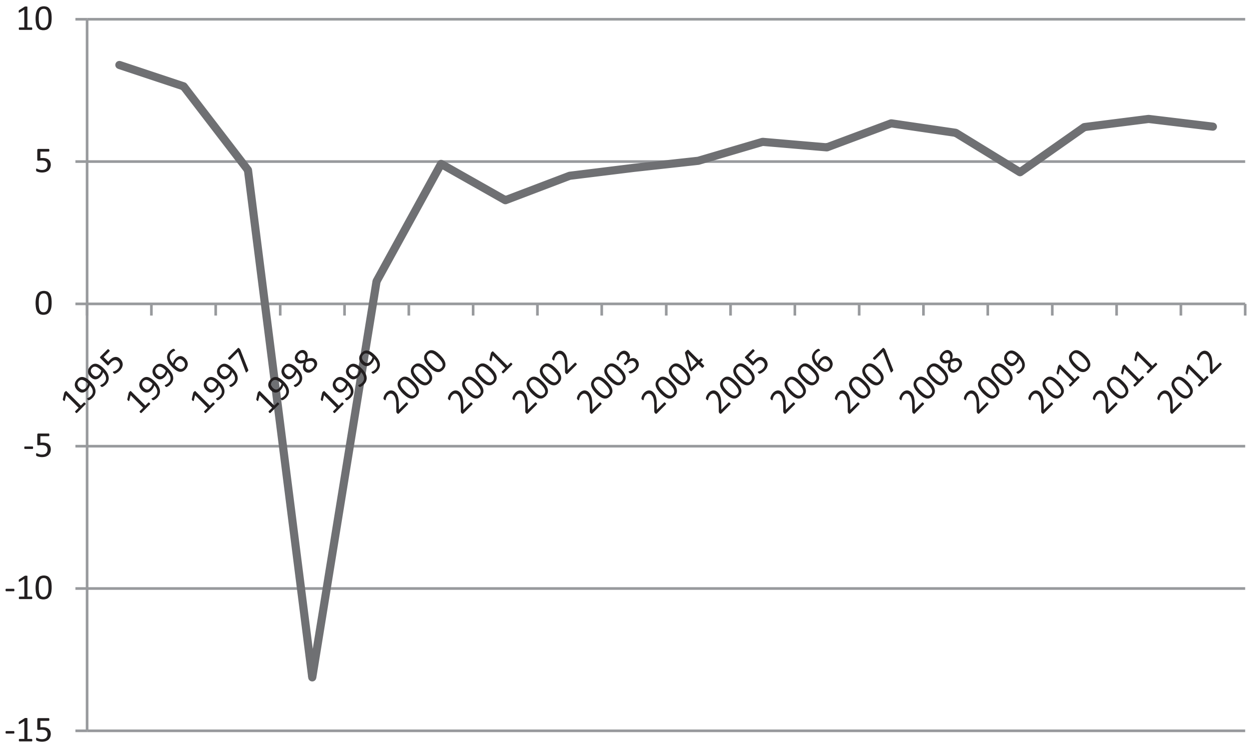
143. World Bank, *Indonesia Country Partnership Strategy FY09–12*, 138.

144. Asian Development Bank, "Country Partnership Strategy: Indonesia, 2012–2014," May 2012, 2 (hereafter cited as ADB, "Indonesia Country Partnership Strategy").

145. World Bank, "Indonesia Economic Update: Continuing Adjustment," October 2013, http://www.worldbank.org/content/dam/Worldbank/document/EAP/Indonesia/IEQ-Oct2013-ENG.pdf, ii.

146. World Bank, *Towards 2015: Spending for Indonesia's Development, Shaping the Prospects of a Middle-Income Country*, August 2009, 2.

Figure 4.7. Indonesia GDP Growth Rate, 1995–2012 (percent)



Note: GDP, gross domestic product.
Source: The World Bank, "Databank: Indonesia GDP," http://databank.worldbank.org/data/views/reports/tableview.aspx.

price of fuel per liter, raising the price in June 2013 to 67 cents thus freeing up nearly $33 billion a year.[147]

Trade remains contentious for Indonesia with many outside observers viewing it as increasingly protectionist. Domestic consumption accounts for approximately 55 percent of Indonesia's GDP. In 2012, Indonesia exported goods and services valued at $187 billion.[148] Although some see Indonesia as being connected to global supply chains, it is not nearly as well connected as some of its neighbors, such as Thailand, Malaysia, and Singapore, especially in the electronics and other sectors. For the United States, Indonesia is the 34th top export destination and the 27th largest source of imports. Indonesia's top export partners (in order) are Japan, China, the European Union, Singapore, and South Korea. Its top import partners are China, Singapore, Japan, the European Union, and Malaysia.[149]

147. Murray Hiebert, Ted Osius, and Gregory B. Poling, *A U.S.-Indonesia Partnership for 2020: Recommendations for Forging a 21st Century Relationship*, Center for Strategic and International Studies, September 2013, 32.

148. CIA, *The World Factbook: Indonesia*, 2013, https://www.cia.gov/library/publications/the-world-factbook/geos/id.html.

149. Ibid., 24–26; World Trade Organization, "Trade Profiles: Indonesia," September 2013, http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=ID.

Over the past several years Indonesia has attracted a significant amount of foreign investment, reaching nearly $20 billion in 2012. Foreign investment is heavily concentrated in the mining and manufacturing sector, accounting for $3.8 billion and $8.1 billion, respectively, in 2011.[150] Indonesia attracts significant FDI from Japan, China, South Korea, the United States, and other ASEAN members, principally Singapore (see Figure 4.8).[151] U.S. investment in Indonesia hit a peak in 2007 at $2.9 billion, but it has declined to $1.4 billion in 2011. This is far behind Japan, for example, which invested $3.6 billion in 2011. Japanese investors, reportedly, see Indonesia as a new China.[152]

Indonesia, however, faces a decelerating economy. The World Bank now predicts that the economy will only grow at 5.3 percent in 2014. Although still robust, it is below the desired 6 percent annual growth.[153] Part of this slowdown is related to weakening commodities prices and a more challenging financing environment. Further, Indonesia continues to struggle with poverty reduction. From March 2007 to March 2012, the poverty rate fell from 16.6 percent to 12 percent, lifting approximately 30 million people out of poverty. In addition, 65 million people live above the poverty line, but, in the World Bank's estimate, remain vulnerable to falling back into poverty.[154] This is particularly true outside major cities and in remote regions such as Aceh or Papua. Indonesia is also increasingly seen as a protectionist country that is overly focused on domestic consumption. Overall, the regulatory environment remains challenging in Indonesia and the country ranks 129 out of 183 on the World Bank's 2013 *Doing Business Report*. The investment environment is further complicated by uneven implementation of rules and regulations.

DONORS

Although Indonesia is a middle income country on the rise, bilateral and multilateral donors maintain a significant presence. Indonesia is able to raise 80 percent of its financing on the global capital markets, which is a dramatic turnaround from a few years ago when it remained dependent on World Bank and Asian Development Bank financing. Yet Indonesia still looks to the multilateral development banks and bilateral donors for financing support for some public infrastructure projects and a series of capacity-building and regulatory reform projects. Beyond the multilaterals—which still have significant operations in Indonesia—there are a series of bilateral donor agencies that work in Indonesia. The most important are Australia, the United States, and Japan, all of which provide a mix of technical assistance, lending, and grant support. For its part, the government of Indonesia implemented a series of five-year economic development plans, currently under way is the second national medium-term development plan covering the years

150. U.S. Department of State, "2013 Investment Climate Statement—Indonesia," March 2013, http://www.state.gov/e/eb/rls/othr/ics/2013/204660.htm.

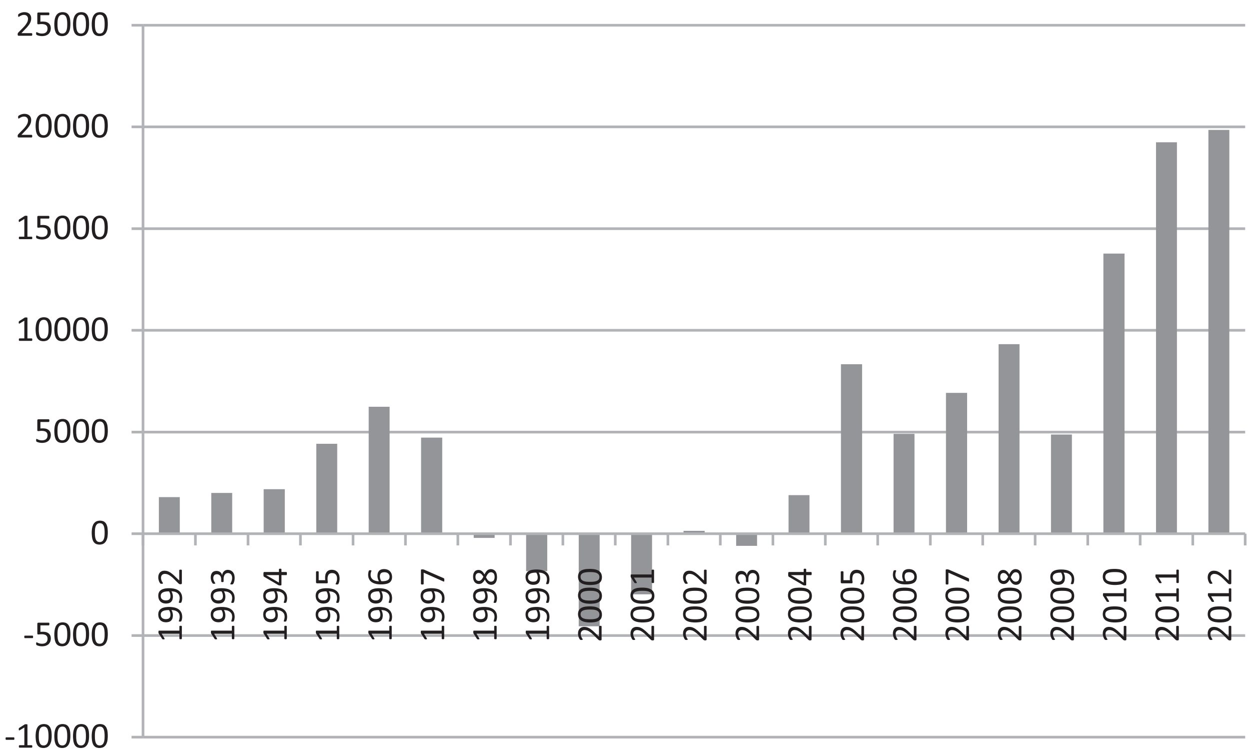
151. Hiebert et al, *A U.S.-Indonesia Partnership for 2020*, 30–31; U.S. Department of State, "2013 Investment Climate Statement—Indonesia," March 2013, http://www.state.gov/e/eb/rls/othr/ics/2013/204660.htm.

152. Anonymous interview, Jakarta, Indonesia, July 22, 2013.

153. World Bank, "Indonesia Economic Quarterly," October 2013, i–ii.

154. World Bank, "FY2013–2015 Country Partnership Strategy for Indonesia," December 13, 2012, 3.

Figure 4.8. Indonesia's Inward FDI Flows, 1992–2012 ($US million)



Note: FDI, foreign direct investment.
Source: UN Conference on Trade and Development, "UNCTADstat: Indonesia FDI," (retrieved: November 4, 2013), http://unctadstat.unctad.org/TableViewer/tableView.aspx.

2010–2014. The plan has a four-track strategy: pro-poor, pro-job, pro-growth, and pro-environment.[155]

International

The Asian Development Bank (ADB) and World Bank both maintain a significant presence in Indonesia. The ADB is operating under a two-year country partnership strategy that has two main pillars: inclusive growth and environmental sustainability that is responsive to climate change mitigation and adaptation. Within the first pillar, the ADB provides support to:

1. Develop energy, transport logistics, and trade facilitation to enhance connectivity among islands and with neighboring countries.
2. Improve access to water supply and sanitation in poor towns and selected cities.
3. Develop the non-bank financial sector to mobilize sources of long-term finance, and enhance access to finance of SMEs and in the emerging areas of housing and energy efficiency.

155. ADB, "Indonesia Country Partnership Strategy," 3.

4. Improve vocational education to cater to the needs of employers and industries in support of the master plan for higher productivity and wages.
5. Develop community-driven basic infrastructure for poor communities.[156]

Under ADB's current multi-year plan, it will allocate $2.5 billion of ordinary capital resources for public lending in Indonesia to support sector projects in energy, transport, finance, water supply and sanitation, education, natural resources, and public sector management.[157]

The World Bank has its largest presence in Indonesia outside of the headquarters in Washington, D.C. Indonesia has graduated from International Development Association funding and now receives World Bank support through the International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC), and the Multilateral Insurance Guarantee Agency (MIGA). Lending levels have varied over the past several years, reaching $4.3 billion in 2009, and projected to be $1.7 billion in 2013. The World Bank is currently implementing its FY13 to FY15 country partnership strategy, which is structured around the current Indonesian economic development plan. The strategy focuses on:

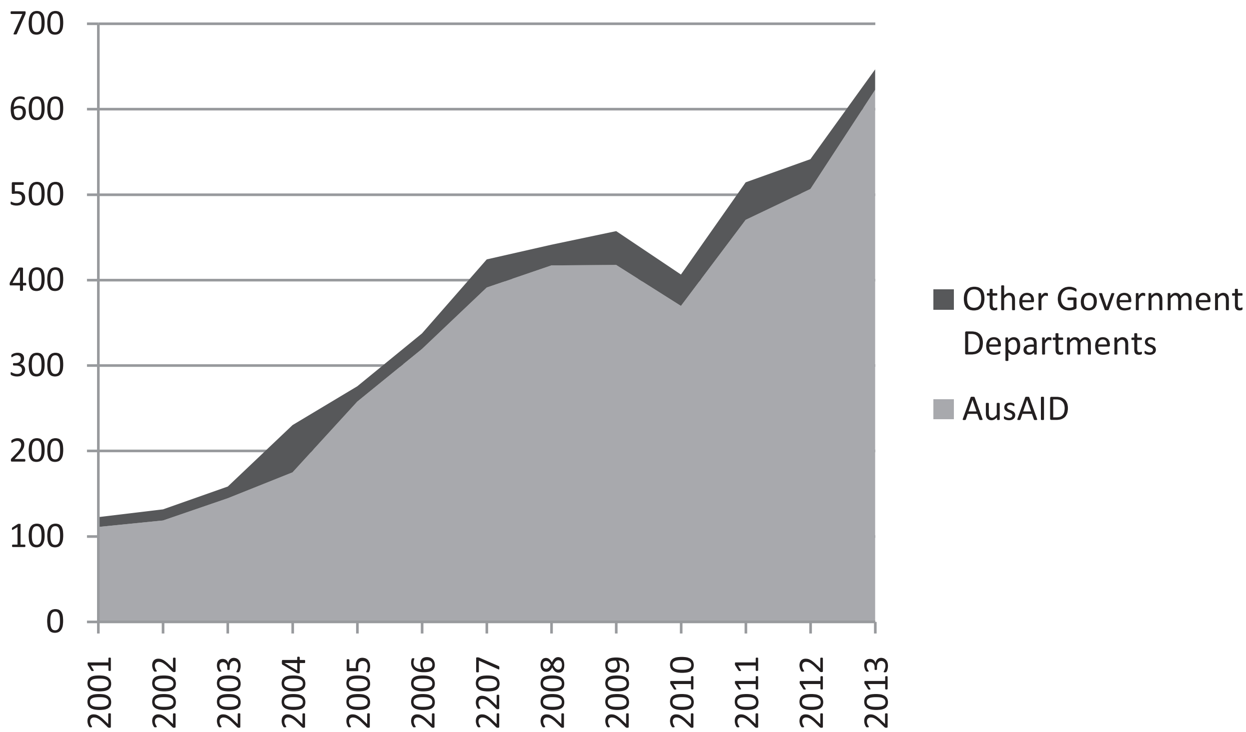
1. promoting prosperity
2. enhancing skills and technology, and improving social protection
3. promoting communities, protecting the vulnerable and improving health outcomes
4. ensuring sustainable development and improving disaster resilience
5. cross-cutting engagement on gender, and governance and anti-corruption[158]

Outside of the two MDBs and the United States, Australia has its largest aid mission in the world in Indonesia. Australia is in the process of completing its 2008–2013 country partnership strategy with Indonesia and will launch a new strategy next year. Its current strategy tackles issues related to the governance and growth nexus. It is understood that the strategy under construction will continue to focus on assisting Indonesia improve its governance and growth prospects. At present, the Australian Agency for International Development (AusAID) has four main pillars of work in Indonesia:

1. sustainable growth and economic management
2. investing in people
3. democracy, justice, and good governance
4. safety and peace[159]

156. Ibid., 4–5.
157. Ibid., 8–9.
158. The World Bank, "FY2013–2015 Indonesia Country Partnership Strategy," 12–14.
159. Australian Agency for International Development, *Australia Indonesia Partnership Country Strategy 2008–2013*, 2008, 8.

Figure 4.9. Australian Aid to Indonesia, 2001–2013 ($Aus million)[160]



AusAID, Australian Agency for International Development.
Source: AusAID, "Indonesia Country Profile: Australian ODA to Indonesia 2001–02 to 2013–14," November 1, 2013, http://aid.dfat.gov.au/countries/eastasia/indonesia/Pages/home.aspx.

Australia views the first pillar as the backbone of its strategy in country with a significant focus on improved economic policy and strengthened economic management at the central level. This involves working with the government of Indonesia on improving its regulatory environment, tax administration, debt management, financial sector regulation, international trade policy, and fiscal policy. Under pillar three, AusAID supports efforts to strengthen the capacity of Indonesia's legal, democratic, and oversight institutions. Australian aid has grown steadily over the last decade, rising from approximately Aus$122 million in 2001 to approximately Aus$650 million in 2013–2014 (see Figure 4.9). During this time, the Australian government steadily increased its support for governance, health, and education, while decreasing support for economic development.

United States

The United States has moved to establish closer ties with Indonesia over the last decade after a cooling period in the 1990s following concerns over human rights abuses by Indonesian security forces toward ethnic minorities and in East Timor. The Obama

160. http://aid.dfat.gov.au/countries/eastasia/indonesia/Pages/home.aspx

administration and the President Yudhoyono signed a comprehensive partnership agreement in 2010, effectively cementing the change in relationship. This agreement includes three main tracks: political and security cooperation, economic and development cooperation, and sociocultural, educational, science and technology, and other cooperation.[161] The United States has a long history of providing foreign assistance to Indonesia, beginning with the Suharto regime in 1965. At present, the United States provides the majority of its foreign assistance to Indonesia through the USAID mission[162] and a newly launched MCC compact.

The FY14 request for USAID included $183 million for Indonesia. This represents a decline of approximately $80 million from the FY09 request of $263 million (see Table 4.2). The decline represents the changing nature of the U.S. foreign assistance relationship with Indonesia, which is reflective of its status as a middle income country. Within the FY14 request, USAID envisions spending $3 million on economic development and $24.1 million on democracy and governance. Economic development spending in Indonesia has declined from $30.4 million in FY09; the remaining economic development money is allocated to a small agricultural development program. USAID's budget request for democracy and governance is distributed as follows: $9.4 million for good governance programs, $5.3 million for rule of law, $8.3 million for civil society, and $1.1 million for political competition.[163]

The United States signed its MCC compact with Indonesia in 2011 and the agreement entered into force in April 2013. The compact is valued at $600 million over five years and consists of three major components:

1. community-based health and nutrition to reduce stunting project ($131.5 million)
2. green prosperity project ($332.5 million)
3. procurement modernization project ($50 million)

The procurement modernization project of the compact seeks to improve government capacity in a particularly important area. Indonesia spends approximately $44 billion out of an approximately $100 billion government budget on procurement. This is highly prone to corruption and an estimated 30 to 40 percent of Indonesia's procurement budget is lost each year. The MCC will focus on creating a cadre at the local level that will receive training and certification. The hope is that this cadre will then spread out across Indonesia's local government entities and help to deepen the procurement capacity.[164] Overall, the program hopes to create a professional procurement corps for a country that up until now has generally treated procurement in an ad-hoc manner.

161. Hiebert et al., *A U.S.-Indonesia Partnership for 2020*, 8.
162. USAID Indonesia is in the process of preparing a country development cooperation strategy. It remains to be seen if they address the governance and growth nexus issues that this paper identifies.
163. Budget numbers drawn from http://www.foreignassistance.gov.
164. Interview with MCA-Indonesia Staff, Jakarta, Indonesia, July 22, 2013.

Table 4.2. U.S. Foreign Assistance (Excluding MCC Assistance) to Indonesia, FY06–FY14 ($US million)

Mission Category	*FY06*	*FY07*	*FY08*	*FY09*	*FY10*	*FY11*	*FY12*	*FY13*	*FY14*
Peace and Security	20.7	38.3	35.9	33.1	37.9	38.4	33.0	28.2	28.9
Democracy, Human Rights, and Governance	31.8	19.9	28.0	37.3	39.9	25.4	24.6	20.7	24.1
Health	45.9	43.0	38.5	43.4	51.7	48.8	45.6	48.9	48.3
Education and Social Services	31.9	29.4	50.0	105.5	47.5	45.0	43.0	36.3	44.0
Economic Development	19.6	28.0	23.4	30.4	18.9	15.6	5.5	4.4	3.0
Environment	7.3	9.2	10.8	13.3	24.8	34.0	27.5	28.4	28.6
Total	157.2	167.8	186.6	263.1	220.8	207.2	179.2	166.9	183.0

Note: Discrepancies in totals are due to rounding. FY, fiscal year; MCC, Millennium Challenge Corporation.
Source: Budget numbers drawn from http://www.foreignassistance.gov/web/OU.aspx?OUID=184&FY=2008&AgencyID=0&budTab=tab_Bud_Planned.

CONTINUING CHALLENGES

As noted above, Indonesia continues to face development challenges. While it is an emerging middle income country that has left the economic disarray caused by the Asian financial crisis far behind, it continues to have high levels of poverty, weak institutional capacity, and high barriers to entry to the formal economy. These challenges fall within the governance and growth nexus and require donors to examine their development priorities in country. There are two challenges that fall within the growth and governance nexus that Indonesia faces:

1. rule of law
2. government capacity

Rule of Law

The court system and general legal protections for business and investments remains an issue for Indonesia. A U.S. State Department report from March 2013, notes, "The court system often does not provide effective recourse for resolving property and contractual disputes. Judges are not bound by precedent and many laws are open to various interpretations."[165] This sentiment was echoed by numerous individuals interviewed in Indonesia during the course of the authors' research trip. According to at least one individual, contract enforcement by the courts is practically nonexistent.[166] The State Department report adds, "Indonesia's commercial code, grounded in Dutch colonial law, has been

165. U.S. Department of State, Bureau of Economic and Business Affairs, "2013 Investment Climate Statement—Indonesia," March 2013, http://www.state.gov/e/eb/rls/othr/ics/2013/204660.htm.
166. Anonymous interview, Jakarta, Indonesia, July 22, 2013.

updated to include provisions on bankruptcy, intellectual property rights, incorporation and dissolution of business, banking, and capital markets." However, "application of the commercial code, including bankruptcy provisions, remains uneven, in large part due to corruption and training deficits for judges, prosecutors, and defense lawyers."[167] The recent case involving alleged corruption by employees of Chevron demonstrates the challenges that companies face and that Indonesia must address if it is to maintain the levels of foreign investment needed. In the Chevron example, judicial officials pursued a case with little or no merit in spite of the fact that the ministries responsible in Jakarta believed that no crime had occurred.

Beyond the arbitration and court system, Indonesia also struggles with property rights and land ownership. Approximately one-third of privately owned land in Indonesia is formally registered, leaving nearly 60 million unregistered parcels. At the current pace of registration (around 1 million parcels per year), the Indonesian authorities will not complete this for 60 years.[168] There is significant ambiguity between formal and customary laws governing land ownership that are frequently exploited by officials and that lead to frequent land disputes.

Government Capacity

The Indonesian government's capacity to deliver public goods, particularly at a local level, is limited and there is some doubt among donors about the government's ability. Capacity of various departments is also uneven; the Ministry of Finance and the Anti-Corruption Bureau are seen as strong and able, while others that manage land ownership and public health are deficient. Ultimately, the high growth and poverty reduction that Indonesia achieved over the last decade is not a reflection of government capacity. Observers in Jakarta agreed that the country could have even higher and more sustainable growth if it tackled the governance challenges, but at present there is no sense of urgency in the government to do so. This largely reflects the government's complacency and contentment with 6 percent growth.[169] This complacency is fueling an implementation gap with Indonesia's laws.

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167. U.S. Department of State, "2013 Investment Climate Statement—Indonesia," March 2013, http://www.state.gov/e/eb/rls/othr/ics/2013/204660.htm.

168. USAID, "Property Rights and Resource Governance: Indonesia," December 2010, http://usaidlandtenure.net/sites/default/files/country-profiles/full-reports/USAID_Land_Tenure_Indonesia_Profile_0.pdf , 8.

169. Anonymous interviews, Jakarta, Indonesia, July 22–24, 2013.

5 Conclusions and Recommendations

The developing world has made immense governance and economic progress over the last 40 years. Many countries reduced their external debt, improved their political stability (largely through democratic processes), and embraced stable macroeconomic policies that have encouraged growth. The gains are impressive, particularly in sub-Saharan Africa and Southeast Asia. In spite of the impressive growth figures and poverty reduction, challenges remain that must be addressed to spur broad-based economic growth. Many donors, including the United States, have yet to address these challenges effectively. For the United States, the focus remains on meeting basic human needs. For aid to remain relevant, this must change. The United States must shift its focus toward the governance and growth nexus; this has the potential to truly deliver the broad-based economic growth necessary to solidify and expand the gains of the last 40 years.

As demonstrated in the case studies discussed in Chapter 4, the lingering challenges that remain fall largely within the nexus of governance and growth. In Tanzania, for example, the lack of—or inconsistent—rule of law remains a significant detriment to greater growth. This manifests itself through an inefficient, non-independent judiciary system (especially its commercial courts) that fails to offer the protection that business needs to grow and that foreign investors need to continue to invest in Tanzania. Addressing this, however, is a not a priority for U.S. assistance in Tanzania; it remains focused on a large public health project, some infrastructure (largely through the concluded the Millennium Challenge Corporation [MCC] compact), and an agricultural program. Indeed, in many of the emerging economies of sub-Saharan Africa—Kenya, Ghana, Senegal, and others—the United States continues to deliver the majority of its assistance toward social goods. Although it is easy to dismiss this, because the majority of U.S. aid to Africa goes to support basic human needs, it is equally true in other regions such as Southeast Asia. This would suggest that more needs to be done at the country level to shift the focus toward governance and growth.

Over the last several years, U.S. development agencies have made strides in better identifying constraints to growth whether the MCC process, the Partnership for Growth (PFG), and USAID's new country development cooperation strategy (CDCS) process. These analyses have been helpful, but in many instances they nibble around the edges of larger problems. As of this writing, USAID has shifted little in terms of resources (money or personnel) to address the constraints identified in the PFG process. Further, many of the constraints identified seem to be “low-hanging fruit,” that is, problems that are important, but not necessarily the most important constraints to growth. This is particularly true in Tanzania. In that case PFG found that electricity and rural roads were the constraints most in need of support. Yet donors have consistently found that Tanzania’s lack of clear land tenure laws is the major constraint for rural poverty reduction and broad-based economic growth.[170] In a country with a strong socialist legacy land is obviously a potent political issue, which makes donors leery of engaging on such an issue. The United States, as Tanzania’s largest bilateral donor, needs to engage on the issue of land by shifting resources. It is not impossible for USAID and other U.S. development actors to do this; in the case of the Philippines, as outlined above, the United States has shown its ability shift resources to address critical governance constraints to growth.[171]

The authors do not intend to suggest that an increased focus on the governance and growth nexus will solve every development challenge. As is clear through the case studies here and other recent work on governance, the nexus issues directly challenge the underlying power structures in many countries. This is not easy work and will require more than technical assistance that targets best practices. Further, the United States should not shift money and resources in a country where governance programs may not have an effect on the existing political order. This will require U.S. development agencies make greater use of political and economic analysis to identify the underlying power structures in a country. The good news is that USAID’s recently released democracy and governance strategy explicitly endorses the use of this kind of analysis by missions when they prepare an in-country governance strategy.

An underlying theme in Acemoglu and Robinson’s *Why Nations Fail* is an explicit critique of the way in which the West, led by the United States, has pursued foreign aid for the last several decades. They write, “The idea that rich countries should provide large amounts of ‘developmental aid’ in order to solve the problem of poverty in sub-Saharan Africa, the Caribbean, Central America, and South Asia is based on an incorrect understanding of what causes poverty.”[172] The authors question if building the inclusive non–rent-seeking institutions needed to lift countries out of poverty is something foreign aid, as currently organized, can accomplish. Given interest group politics, the organizations, and overarching strategy that governs U.S. development policy, it remains to be seen if the recommendations proposed in this paper can be carried out. But it is an issue that must be addressed before the governance and growth nexus can become an integral part of U.S. development policy.

Although this paper argues that the United States needs to focus more attention on the governance and growth nexus, this does not mean that it should ignore other related critical areas. For example, for many developing countries physical infrastructure in

170. Anonymous interviews, Dar es Salaam, Tanzania, May 20–22, 2013.

171. It should be noted that USAID is in the process of completing Tanzania’s CDCS, which may very well address many of the issues discussed in this paper. Furthermore, the Tanzania Growth Diagnostic conducted under the Partnership for Growth process did identify land issues as a binding constraint to growth, but in the end it was not accepted as one of the “top” binding constraints.

172. Acemoglu and Robinson, *Why Nations Fail*, 453.

particular presents a constraint to growth. From an investment standpoint, there is a significant gap between the funding available and what is required to address the developing world's deficiencies. Sub-Saharan Africa requires approximately $93 billion per year for infrastructure, but only $45 billion is available. One-third of the financing available is covered by donors and the private sector.[173] The United States should certainly continue to provide discrete infrastructure funding, particularly through the MCC and support to the MDBs, but increasing U.S. spending on infrastructure will not close the gap. The better approach is to focus on the governance and growth nexus to create an enabling environment that will lead to greater private-sector investment and an improvement in the public finances of developing countries.

In order to address the governance and growth nexus, the United States should do the following:

1. *Increase focus at the country level on governance and growth.* USAID now has an updated governance strategy, as well as its 2008 economic growth strategy. Both of these integrate elements of the governance and growth nexus. USAID should direct missions at the country level to begin to integrate the two streams of work. Critically this should support the country development cooperation strategy (CDCS) and PFG process that is ongoing for a number of countries. This directive to the country missions should give particular attention to the four areas of the nexus:

    a. government effectiveness
    b. rule of law
    c. critical regulatory policies
    d. barriers to entry

    As part of this process, USAID should direct the missions to prepare an analysis of the resources needed to strengthen its work in these areas. This should then be incorporated into the budgeting process at the USAID level in Washington, D.C. Resources must be shifted to support this work, but it must be done in a way tied to analysis of the on-the-ground situation.

2. *Tackling the politics of governance and growth reform.* An underlying issue in addressing governance and growth reform is a need to understand the local politics that prevent reform from occurring. Carothers and de Gramont note that "many governance aid specialists came to realize that while important technical deficiencies in the governing institutions in question certainly existed, they were rooted in underlying political conditions and structures that prevented any simple fixes."[174] Technical assistance aimed at reforming bureaucratic processes and building the capacity of the civil service is certainly useful, but if it simply reinforces existing exclusive institutions it will have little long-term effect on broad-based growth.

173. Amadou Sy, "Financing Africa's Infrastructure Gap," Brookings Up Front, October 9, 2013, http://www.brookings.edu/blogs/up-front/posts/2013/10/09-financing-africa-infrastructure-gap-sy.

174. Carothers and de Gramont, "Aiding Governance in Developing Countries," 5.

3. *Shift funds to support governance and growth programming.* As part of its new governance and growth strategy, USAID should shift significant funds to support governance and growth nexus activities. This would not entail seeking additional funds from Congress, but rather reprogramming existing allocations to support new work. As an initial goal, USAID should identify $1.5 billion that would support additional governance and growth work under the new strategy. This money would come from two sources: reprogrammed from other categories (that is, global health, education, etc.) and money that is preserved and transferred from Afghanistan and Pakistan as the U.S. military drawdown continues. In three years, based upon results, USAID should identify an additional $1.5 billion that would be transferred. This would increase total spending on these two areas to approximately $9.7 billion.

4. *Improve internal and external coordination.* A major stumbling block identified in this paper is the internal divisions that occur within USAID between its governance and economic growth work. This would involve creating a coordinating body within USAID that would oversee the work of the relevant two bureaus (Bureau for Democracy, Human Rights, and Governance and the Bureau for Economic Growth, Environment, and Education). Most importantly, this coordinating body would seek to bring the assistant administrators of the two bureaus together to discuss common policy. A major reorganization of USAID is likely impossible, but this would offer a good first step to achieving better coordination on these critical issues.

   Externally, the U.S. government should improve its ability to coordinate with other donors in country, in particular around the areas described in this paper. Bilateral donors, such as the United Kingdom, and multilateral donors such as the World Bank, allocate significant resources to governance and growth issues. The United States should engage in a more strategic manner—particularly in those countries where governance is a major constraint to growth—with these donors.

5. *Identify a group of countries that would benefit most.* Although governance is a challenge in most developing countries, the specific nexus of issues described in this paper are applicable in fewer countries. It is unlikely, for example, that it would make sense to pursue such a policy in the Democratic Republic of the Congo. The United States has already taken the initial step by establishing the Partnership for Growth process, which focuses on Ghana, Tanzania, El Salvador, and the Philippines. Ideally USAID could build on this process and expand it to additional countries. As the Philippines process has demonstrated, it is possible to use PFG and other constraints analyses to reprogram or program U.S. foreign assistance to address critical governance and growth challenges. As part of this process, the U.S. government should begin a sustained policy dialogue on these issues, as many of them require the political support of local governments in order to affect the lasting reforms needed. The subset of countries would likely involve current PFG countries and MCC compact nations.

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