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Executive Summary

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# The Millennium Challenge Account: Linking Aid with Economic Freedom

*Paolo Pasicolan and Sara J. Fitzgerald*

President George W. Bush announced the formation of the Millennium Challenge Account (MCA) during the United Nations Financing for Development Conference in Monterrey, Mexico, in March 2002. The MCA will attempt to address the failure of current U.S. development assistance programs to meet their stated goals. Most recipients of U.S. development aid are poorer now than they were before first receiving that aid. According to the Organisation for Economic Co-operation and Development, the United States provided $167 billion to 156 developing countries from 1980 to 2000. But for the 97 for which reliable economic data for that period are available, the World Bank reports that median per capita gross domestic product (GDP) declined from $1,076 in 1980 to $994 in 2000.

Recognizing this problem, President Bush specified that the MCA would be "above and beyond existing aid" and, for the first time, would be distributed only to developing countries that "govern justly, invest in their people and encourage economic freedom." The MCA will not replace existing development assistance programs or subtract from their budgets. In fact, President Bush allocated an additional $5 billion, phased in over a three-year period: a $1.7 billion increase in fiscal year (FY) 2004, $3.3 billion in FY 2005, and the full $5 billion in FY 2006 to fund the MCA. As a separate and distinct entity, the MCA is essentially an experimental program that attempts to learn from past mistakes and explore new strategies to improve the effectiveness of future development aid programs.

The President's three broad criteria that recipients must meet to qualify for MCA assistance—good governance, investment in health and education, and sound economic policies—are consistent with the findings of numerous studies that show that good policies, not aid, are the primary drivers of development. At best, foreign development assistance will accelerate the economic growth that results from sound policies and good governance.

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While the President laid out a broad framework for the MCA, much work remains to be done to flesh out the details if the MCA is to succeed where previous development efforts have failed. The Bush Administration must first determine which developing countries could receive this funding. A good starting point is the World Bank's International Development Association (IDA) program, which provides concessional loans to 79 of the poorest developing countries that do not qualify to borrow from the International Bank for Reconstruction and Development.

The primary requisite for MCA funds, however, should be progress toward reform, not merely poverty. Therefore, other developing countries not poor enough to be in the IDA, like Botswana, Guatemala, and Peru, also should be considered. Rather than the mere disbursement of development assistance, the goal is to maximize the effectiveness of development assistance.

For the MCA to be an effective catalyst for development, it must encourage economic freedom—the most reliable and consistent determinant of economic growth, which in turn alleviates poverty. Furthermore, policies that promote economic freedom support good governance and increase per capita income that provides the environment and resources necessary to improve health and education standards. Countries with higher per capita income can afford to invest in schools, hospitals, better sanitation, and a clean water supply. That is why richer countries have longer life expectancy, higher literacy rates, lower incidence of child labor, access to safe drinking water, and better air quality.

Therefore, the MCA should allocate resources to developing countries that have made demonstrable progress in adopting policies that advance economic freedom. The Administration should develop an objective measure of economic policies that permits comparison between possible aid recipients and monitor their progress over time. A model for this measure is the *Index of Economic Freedom*, published annually by the Heritage Foundation and *The Wall Street Journal*. Since its inception in 1995, the *Index* has shown consistently that the freer the economy, the higher its real per capita GDP. The *Index* measures economic freedom by analyzing 50 economic indicators and grouping them into 10 independent factors:

1. **Trade Policy**—the degree to which government hinders the free flow of goods and services.
2. **Fiscal Burden of Government**—the burden a government imposes on its citizens through taxes and government spending.
3. **Government Intervention in the Economy**—the government's direct use and control over resources.
4. **Monetary Policy**—the average rate of inflation over a 10-year period.
5. **Capital Flows and Foreign Investment**—how the free flow of foreign and domestic capital is restricted.
6. **Banking and Finance**—the regulations imposed on banks and other financial institutions.
7. **Wages and Prices**—the extent to which a government allows the market to set wages and prices.
8. **Property Rights**—the extent to which the government protects private property and how safe private property is from expropriation.
9. **Regulation**—the degree to which the government imposes regulations that are burdensome to business.
10. **Black Market**—the pervasiveness of the market for illegal goods and services, capturing the effects of government interventions not measured elsewhere.

Of the 79 IDA-eligible countries, Armenia, Bolivia, and Cambodia are a few examples of economies that the *Index* determined to be "mostly free" and therefore most capable of maximizing development assistance to accelerate economic growth. The transparency of such objective analysis would assure potential aid recipients that development is the sole goal of the MCA and that its eligibility would be based principally on sustained policy improvement over time rather than on political considerations unrelated to economic growth.

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# THE MILLENNIUM CHALLENGE ACCOUNT: LINKING AID WITH ECONOMIC FREEDOM

*PAOLO PASICOLAN AND SARA J. FITZGERALD*[1]

While in Mexico in March 2002, President George W. Bush announced the creation of a new development assistance program, the Millennium Challenge Account (MCA). The program, which will be "above and beyond existing aid," will distribute U.S. economic aid to developing countries that are determined to "govern justly, invest in their people and encourage economic freedom."[2]

The President's plan is the first serious attempt to address the fact that current U.S. development assistance programs consistently fail to meet their stated goals. Despite decades of economic aid, most recipients are poorer now than they were before first receiving development assistance. From 1980 to 2000, the United States disbursed $167 billion to 156 developing countries; but among the 97 countries for which reliable economic data for that period are available, median per capita gross domestic product (GDP) declined from $1,076 in 1980 to $994 in 2000.[3]

As the President made clear, the MCA will not replace existing development assistance programs or subtract from their budgets. To fund the MCA, President Bush has allocated an additional $5 billion to the current development assistance budget, phased in over a three-year period.[4] As an

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1. The authors would like to thank Brett D. Schaefer, Jay Kingham Fellow in International Regulatory Affairs in the Center for International Trade and Economics, for his insight and guidance on this issue, and Anthony Kim, Research Assistant in CITE, for his statistical contributions to this paper.

2. President George W. Bush, remarks at United Nations Financing for Development Conference, Monterrey, Mexico, March 22, 2002, at *www.whitehouse.gov/infocus/developingnations*.

3. GDP data and per capita GDP data from World Bank, *World Development Indicators 2002*. Unless otherwise noted, all per capita GDP figures are 2000 real per capita GDP in constant 1995 U.S. dollars. The median is a better statistical measure than the mean for highly skewed distributions like income because it is less sensitive to extreme scores.

4. U.S. Agency for International Development (USAID), "Millennium Challenge Account Update," June 3, 2002, at *http://www.usaid.gov/press/releases/ 2002/fs_mca.html*.

entity separate and distinct from current development programs, the MCA is essentially an experimental program that attempts to learn from past mistakes and explore new strategies to improve the effectiveness of future development assistance programs.

The three broad criteria President Bush established for MCA assistance—good governance, investment in health and education, and sound economic policies—are consistent with policies that many studies show are the primary drivers of development. At best, foreign development assistance accelerates the economic growth that results from sound policies and good governance.

While the President laid out a broad framework for the MCA, much work remains to be done to flesh out the details if it is to succeed where previous development efforts have failed. The Administration must first determine which developing countries can receive MCA funding. A good starting point is the World Bank's International Development Association (IDA), which provides concessional loans to 79 of the poorest developing countries that do not qualify to borrow from the International Bank for Reconstruction and Development (IBRD).[5]

The primary requisite for MCA funds, however, should be progress toward reform, not merely poverty. Therefore, other developing countries not poor enough to be on the IDA list, like Botswana, Guatemala, and Peru, should also be considered for MCA funds. The goal, after all, is not to distribute development assistance, but to maximize its effectiveness.

The President is right to say that, for the MCA to be an effective catalyst for development, it must "encourage economic freedom." Economic freedom is the most reliable and consistent determinant of economic growth, which in turn alleviates poverty. Furthermore, policies that promote economic freedom support good governance and increase per capita income, both of which provide the environment and resources a country needs to improve its health and education standards.

Thus, the Administration should focus the Millennium Challenge Account's aid resources on developing countries that have made demonstrable progress in adopting policies that advance economic freedom. To do this, it will need to develop an objective measure of economic policies that permits comparison among possible aid recipients and a monitoring of their progress over time.

A good model for this new measure is the *Index of Economic Freedom*, published annually by The Heritage Foundation and *The Wall Street Journal*.[6] Since its inception in 1995, the *Index* has shown consistently that the freer the economy, the higher to real per capita GDP. The *Index* measures economic freedom by analyzing 50 economic indicators and grouping them into 10 independent factors—trade policy, fiscal burden of government, government intervention in the economy, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation, and black market activity.

Comparing the 2002 *Index* scores with the 79 IDA-eligible countries shows that Armenia, Bolivia, and Cambodia are among the "mostly free" economies that would be most capable of using U.S. development aid to accelerate economic growth. Moreover, the transparency of an objective analysis of economic policies would assure potential aid recipients that development is the sole goal of the MCA and that eligibility would be based principally on sustained policy improvement over time, rather than on political considerations unrelated to economic growth.

5. The 79 IDA-eligible countries are Afghanistan, Albania, Angola, Armenia, Azerbaijan, Bangladesh, Benin, Bhutan, Bolivia, Bosnia–Herzegovina, Burkina Faso, Burma, Burundi, Cambodia, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Democratic Republic of Congo, Republic of Congo, Djibouti, Dominica, Eritrea, Ethiopia, Gambia, Georgia, Ghana, Grenada, Guinea, Guinea–Bissau, Guyana, Haiti, Honduras, India, Indonesia, Ivory Coast, Kenya, Kiribati, Kyrgyz Republic, Laos, Lesotho, Liberia, Madagascar, Malawi, Maldives, Mauritania, Moldova, Mongolia, Mozambique, Nepal, Nicaragua, Niger, Nigeria, Pakistan, Papua New Guinea, Rwanda, Samoa, Sao Tome, Senegal, Sierra Leone, Solomon Islands, Somalia, Sri Lanka, St. Lucia, St. Vincent, Sudan, Tajikistan, Tanzania, Togo, Tonga, Uganda, Uzbekistan, Vanuatu, Vietnam, Yemen, Yugoslavia, Zambia, and Zimbabwe.

6. Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Mary Anastasia O'Grady, *2002 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2002).

## FAILURE OF THE CURRENT AID REGIME

The United States is the largest bilateral donor to the developing world, contributing $10.9 billion in official development assistance (ODA) in 2001—roughly equivalent to the entire economic output of Kenya.[7] Yet U.S. official development assistance has failed consistently to achieve its stated goals to "assist peoples of the world in their efforts toward economic development."[8]

After receiving millions of dollars in U.S. development assistance over the years, most recipients are poorer today than when they first received it. From 1980 to 2000, some 23 recipients received development assistance that amounted to 25 percent of their GDP in 2000, but their compound annual per capita GDP growth averaged an appalling –0.16 percent. Despite the massive infusion of economic aid, they are no closer to achieving strong, reliable economic growth today than they were two decades ago.

The failure of U.S. official development assistance is not, as some have argued, due to lack of funding. According to former World Bank economist William Easterly,

> In 1951, the U.N. Group of Experts calculated exactly how much aid poor countries needed to achieve an annual growth rate of 2 percent per capita, coming up with an amount that would equal $20 billion in today's dollars.[9]

Over the past 50 years, the United States alone has contributed over $500 billion (not adjusted for inflation)—25 times the U.N. threshold. Adjusting for inflation and interest, this infusion cost American taxpayers an estimated $2 trillion.[10] Developed countries together spend more than $50 billion annually on official development assistance—more than twice the amount the U.N. Group of Experts identified.[11] Yet the original U.N. target of generating sustained economic growth in the developing world has not been achieved.

In many cases, this failure is the inevitable consequence of aid's having been directed toward governments that embrace misguided policies that undermine economic development, or corrupt regimes that misallocate or steal the funds. Under a succession of corrupt dictators, for example, Nigeria has received over $190 million in U.S. development assistance from 1980 to 2000, despite being ranked consistently as one of the world's most corrupt countries.[12] Per capita GDP in Nigeria is $254.

More money in cases like this only reinforces the policies that retard economic growth in developing countries, contributing to their current predicament and increasing their dependence on international donors. As Harvard Professor George Lodge notes, "at times foreign aid has even worsened the plight of the poor, by sustaining the corrupt or otherwise inefficient governments that caused their misery in the first place."[13]

Although much development assistance has been given to these countries, America all too often either fails to demand tangible evidence of reform before disbursing the assistance or halves the disbursement if reform is not adopted. According to Representative J. C. Watts (R–OK),

> Too often, foreign aid is given in the form of a blank check. No strings are attached. But herein lies the problem. Historically this assistance fails to integrate countries into the global economy, serving more as a

7. ODA data are from Organisation for Economic Co-operation and Development (OECD), *International Development Statistics 2002* on CD–ROM. GDP amounts in current U.S. dollars are from World Bank, *World Development Indicators 2002*.
8. Foreign Assistance Act of 1961 (P.L. 87–195). This act created the U.S. Agency for International Development.
9. William Easterly, "The Cartel of Good Intentions," *Foreign Policy*, July–August 2002.
10. Figures may be found in *Foreign Aid Revitalization Act of 1995, Report of the Committee on Foreign Relations to Accompany S. 908*, Report 104–95, Committee on Foreign Relations, U.S. Senate, 104th Cong., 1st Sess., June 9, 1995, p. 13.
11. Organisation for Economic Co-operation and Development, Development Assistance Committee, at *http://www.oecd.org/EN/document/0,,EN-document-57-2-no-12-29438-0,00.html*.
12. Robin Hodess, ed., with Jessie Banfield and Toby Wolfe, *Global Corruption Report 2001*, Transparency International, 2001, at *http://www.globalcorruptionreport.org/#download*.
13. George C. Lodge, "The Corporate Key: Using Big Business to Fight Global Poverty," *Foreign Affairs*, July 1, 2002.

Band-Aid approach rather than an engine of growth.[14]

A recent Columbia University paper supports this assessment, stating that "Where institutions are weak, money alone does not produce sustained development."[15] And a 1997 World Bank report concludes that

> aid has a positive impact on growth in developing countries with good fiscal, monetary, and trade policies. In the presence of poor policies, on the other hand, aid has no positive effect on growth.[16]

The *Index of Economic Freedom* analysis confirms that the most reliable and consistent determinant of economic growth is economic freedom, not aid. The *Index* has identified 10 independent factors that measure the level of economic freedom. (See text box.)

The lesson is clear: However well-intentioned it may be, development assistance alone is not sufficient to stimulate economic growth and development. If aid is to be effective and a positive contributor to development, donors must be more selective in its distribution. They must reward only those recipients that willingly adopt good policies and institutions.

### THE *INDEX OF ECONOMIC FREEDOM'S* 10 FACTORS THAT MEASURE ECONOMIC FREEDOM

1. **Trade Policy—**the degree to which government hinders the free flow of goods and services.
2. **Fiscal Burden of Government—**the burden a government imposes on its citizens through taxes and government spending.
3. **Government Intervention in the Economy—**the level of direct use and control the government has over resources.
4. **Monetary Policy—**a country's average rate of inflation over a 10-year period.
5. **Capital Flows and Foreign Investment—**how the free flow of foreign and domestic capital is restricted.
6. **Banking and Finance—**the regulations imposed on banks and other financial institutions.
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Source: Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Mary Anastasia O'Grady, *2002 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2002).

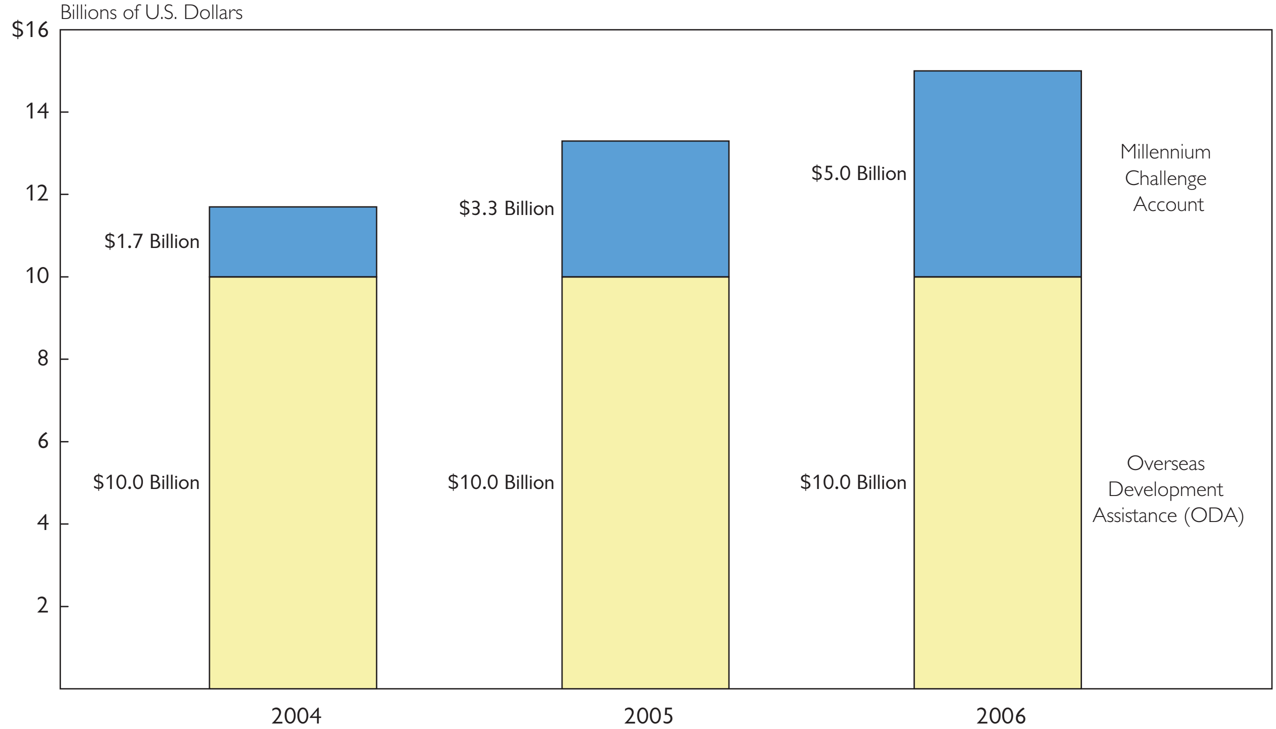
## LESSONS FOR THE MILLENNIUM CHALLENGE ACCOUNT

President Bush launched the Millennium Challenge Account on May 14 to help address the structural problems that plague U.S. development assistance programs. The MCA will increase the level of official development assistance by $5 billion annually, phased in over a three-year period: a $1.7 billion increase in fiscal year (FY) 2004, $3.3 billion in FY 2005, and the full $5 billion in FY 2006.[17] Thus, the MCA will not affect existing development assistance. (See Chart 1.)

14. The Honorable J. C. Watts, Jr., keynote address to Constituency for Africa Conference, Washington, D.C., October 30, 2001.
15. Steven W. Sinding and George Patterson, *Re-engaging with the Developing World: The Aid Imperative* (New York: Columbia University, 2002), p. 17.
16. Craig Burnside and David Dollar, "Aid, Policies, and Growth," World Bank, Policy Research Department, Macroeconomic and Growth Division, 1997.
17. USAID, "Millennium Challenge Account Update."

Chart 1 B1602

**Additional Funding from the Millennium Challenge Account**




**Source:** U.S. Agency for International Development, "Millennium Challenge Account Update Fact Sheet," June 3, 2002, at *http://www.usaid.gov/press/releases/2002/fs_mca.html*

More important, the MCA will link the development assistance with economic reforms and good governance. President Bush announced that the MCA, as a separate and distinct development assistance program, will be available only to countries that meet three criteria—that display good governance, invest in the health and education of their people, and enact sound policies that promote economic freedom. The Administration is currently developing ways to measure compliance with these three broad eligibility criteria as well as a system to administer the account.

In its efforts to do this, the Administration should take into account previous lessons learned from the development assistance track record and incorporate these lessons into the criteria for the MCA.

*First,* reform cannot be imposed from outside; it must have domestic support. Otherwise, recipients will merely revert to previous policies once development assistance ceases.

*Second,* providing money before reform is a recipe for inaction and dependency. The International Monetary Fund (IMF) learned this lesson after its policy of "conditionality"—that is, providing loans on condition that recipients would later implement a reform agenda—proved to be a failure. The IMF repeatedly disbursed funds to countries that have a history of violating previous reform conditions. For example, Argentina's present economic collapse can be attributed to poor economic policies exacerbated by decades of conditional IMF loans. As noted in a previous Heritage study,

> Since 1983, successive Argentine governments have failed to meet the conditions attached to each IMF loan. In addition, the $30 billion in loans that the IMF has given to Argentina over the past 18 years has failed to foster economic growth or stability.[18]

IMF loans create a moral hazard by diminishing the consequences of bad investment decisions. Argentina continued to request more money instead of making prudent, albeit politically difficult, reforms because economic assistance was readily available without the need for prior reform.

*Third,* governments and international institutions are often swayed into giving assistance for political reasons, regardless of a country's economic policies. Politics should not influence the distribution of assistance from the MCA fund. The criteria for eligibility should be objective and transparent so that both donor and recipient can ascertain progress and the reasons why one country qualifies over another.

These lessons dictate a specific policy of rewarding countries with a demonstrable record of improving or maintaining progress in objective criteria. An example may be an inflation target or reduction in corruption in the customs service as identified by independent observers. Such *a priori* criteria would help ensure that the sound policies necessary for development assistance to be effective are in place.

Only after progress is verified should countries receive U.S. funding for programs that include—but are not limited to—judicial reform, vaccinations, or micro-finance. Means of implementing these programs should be flexible to fit the circumstances of each country as closely as possible. The government may perform the program, or non-governmental organizations may bid on contracts to fulfill the objectives. A combination of both is also possible. Nevertheless, the Administration should design a system that directs funds to countries best able to use them through cost-effective programs that help the most people.

Competition for funds is an excellent method of achieving this objective. It is not an issue of spending less, since a fixed amount has already been apportioned to the MCA; rather, it is an incentive mechanism to develop programs that work. It is better not to allocate the full amount rather than repeat past aid errors by rewarding poor policy decisions, which would negate any benefits that development assistance might bestow.

The Administration should take this logic one step further and have countries meet moving benchmarks in order to maintain MCA-eligibility. For instance, if the Administration decides to use inflation as one measure of economic freedom, a country should have a 10-year average inflation rate of 12 percent to qualify for MCA funds. After five years of economic aid, the inflation target should be lowered to 6 percent. The country's development programs should also be based on pre-defined goals upon which continued funding is dependent. For instance, micro-finance programs should be evaluated on maximizing the number of new participants without sacrificing the default rate.

It is likely that the U.S. Agency for International Development, which administers America's official development assistance, will oversee the MCA. The Administration should establish the necessary guidelines to ensure that the account remains separate and distinct from traditional development programs. Such independence will allow the MCA to develop new strategies and methods of providing development assistance. This approach may require a separate budget and a special administrative team tasked specifically with the account. Establishing a "Chinese Wall" between the MCA and traditional development assistance programs is necessary for conducting any comparative analysis that could help reform existing programs.

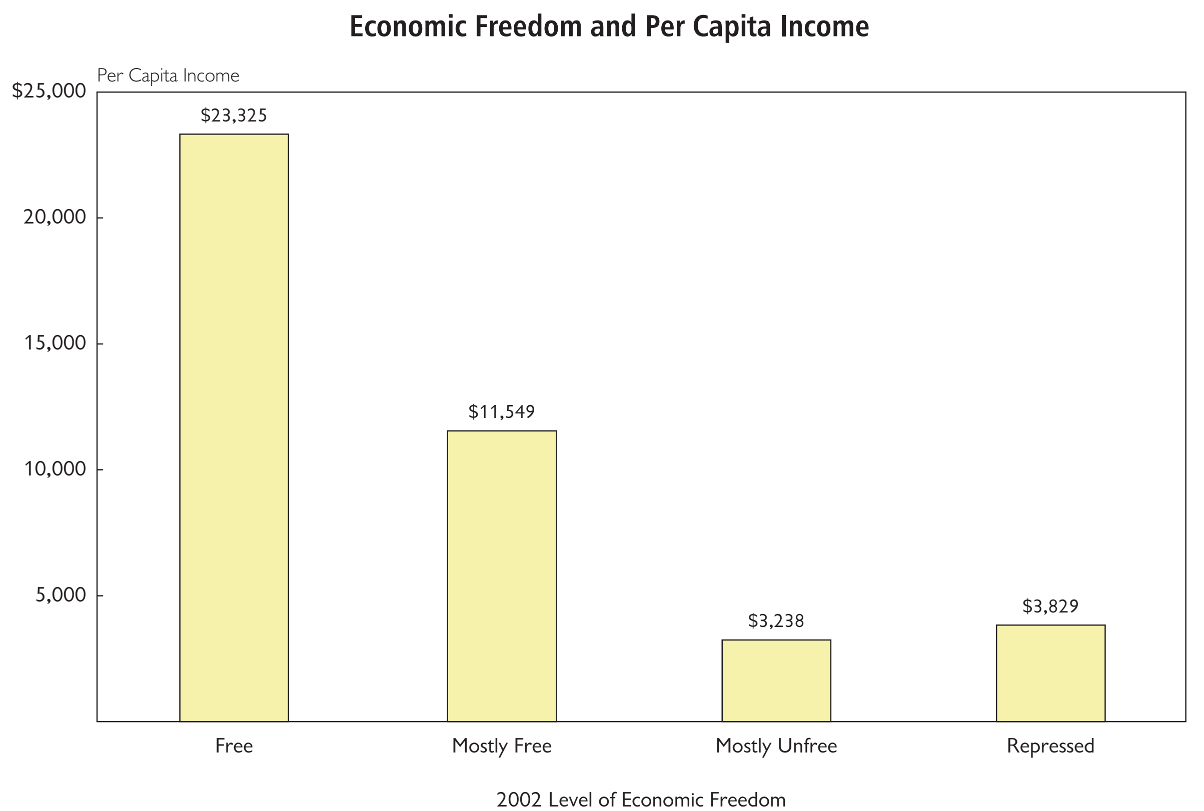
## WHY ECONOMIC FREEDOM IS PARAMOUNT

Adherence to policies that promote economic freedom should be the most heavily weighted of the three broad criteria that countries must meet in order to qualify for MCA funding. Only economic freedom, which depends on the rule of law, leads to higher per capita income and the alleviation of poverty. While improvements in health and education are not prerequisites of economic development, they are its consequences.

Economic freedom is the most consistent and reliable determinant of economic growth. The 2001 edition of the *Index of Economic Freedom* concluded that "countries with the most economic freedom also have higher rates of long-term economic

18. Ana I. Eiras, "Argentina: No Aid Without Reform," Heritage Foundation *Backgrounder* No. 1537, April 16, 2002.

Chart 2 B1602




Source: Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Mary Anastasia O'Grady, *2002 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2002).

growth and are more prosperous than are those with less economic growth."[19]

By analyzing 50 economic indicators classified under 10 independent factors, the *Index* comes up with a composite score for the country that ranges from 1.00 to 5.00, with 1.00 signifying a "free" economy and 5.00 an economically "repressed" one. The *Index* found that citizens of "free" countries, with scores between 1.00 and 1.95, enjoy a per capita income that is twice as high as their counterparts in "mostly free" (2.00 to 2.95) countries.[20] "Free" countries have an average per capita income of $23,325, whereas the average per capita income in a "mostly free" country is only $11,549.[21] Countries that are "mostly unfree" (3.00 to 3.95) have an average per capita income of $3,238. Countries that are economically "repressed" (4.00 to 5.00) have an average per capita income of $3,829, less than one-sixth of that of economically "free" countries. (See Chart 2.)

This difference occurs because open markets promote healthy competition, which requires the institutionalization of transparency and the rule of law and also results in the most efficient allocation of resources. Contrary to popular myth, economic growth benefits the poor directly. In the words of a World Bank working paper on the effects of economic growth on the poor, "As overall income increases, on average [the] incomes of the poor increase exactly the same amount."[22] The study

19. Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Melanie Kirkpatrick, *2001 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2001), p. 1.

20. O'Driscoll *et al.*, *2002 Index of Economic Freedom*, p. 3.

21. *Ibid.*, p. 2.

concludes that economic growth does not worsen inequality.

Policies that promote economic freedom often coincide with or directly result in good governance and permanent improvements in health and education standards. For example, an environment conducive to commercial enterprise requires fair and equitable dispute settlement in the form of an independent judiciary, which is also essential for good governance. In addition, corruption is most severe in areas where commercial interests are at stake because of such policies as excessive taxation, government procurement, and tariffs. Free-market policies that encourage open competition and minimal government intervention render corruption unprofitable or remove opportunities for corruption, creating a natural incentive for good governance.

A wealth of objective research shows that the higher per capita income that accompanies economic freedom also corresponds with higher health and education standards. Countries with higher per capita income can afford to invest in hospitals, better sanitation services, and a clean water supply. This correlation may help to explain why populations in higher-income states live longer. Countries with a per capita income greater than $10,000 have an average life expectancy of 77.3 years. For countries with a per capita income from $5,001 to $10,000, life expectancy is 73.6 years; for countries with a per capita income from $1,001 to $5,000, it is 68.1 years; and for countries with a per capita income less than $1,000, it is 56.0 years.[23]

Richer countries also have higher literacy rates than poor ones. Countries with per capita incomes greater than $1,000 have literacy rates of over 96 percent, while countries with per capita incomes of less than $1,000 have literacy rates of 62.5 percent.[24] Countries with higher per capita incomes can build more schools, hire more teachers, design better course syllabi, and educate more children because those children are less pressured to stay out of school to work to help support their poor families.

World Bank research confirms that higher per capita incomes also result in lower rates of child labor. Countries with per capita incomes of less than $1,000 have child labor rates of 21.7 percent, while countries with per capita incomes between $1,000 and $5,000 have child labor rates of 5.6 percent. Countries with per capita incomes greater than $5,000 have rates less than 1.0 percent.[25] A Stanford University study concludes that per capita GDP explains 80 percent of the worldwide variation in the incidence of child labor.[26]

There is also very strong statistical evidence that economic growth results in better environmental protection. A World Bank study of 11 developing nations found that certain economic policies like reducing government deficits, promoting market liberalization, and fostering international openness have a positive effect on the environment.[27]

Policies that restrict economic freedom prevent the market from allocating resources efficiently, resulting in profligate use of resources, which leads to environmental degradation. For example, 30 percent or more of China's pollution is due to the economic inefficiencies that result from its centralized economy.[28] As Jerry Taylor of the Cato Institute explains:

> economic liberalization leads to economic growth which in turn generates new economic opportunities and sources of livelihood, thereby alleviating poverty and reducing pressures on the environment due to over-exploitation of fragile resources by the unemployed.[29]

22. David Dollar and Aart Kraay, "Growth Is Good for the Poor," World Bank Development Research Group, March 2000, p. 2.
23. World Bank, *World Development Indicators 2001*.
24. *Ibid*.
25. *Ibid*.
26. Anne Kreuger, "Observations on International Labor Standards and Trade," National Bureau of Economic Research, *NBER Working Paper* No. 5632, 1996.
27. Mohan Munasinghe and Wilfredo Cruz, "Economywide Policies and the Environment: Lessons from Experience," *World Bank Environment Paper* No. 10, 1995.
28. Vijay Vaitheeswaran, "How Many Planets? A Survey of Global Environment," *The Economist*, July 6, 2002, p. 16.

Taylor's study points out the strong correlation between deforestation and poverty. The biggest reason for deforestation in developing countries is the need for agricultural land. Richer economies with more modern technology and agricultural practices can produce more output using less land. Another major reason is that the poor still use wood for fuel because electricity is either unavailable or too expensive. This observation may explain why deforestation abated after per capita income exceeded $4,760 in Africa and $5,420 in Latin America.[30]

Similar correlations exist between per capita income and access to safe drinking water and sanitation, improvements in air quality, decline in land degradation, and other objective measures of environmental standards.

## MEASURING ECONOMIC FREEDOM

In the face of such overwhelming empirical evidence, the Administration should establish comprehensive criteria to measure fully the level of economic freedom in countries that seek MCA eligibility. A good model exists in the *Index of Economic Freedom*, which ranks more than 150 countries each year. The *Index* may not necessarily be the only method the MCA should employ to measure economic freedom, but it could serve as the initial model.

Cross-referencing the 2002 *Index* countries with the list of 79 IDA-eligible countries provides a preliminary pool of seven countries with "mostly free" economies (with overall scores of less than 3.00) that could be eligible for the MCA funding: Armenia, Bolivia, Cambodia, Ivory Coast, Mali, Mongolia and Sri Lanka. Three more countries are on the cusp: the Central African Republic (3.05), Mozambique (3.05), and Uganda (3.00).

Several other developing countries like Botswana (2.90), Guatemala (2.80) and Peru (2.75) are not IDA-eligible. Although they may be poor, they already have in place policies that are conducive to economic growth and thus have a greater chance to maximize the effects of development assistance. Countries like these deserve consideration for MCA assistance.

The Administration should consider incorporating into the eligibility criteria for the MCA the *Index*'s 10 factors that measure economic freedom. Among the 50 key economic indicators that the *Index* tracks within those 10 major factors are the following:

1. **Trade Policy.** Openness to trade is a catalyst for increased economic growth because competition forces producers to make better products and gives consumers more choices of products at lower prices, effectively raising their purchasing power. Tariffs and non-tariff barriers are invisible taxes and clearly hinder a nation's prosperity. The variables that the *Index* uses to measure this factor are the average tariff rate, non-tariff barriers, and corruption in the customs service.[31] For example, although Vietnam has a long way to go to achieve an open trade policy, "as the nation has opened up, it has experienced a large increase in per capita income and no significant change in inequality," note economists David Dollar and Aart Kraay. Thus, "the income of the poor has risen dramatically, and the number of Vietnamese living in absolute poverty dropped sharply from 75 percent of the population in 1988 to 37 percent in 1998."[32]
2. **Fiscal Burden of Government.** High taxes and various other mechanisms that transfer private income to government coffers discourage productive enterprise and stifle economic growth. Measuring income and corporate tax rates as well as government expenditures as a percentage of GDP gives a good indicator of a country's fiscal burden of government.

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29. Jerry Taylor, "Sustainable Development: A Dubious Solution in Search of a Problem," Cato Institute, *Cato Policy Analysis* No. 449, August 26, 2002, p. 28.
30. Maureen Cropper and Charles Griffith, "The Interaction of Population and Growth and Environmental Quality," *American Economic Review*, Vol. 82, No. 2 (1994), pp. 250–254.
31. For the methodology for each of the 10 factors, see William W. Beach and Gerald P. O'Driscoll, Jr., "Explaining the Factors of the Index of Economic Freedom," in O'Driscoll *et al.*, *2002 Index of Economic Freedom*, p. 59.
32. David Dollar and Aart Kraay, "Spreading the Wealth," *Foreign Affairs*, January 1, 2002.

3. **Government Intervention in the Economy.** Excessive government intervention in the economy crowds out private industry, thereby thwarting economic growth. It also makes corruption more lucrative as government officials are given control over or are otherwise able to influence contracts or industries. The *Index* determines this factor by measuring government consumption as a percentage of the economy, government ownership of businesses and industries, the share of government revenues from state-owned enterprises, government ownership of property, and the economic output produced by the government.
4. **Monetary Policy.** A constantly depreciating currency erodes the value of investment and savings. Investors will look elsewhere, taking potential jobs with them, if they constantly fear that the currency is unstable and prices continue to rise. Since "the value of a country's currency is shaped largely by its monetary policy,"[33] the monetary policy factor seeks to determine whether a country allows market pricing or distorts it. This factor examines a country's average rate of inflation over a 10-year period.
5. **Capital Flows and Foreign Investment.** Developing countries cannot maximize their comparative advantage, be it in the form of a competitive labor market or specific natural resources, if they restrict capital flows that seek out such market efficiencies. Restrictions on foreign investment therefore limit a country's ability to achieve its economic potential. "It is particularly important for developing countries to remain open to direct foreign investment," explains the *Economist*, "which is the least volatile form of capital flows and in recent years, by far the most important quantitatively, amounting to $170 billion in 2001."[34] This factor analyzes the foreign investment code, restrictions on foreign ownership of business, restrictions on the industries and companies open to foreign investors, restrictions and performance requirements on foreign companies, foreign ownership of land, equal treatment under the law for both foreign and domestic companies, restrictions on the repatriation of earnings, and the availability of local financing for foreign companies.
6. **Banking and Finance.** Regulations on banking and finance limit the availability of credit and raise its cost (interest rates). This affects foreign investors, entrepreneurs, and even households. Low-income households, particularly farming communities, are more vulnerable to income fluctuations because seasonal harvests depend on forces like inclement weather and volatile market prices. These households rely on consumption-smoothing financial services so they can save during a bumper crop and borrow during droughts to maintain relatively stable living standards. The banking and finance factor examines government ownership of banks; restrictions on the ability of foreign banks to open branches and subsidiaries; government influence over the allocation of credit; banking regulations; and freedom to offer all types of financial services, securities, and insurance policies. Hong Kong (with a per capita GDP of $24,218) is a global banking center with very few restrictions.
7. **Wages and Prices.** In an open market, supply and demand determine prices and allocate limited resources efficiently. As the *Index* points out, market-determined prices allocate resources to their highest use.[35] Artificially setting wages and prices causes economic distortions—like high unemployment, shortages in essential commodities, and overpriced surplus inventory—that hurt developing countries. This factor analyzes "the extent to which a government allows the market to set wages and prices" by examining minimum wage laws, freedom to set prices privately without government influence, government price controls and the extent to which they are used, and government subsidies to businesses that affect prices.
8. **Property Rights.** The protection of private property is the bedrock of commercial enterprise. Entrepreneurs and investors will not

33. O'Driscoll *et al.*, *2002 Index of Economic Freedom*, p. 69.
34. Kenneth Rogoff, "Managing the World Economy," *The Economist*, August 3, 2002.
35. O'Driscoll *et al.*, *2002 Index of Economic Freedom*, p. 71.

engage in productive activity if the fruits of their labor can be stolen or confiscated arbitrarily. Nobel Prize-nominee Hernando de Soto believes that capital is "created by people whose property systems help them to cooperate and think about how they can get the assets they accumulate to deploy additional production."[36] De Soto argues further that poverty persists not because the poor lack capital—the world's poor own $9.3 trillion in property—but because inadequate property rights laws fail to recognize their assets. Without formal titles and legal systems to protect them, poor people are left with "dead wealth." Untitled land is difficult to buy or sell, and it cannot be used as collateral for investment. Property taxes are impossible to collect if there is no one from whom to collect them. Government bureaucracy is often to blame: In the Philippines, making an urban land claim requires a 168-step process that takes up to 25 years.

The property rights factor examines freedom from government influence over the judicial system, the commercial code defining contracts, sanctions of foreign arbitration of contract disputes, government expropriation of property, corruption within the judiciary, delays in receiving judicial decisions, and legally granted and protected private property. Indonesia, the world's fourth most populous nation, is blessed with bountiful natural resources yet has a per capita GDP of $994 partly because of a corrupt judicial system. In Indonesia, court rulings are recognized as "arbitrary and inconsistent."[37]

9. **Regulation.** A high level of regulation calculates into increased overhead costs for entrepreneurs and investors and is an impediment to economic growth. Finland, for instance, has a low level of regulation; the World Economic Forum has ranked Finland as "the world's most competitive economy and best overall business environment."[38] This factor examines licensing agreements to operate a business; ease of obtaining a business license; corruption within the bureaucracy; labor regulations such as established work weeks, paid vacations, and parental leave as well as other selected labor, environmental, consumer safety, and worker health regulations; and regulations that impose a burden on business.
10. **Black Market.** Black markets often thrive because of high regulation in the legal market, government corruption, or high taxes. A high level of black market activity deters investment in a country. Investors do not want their products to be pirated or sold on the black market and thus will direct their investments to other countries. The black market factor examines smuggling, piracy of intellectual property, agricultural production, manufacturing, services, transportation, and labor that are supplied on the black market.

Using these *Index* factors, the policies of the 79 IDA-eligible countries and others can be more easily evaluated to see whether they meet the three broad eligibility criteria for MCA development assistance established by the President—they must "govern justly, invest in their people and encourage economic freedom."[39]

## CONCLUSION

Despite an abundance of development assistance that has been disbursed over the past two decades, half of the world remains poverty-stricken. While advocates call for more development assistance, many countries are poorer than they were decades ago, before they received the aid. In many cases, development assistance funds have not been used efficiently or have fallen into corrupt hands.

The era of giving aid to any outstretched hand must end. Just as the United States has reformed welfare to help people end the cycle of poverty, so should the United States reform its development assistance program to ensure economic growth and prosperity rather than dependency in recipient countries.

36. Hernando de Soto, *The Mystery of Capital* (New York: Basic Books, 2000), pp. 64–65.

37. O'Driscoll *et al*, *2002 Index of Economic Freedom*, p. 232.

38. *Ibid.*, p. 193.

39. President George W. Bush, remarks at United Nations Financing for Development Conference.

Future allocations of development assistance should be given only to those countries that demonstrate sound economic policies. President Bush's Millennium Challenge Account proposal seeks to accomplish this by reversing the traditional aid formula to one of reform *before* aid, not to give aid to get hoped-for reforms. As President Bush has stated, "The new compact recognizes that economic development assistance can be successful only if it is linked to sound policies in developing countries."[40]

For economic development assistance to be effective, the Administration must focus the MCA eligibility criteria on economic reform. While many nonprofit organizations are lobbying to emphasize health care, environmental standards, and education—all very noble causes—these are actually the benefits of prosperity; they do not address the origins of poverty. Recipient countries must first build a firm foundation of economic freedom in order to reap these benefits.

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40. *Ibid.*