

# Background

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## Proposals for an Environmental Indicator for the MCA Should Be Resisted

*Brett D. Schaefer*

President George W. Bush first proposed the Millennium Challenge Account (MCA) as an alternative to existing foreign assistance programs that have proven notoriously ineffective at promoting economic growth in recipient nations.<sup>1</sup> Recognizing past failures to use aid to change policy in recipient nations, President Bush called for a “new compact for global development” in which aid would be disbursed more selectively to nations that “rule justly, invest in their people, and encourage economic freedom.”<sup>2</sup> Sixteen criteria were developed to measure eligible countries on their commitment to these policies and determine which countries would receive MCA grants.<sup>3</sup>

However, restricting the MCA eligibility criteria to just these 16 has been difficult because many groups are seeking to leverage the MCA funding mechanism to promote their particular priorities. Among the most persistent are those seeking to add an environmental indicator to the 16 eligibility criteria.<sup>4</sup>

In response to pressure from environmental groups and Members of Congress, the Millennium Challenge Corporation (MCC) launched a search for a “natural resources management” indicator in 2005. The MCC appropriately desires an indicator based on solid data, objectively determined and linked to its core mission of assisting economic growth and development. However, there is considerable risk that this due diligence will be hijacked by those who are seeking to use the MCA to pressure developing countries into meeting politically determined environmental

### Talking Points

- Environmental degradation is a symptom of poverty, not its cause. The evidence demonstrates that wealthier societies are more likely to demand and implement greater environmental protection because they can better afford the costs of those policies.
- Economic growth is key to increasing environmental protection in developing nations and is associated with greater economic freedom, property rights, and the rule of law—three areas already well covered by MCA criteria.
- The surest way to promote sustainable environmental policies around the world is to increase economic growth and the standard of living in poor countries. Unless per capita income is increased through higher economic growth, efforts to improve environmental quality through MCA criteria will prove fruitless and possibly counterproductive, especially if they lead to greater government regulation that impedes market-led growth.

This paper, in its entirety, can be found at:  
[www.heritage.org/research/tradeandforeignaid/bg1896.cfm](http://www.heritage.org/research/tradeandforeignaid/bg1896.cfm)

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214 Massachusetts Avenue, NE  
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(202) 546-4400 • [heritage.org](http://heritage.org)

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objectives. Such pressure should be resisted for three reasons.

*First*, the MCC, the governing body of the MCA, is already in the process of adopting environmental guidelines for its grants. While questions remain over the specificity of the guidelines, there is little doubt that the MCC will adhere to standards that ensure that projects do not cause undue environmental consequences. This will largely address concerns over the possibly detrimental environmental impact of MCC projects.

*Second*, identifying a single indicator presents significant problems. The MCC currently uses four intermediate measures of environmental policy in the selection process: percentage of land dedicated to protecting or maintaining biological diversity, performance in implementing the Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES), change in forest cover, and percent of the rural and urban population with access to improved sanitation.<sup>5</sup>

The problem with these indicators is that “one size fits all” is unlikely to work across the broad range of countries eligible for MCA grants. For instance, should small island nations be penalized

for failing to set aside significant portions of scarce land to protect biodiversity? CITES implementation says little about countries with few or no endangered species threatened by trade, and CITES implementation is not synonymous with enforcement. Measuring change in forest cover would be largely irrelevant to an arid nation.

Finally, improved sanitation may benefit economic growth, but investment in that area is expensive and takes significant time to build, making it difficult for candidate countries to achieve MCA eligibility quickly. The MCC has asked independent experts to review several proposals for an indicator, but there seems to be no single appropriate indicator.

*Third*, the evidence strongly indicates that a new indicator is unnecessary. The data show that environmental sustainability is highly correlated with the level of per capita income. Environmental degradation is the symptom, and economic growth is the solution. Economic growth is associated with greater economic freedom, property rights, and the rule of law—three areas already well covered by MCA criteria.

The surest way to promote sustainable environmental policies around the world is to increase eco-

1. See Brett D. Schaefer, “The U.N.’s World Summit Is Wrong on Development Assistance,” Heritage Foundation *Background* No. 1881, September 26, 2005, at [www.heritage.org/Research/TradeandForeignAid/bg1881.cfm](http://www.heritage.org/Research/TradeandForeignAid/bg1881.cfm).
2. Millennium Challenge Corporation, “The Millennium Challenge Account,” at [www.mca.gov/about\\_us/overview/index.shtml](http://www.mca.gov/about_us/overview/index.shtml) (November 7, 2005).
3. The six indicators for “governing justly” (and their sources) are: civil liberties (Freedom House); political rights (Freedom House); voice and accountability (World Bank Institute); government effectiveness (World Bank Institute); rule of law (World Bank Institute); and control of corruption (World Bank Institute). The four indicators for “investing in people” are: public expenditures on health as percent of gross domestic product (GDP) (national governments); immunization rates for diphtheria, pertussis, tetanus, and measles (World Health Organization); public primary education spending as percent of GDP (national governments); and primary education completion rate for girls (World Bank/United Nations Educational, Scientific and Cultural Organization). The six indicators for promoting economic freedom are: cost of starting a business (World Bank); inflation (International Monetary Fund [IMF] and others); three-year budget deficit as a percent of GDP (IMF/national governments); days to start a business (World Bank); trade policy (The Heritage Foundation); and regulatory quality (World Bank Institute). In addition to passing a majority of the indicators in each category, countries must pass the “control of corruption” indicator to qualify. For more information about the Millennium Challenge Accounts, see Millennium Challenge Corporation, “MCC Selection Policy Indicators: Short Descriptions,” at [www.mca.gov/countries/selection/short\\_descriptions.shtml](http://www.mca.gov/countries/selection/short_descriptions.shtml) (November 7, 2005).
4. Brookings Institution, “Environment, Poverty, and the Millennium Challenge Corporation: Leveraging U.S. Aid to Improve Natural Resource Management” conference transcript, June 24, 2005, at [www.brookings.edu/jp/events/20050624\\_MCCtranscript.pdf](http://www.brookings.edu/jp/events/20050624_MCCtranscript.pdf) (November 8, 2005).
5. Millennium Challenge Corporation, “Natural Resources Working Group,” June 2005, at [www.mca.gov/public\\_affairs/fact\\_sheets/NRWG\\_factsheet.pdf](http://www.mca.gov/public_affairs/fact_sheets/NRWG_factsheet.pdf) (November 7, 2005).

economic growth and the standard of living in poor countries. Unless per capita income is increased through higher economic growth, efforts to improve environmental quality will be unsustainable. The MCC has adopted a policy of taking the appropriate intermediate indicators into account during consideration of countries for MCA eligibility. Such a process, along with appropriate environmental guidelines for MCC projects, will ensure that environmental concerns are given due weight. Therefore, those truly concerned with protecting the environment should support MCA criteria that focus on increasing economic freedom, good governance, and the rule of law rather than on encouraging unwarranted environmental regulation through a formal indicator.

### Protecting the Environment Through Economic Freedom

Economic growth is key to increasing environmental protection in developing nations. The evidence demonstrates that wealthier societies are more likely to demand and implement greater environmental protection because they can better afford the costs of those policies. Wealthier societies not only can better afford environmental protection, but also demonstrate increasing desire for such protection as income grows.<sup>6</sup> For example, economists Gene M. Grossman and Alan B. Krueger concluded:

Pollution appears to rise with GDP [gross domestic product] at low levels of income,

but eventually to reach a peak, and then to fall with GDP at higher levels of income.... We find that economic growth brings an initial phase of deterioration followed by a subsequent phase of improvement.<sup>7</sup>

According to Grossman and Krueger, "The turning points for the different pollutants vary, but in most cases they come before a country reaches a per capita income of \$8,000."<sup>8</sup> More recent studies reinforce different turning points for different pollutants.<sup>9</sup>

This "environmental Kuznets curve," in which environmental quality declines in the early stages of development but improves as incomes rise, has been confirmed by subsequent research. A 2002 paper by Jeffery Frankel and Andrew Rose noted that "our results generally support the environmental Kuznets curve, which says that growth harms the environment at low levels of income and helps at high levels, and to support the proposition that openness to trade accelerates the growth process."<sup>10</sup> While voicing caution about linking environmental outcomes to per capita incomes, Brian Copeland and Scott Taylor conclude that "there is now a great deal of evidence supporting the view that rising incomes affect environment quality in a positive way."<sup>11</sup>

Quite simply, the evidence indicates that as a country's standard of living rises, its citizens have more discretionary income to allocate toward improved environmental quality and can more readily afford to control emissions.<sup>12</sup> This increased

6. See Gene M. Grossman and Alan B. Krueger, "Environmental Impacts of a North American Free Trade Agreement," National Bureau of Economic Research *Working Paper* No. W3914, November 1991, and Jagdish Bhagwati, "Trade and the Environment: The False Conflict?" in Durwood Zaelke, Paul Orbuch, and Robert F. Housman, eds., *Trade and the Environment: Law, Economics, and Policy* (Washington, D.C.: Center for International Environmental Law, 1993), pp. 159–190.
7. Gene M. Grossman and Alan B. Krueger, "Economic Growth and the Environment," National Bureau of Economic Research *Working Paper* No. W4634, February 1994, p. 14.
8. *Ibid.*
9. Jeffery Frankel and Andrew Rose found that peaks for particulate matter, sulfur dioxide, and nitrogen dioxide are at \$2,882, \$5,770, and \$7,665 per capita, respectively. Jeffery A. Frankel and Andrew K. Rose, "Is Trade Good or Bad for the Environment? Sorting Out the Causality," National Bureau of Economic Research *Working Paper* No. 9201, September 2002, p. 19.
10. Frankel and Rose, "Is Trade Good or Bad for the Environment?" abstract.
11. Brian R. Copeland and M. Scott Taylor, "Trade, Growth and the Environment," National Bureau of Economic Research *Working Paper* No. 9823, July 2003, pp. 91–92.
12. Jeffery A. Frankel, "The Environment and Globalization," National Bureau of Economic Research *Working Paper* No. 10090, November 2003.

wealth resulting from economic growth allows countries and individuals the luxury of valuing green spaces for their aesthetic, health, and environmental value rather than just for their potential as fields for crops or trees for fuel. By concentrating on increased economic growth first, the development strategy permits greater opportunities and resources for environmental protection down the road. The United States is an example of this process of environmental protection. As incomes have risen over the past three decades, “real spending by government and business on the environment and natural resource protection has doubled.”<sup>13</sup>

Research indicates that the best way for countries to increase economic growth is to adopt policies that promote economic freedom and the rule of law, factors measured in the *Index of Economic Freedom*, published annually by The Heritage Foundation and *The Wall Street Journal*. The *Index* analyzes 50 economic indicators in 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 informal market activity. Those 10 factors are graded from 1 to 5, with 1 being the most free and 5 being the least free. Those 10 scores are then averaged to give an overall country score for economic freedom. Countries are designated “free,” “mostly free,” “mostly unfree,” or “repressed” based on their overall scores.

For example, in the 2005 *Index*, “free” countries on average have a per capita income that is twice that of “mostly free” countries. “Mostly free” countries have a per capita income that is more than three times that of “mostly unfree” and “repressed” countries. Chart 1 illustrates this relationship. Economically free coun-

tries are associated with higher per capita incomes than are countries with less free economies.

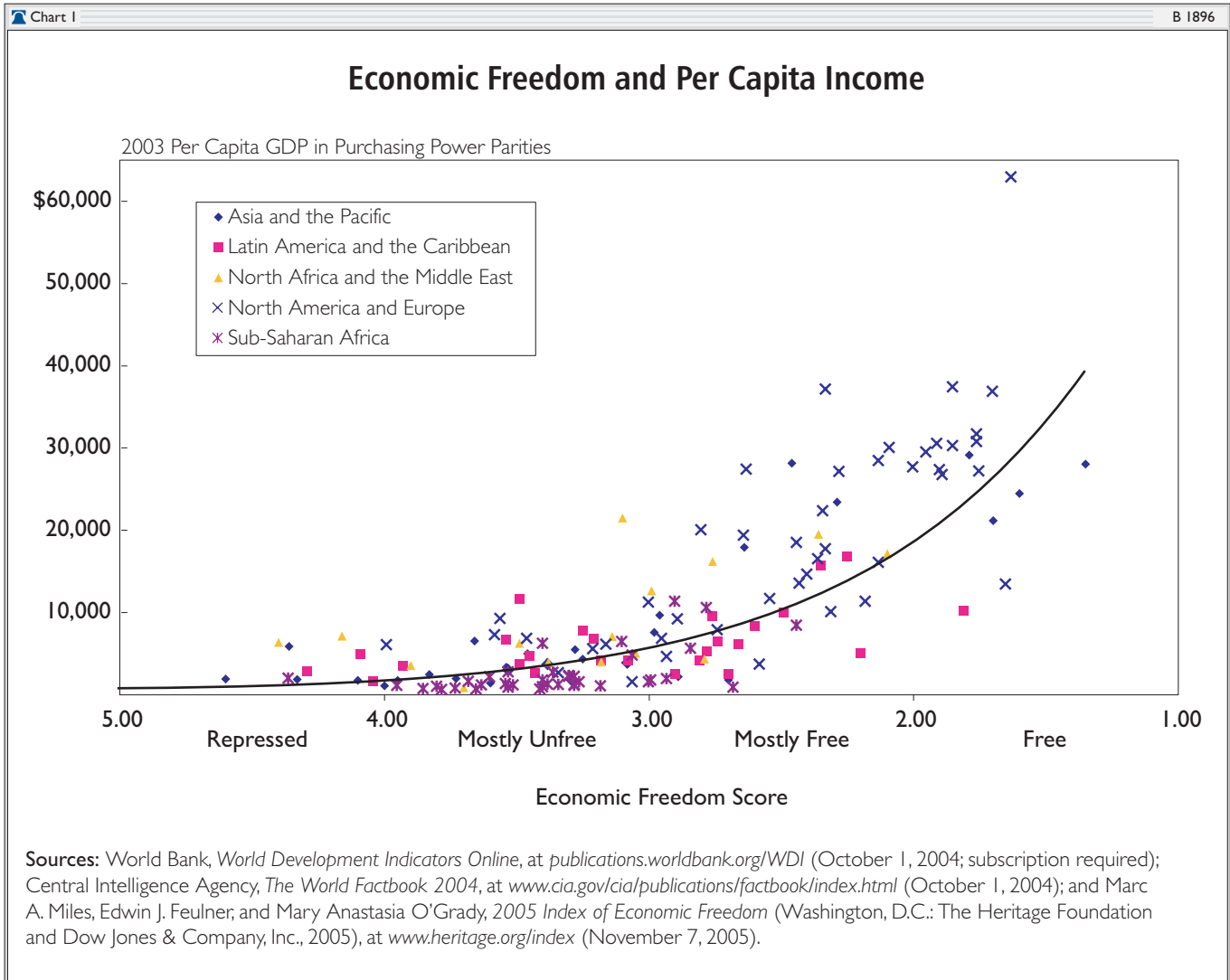
Not only is higher economic freedom clearly associated with higher levels of per capita GDP, but higher GDP growth rates are associated with improvements in a country’s economic freedom score.<sup>14</sup> Chart 2 ranks the graded countries according to their improvement in economic freedom between 1997 and 2005. The countries represented in the left-hand bar were most improved, and those in the right-hand bar were least improved. Average growth rates across the eight years of changes were then computed for the countries in each bar or group.

Across the spectrum, the more a country improved its economic freedom, the higher was its average economic growth. Countries that consistently march toward improved economic freedom enjoy the most progress toward prosperity.

These relationships have significant implications for efforts to include an environmental indicator in the MCA criteria. Research indicates that onerous regulation, including environmental regulation, reduces economic freedom and deters economic growth.

Imposing environmental standards through the MCA could very well undermine long-term efforts to increase environmental standards in the developing nations. Encouraging countries to adopt regulatory standards or other restrictions early in their development undermines economic freedom, which will likely reduce economic growth and the chance of reaching a level of per capita income consistent with the desire for higher environmental standards.<sup>15</sup> The cost of regulation may be acceptable to wealthier nations, but the priority for poor nations must be to increase economic growth first.

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13. See William A. Brock and M. Scott Taylor, “Economic Growth and the Environment: A Review of Theory and Empirics,” National Bureau of Economic Research *Working Paper* No. 10854, October 2004, and Daniel T. Griswold, “Trade, Labor, and the Environment: How Blue and Green Sanctions Threaten Higher Standards,” Cato Institute *Trade Policy Analysis* No. 15, August 2, 2001, p. 10, at [www.freetrade.org/pubs/pas/tpa-015b.pdf](http://www.freetrade.org/pubs/pas/tpa-015b.pdf) (November 7, 2005).
14. Marc A. Miles, “Introduction,” and Marc A. Miles, Edwin J. Feulner, and Mary Anastasia O’Grady, “Executive Summary,” in Marc A. Miles, Edwin J. Feulner, and Mary Anastasia O’Grady, *2004 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2004), pp. 2 and 18.
15. Brock and Taylor note that regulation designed to abate pollution also appears to create a drag on economic growth by constraining output. See Brock and Taylor, “Economic Growth and the Environment.”



Statistical analysis also supports the assertion that increasing economic freedom bolsters environmental sustainability. In 2005, the World Economic Forum, the Center for International Earth Science Information Network (CIESIN), and the Yale Center for Environmental Law and Policy published an Environmental Sustainability Index (ESI). The ESI “provides a composite profile of national environmental stewardship based on a compilation of 21 indicators that derive from 76 underlying data

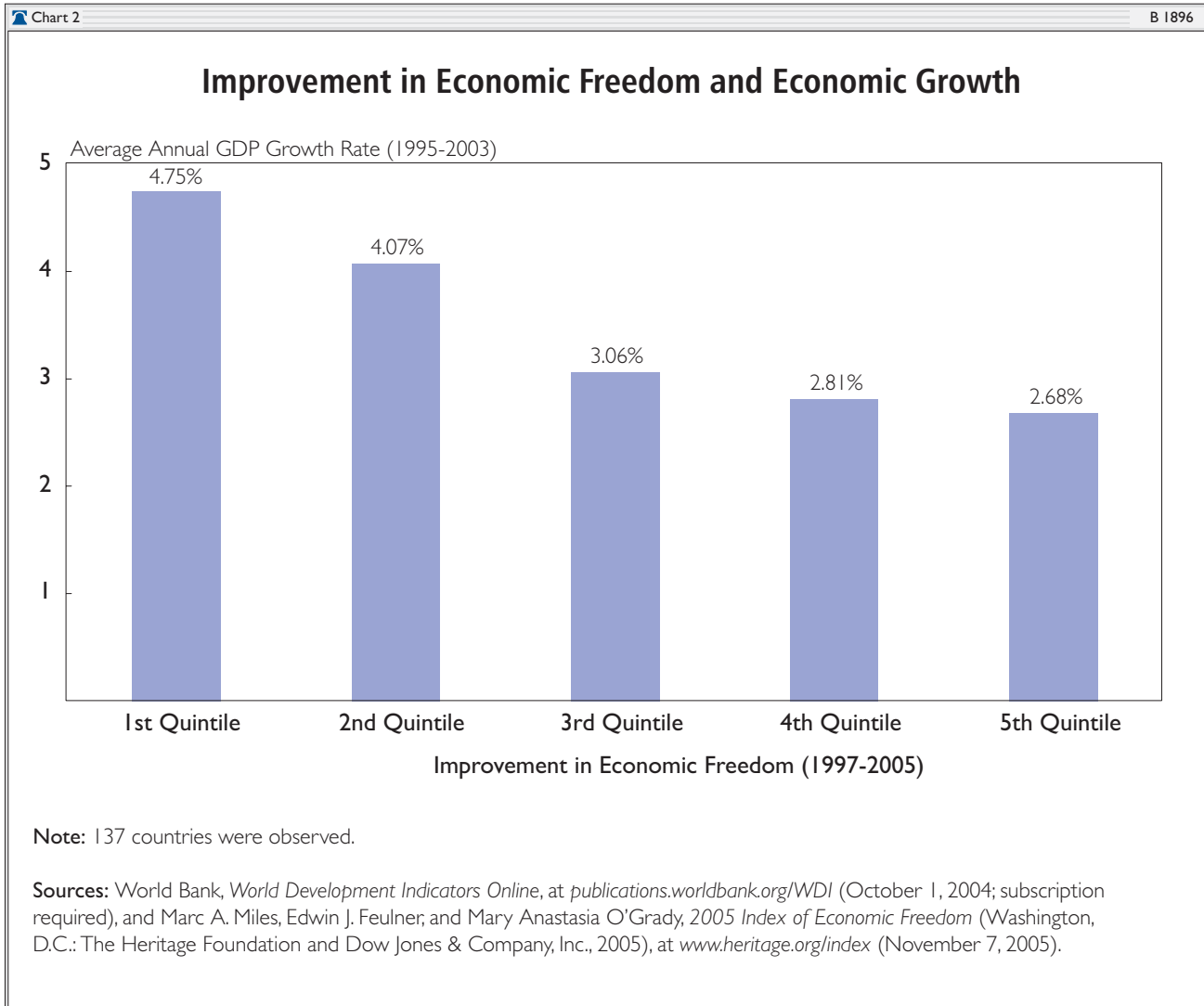
sets.”<sup>16</sup> The lower the composite number is, the worse is a country’s ability to sustain its environment as measured by the ESI.

Chart 3 illustrates a strong relationship between 2005 *Index* scores and the 2005 ESI. The freer an economy is, the greater is its level of environmental sustainability as measured by the ESI.

Moreover, despite several studies that have shown an initial decline in environmental standards as income grows, there appears to be little

16. Daniel C. Esty, Marc Levy, Tanja Srebotnjak, and Alexander de Sherbinin, *2005 Environmental Sustainability Index: Benchmarking National Environmental Stewardship* (New Haven, Conn.: Yale Center for Environmental Law and Policy, 2005), p. 7, at [www.yale.edu/esi/ESI2005\\_Main\\_Report.pdf](http://www.yale.edu/esi/ESI2005_Main_Report.pdf) (November 7, 2005).





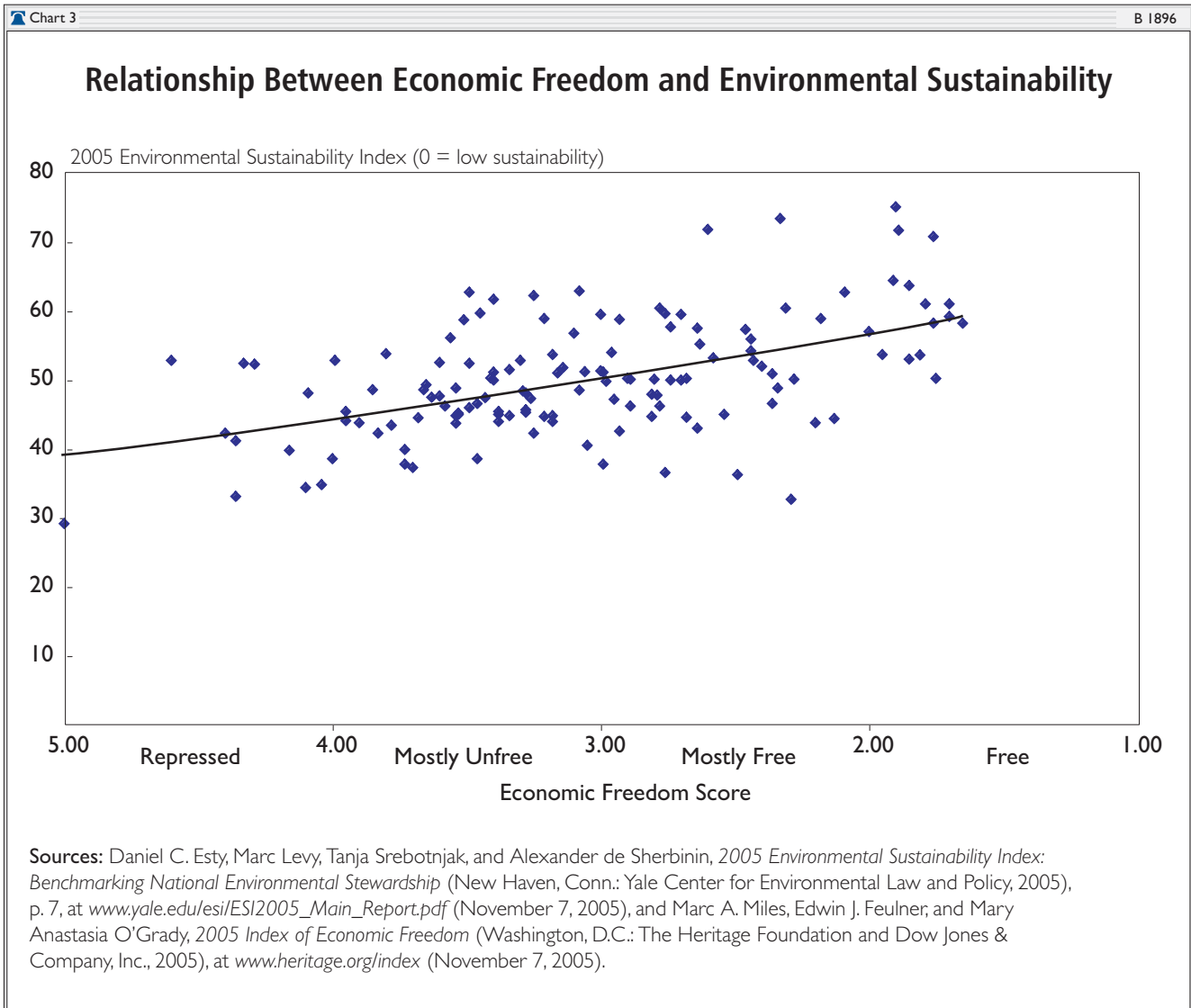
evidence of a decline in environmental sustainability as economic freedom as measured by the *Index* increases.<sup>17</sup> On the contrary, economically free countries have an average environmental sustainability score that is more than 30 percent higher than the scores of countries with repressed economies. The lesson of Chart 4 is that economic

freedom can be compatible with high environmental standards.

### Conclusion

Poverty is the biggest threat to the environment. As Dr. Alan Moghissi, president of the Institute for Regulatory Science, pointed out in his

17. Gene M. Grossman and Alan B. Krueger analyzed the relationship between environmental indicators (concentrations of urban air pollution, measures of the state of the oxygen regime in river basins, concentrations of fecal contaminants in river basins, and concentrations of heavy metals in river basins) and the level of a country's per capita income. Their analysis revealed that economic growth is accompanied initially by deterioration in environmental conditions but quickly improves as per capita income increases. According to Grossman and Krueger, "The turning points for the different pollutants vary, but in most cases they come before a country reaches a per capita income of \$8,000." See Grossman and Krueger, "Economic Growth and the Environment," p. 14.



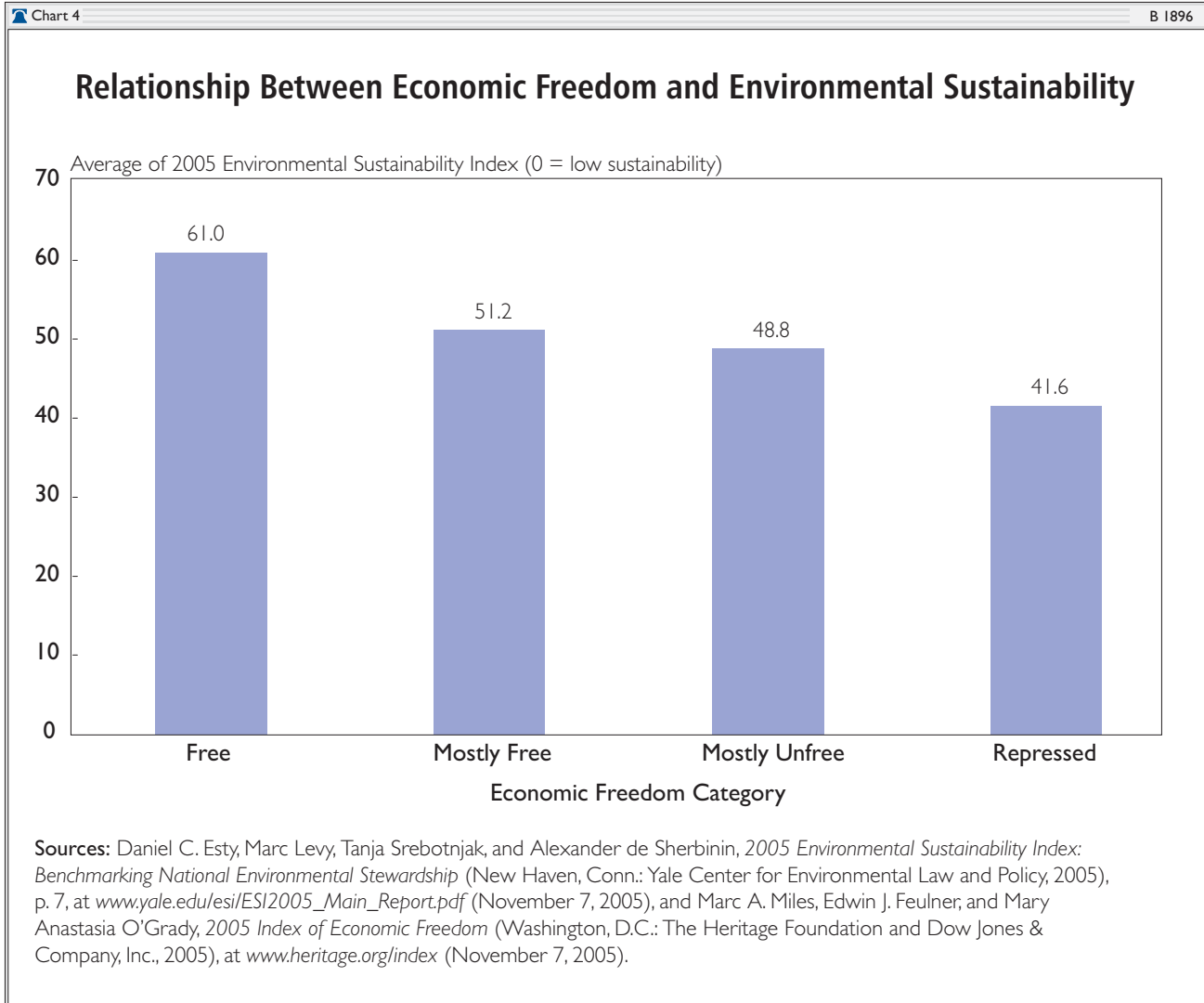
testimony before the International Financial Institutions Advisory Commission (the Meltzer Commission), “how do you explain to a father in the Brazilian rain forest, who is poor, has sick children, and is hungry that he should not cut trees because it may impact the biodiversity?”<sup>18</sup> In essence, trying to address environmental quality in poor countries focuses on the symptom rather than the disease. Unless economic growth

increases, “poverty [will be] the equivalent to exposure to the most toxic pollutant.”<sup>19</sup>

Research at The Heritage Foundation indicates that the best way for countries to increase economic growth is to adopt policies that promote economic freedom and the rule of law. Even if an indicator appropriate to all MCA candidate countries is identified, making MCA grants contingent on meeting such an indicator could undermine efforts to

18. A. A. Moghissi, “Testimony Before the Commission of International Financial Institutions,” November 17, 1999, available from Institute for Regulatory Science, Columbia, Maryland.

19. *Ibid.*



increase environmental sustainability in the developing nations by encouraging them to adopt regulatory standards or other measures in an attempt to qualify for MCA grants. This would undermine economic freedom and impose greater costs on economic activity, thereby diminishing their chances of achieving increased economic growth.

Adding a natural resources management indicator to the 16 eligibility criteria is unnecessary. Adding one designed to impose politically driven environmental objectives with little relation to economic growth would be counterproductive. Those truly

concerned with ensuring that Millennium Challenge Account grants do not undermine environmental quality should support MCA criteria that focus on increasing economic freedom, without which economic growth is unlikely, rather than encouraging unwarranted environmental regulation.

—Brett D. Schaefer is Jay Kingham Fellow in International Regulatory Affairs in the Margaret Thatcher Center for Freedom, a division of the Kathryn and Shelby Cullom Davis Institute for International Studies, at The Heritage Foundation.