# ❑ THE MCA PROMOTES SOUND ECONOMIC POLICIES

*By E. Anthony Wayne, Assistant Secretary Of State for Economic and Business Affairs*

*Development does not just "happen"; it requires economic growth that occurs when people and governments respond to economic incentives, says E. Anthony Wayne, Assistant Secretary of State for Economic and Business Affairs. "But throwing money at problems without the foundation of sound government policies will not have lasting impact on people's lives," he says. That is why the Millennium Challenge Account (MCA) intends to promote and reward economic policies that work – sound macroeconomic governance, an efficient regulatory system, an open trade regime and a healthy climate for business investment.*

*Wayne says economic freedom created by these policies is essential for mobilizing domestic assets and encouraging entrepreneurship, as well as boosting trade and attracting foreign investment. He cites agriculture as one of the areas where the MCA could have a higher return in countries that are committed to economic freedom. But the MCA initiative will succeed only if the United States selects countries really committed to pursuing pro-growth policies and addressing the main bottlenecks to development, he says.*

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In announcing the Millennium Challenge Account (MCA) initiative last March, President Bush reconfirmed the commitment of the United States to bring hope and opportunity to the world's poorest people and called for a new compact for development defined by greater accountability for rich and poor nations alike. To fulfill our part of the compact the United States, with congressional approval, will increase its core development assistance by $5 billion through the MCA – an increase of 50 percent – over the next three years. The President has submitted this new program to Congress for its authorization and appropriation of funds. These funds, the President said, will be "devoted to projects in nations that govern justly, invest in their people, and encourage economic freedom."

Aptly named, this initiative challenges developed and developing countries to work together as real partners to establish a new results-based paradigm for economic development. It aims to tackle one of the most vexing problems of our times – how to support lasting improvements in living standards and reduce poverty in the poorest nations of the developing world.

## PROVIDING INCENTIVES AND SEEKING RESULTS

Development doesn't just "happen," no matter how much money you throw at it. From over 30 years of experience in attempting to spur development growth abroad, we have learned several simple lessons. Development requires economic growth. Economic growth occurs when people and their governments respond to economic incentives. Money is an incentive, certainly. But throwing money at problems without the foundation of sound government policies will not have lasting impact on people's lives. Government mismanagement or outright corruption is an even greater disincentive to development, thwarting the fundamental entrepreneurial spirits of citizens and businesses alike. President Bush's Millennium Challenge Account puts incentives in place to encourage policies that work: first by setting policy- and commitment-based eligibility requirements to qualify for the MCA program; second by providing additional funds; and third by insisting that MCA programs show results by meeting mutually agreed benchmarks and development objectives.

We know that aid alone cannot lead to sustainable economic growth. Most of the developing world already possesses substantial assets that could be mobilized to promote their economic development. For a country to build on its wealth, however, that wealth must stay at home. For this to happen, countries must attract capital and put in place economic incentives to discourage capital flight. Estimates of sub-Saharan African country external assets, for example, exceed the stock of their external debt – a sure indication of capital flight. The MCA will promote a sound investment climate that can help pull some of this capital back into Africa.

Trade and investment flows dwarf the MCA's $5 billion and the $50 billion given by all donors in official development assistance each year. Developing countries exported close to $2 trillion in goods and services in 2001. Foreign investment flows to and among developing countries amount to $180-200 billion annually. And, of course, the biggest source of capital are the hardworking people of developing countries themselves, who produce goods and services valued at over $6 trillion dollars each year and savings amounting to over $1 trillion. The MCA will provide incentives and practical support to promote the sound economic policies and build the capacity that developing countries need to tap productively these far greater sources of development finance.

## ENCOURAGING ECONOMIC FREEDOM

The link between development progress and governments that support freer markets, individual liberties, and effective institutions is robust. Sustainable development also takes hold when good governance is joined with a dynamic private sector. A vibrant private sector gives free reign to human creativity, fostering innovation and improving the living standard of everyday people. The most vital resources a country possesses are the skills and entrepreneurial spirit of its citizens. Unfortunately, domestic economic resources and capital have all too often been squandered, sometimes by conflict, but also by economic policies that do not give individual families and firms the proper incentives to save and invest in their future, and to innovate and engage in productive enterprise.

To qualify for the MCA, each MCA candidate will need to encourage economic freedom through good macroeconomic governance, an efficient regulatory system, an open trade regime, and a healthy climate for business investment. The MCA will then help qualifying countries boost their economic growth by providing grants to productivity-enhancing areas such as agricultural development and private enterprise, building trade and investment capacity, and investing in health and education.

**Good Macroeconomic Governance:** Governments help set the stage for lasting economic development through their macroeconomic policies. The MCA recognizes this and assesses potential MCA countries on two indicators of macroeconomic health. It will give credit to countries whose inflation rate, based on IMF data, is less than 20 percent and whose three-year budget deficit is less than most other peer countries.

MCA recipient countries provide a supportive economic environment for their private sectors with prudent monetary and fiscal policies. Prudence in these areas reduces currency risk, helps attract foreign investment, and allows domestic enterprises to make long-term investments. There are few examples of long-term economic development by countries with persistent high inflation while there are many examples of economies falling prey to hyperinflation. Inflation disproportionately hurts the poor, who are less able to protect their assets. In addition, the uncertainty caused by inflation discourages long-term financial contracts. These dangers argue for great care on the part of monetary authorities in the creation of domestic credit and printing of money to avoid soaring interest rates and flight of the capital so necessary for development.

Sound fiscal policy management is also an essential part of an enabling environment that promotes income and job-creating economic activity of all types. The fundamental elements of good fiscal governance reflect transparency and accountability. They begin with the honest administration of public funds through a transparent budget process – expenditures must be subject to public audit and accountability. Government deficits can lead to higher interest rates, which “crowd out” private sector investment projects. Furthermore, high deficits often lead developing governments to pressure financial institutions to buy government debt, which can erode the stability of the financial system. Government policies are pro-growth when they have limited control of the economy and let the free market flourish in playing its essential role in signaling how to allocate resources.

**A Fair and Transparent Regulatory System:** The MCA will compare the regulatory environment for business in MCA candidate countries by looking to the World Bank Institute's indicator of Regulatory Quality. An overly onerous regulatory system, especially one that is exercised arbitrarily, can encourage corruption. Furthermore, this can encourage firms to stay small to avoid regulation, reducing their ability to take advantage of economies of scale and eroding the tax base of the country. While an effective and fair regulatory regime is essential, the MCA encourages countries to limit regulation and government intervention that can damage prospects for economic growth. New business ventures flourish when only days, not months, are needed to obtain necessary approvals from government regulatory agencies. That is why the MCA will consult the simple indicator from the World Bank of “Days to Start a Business,” which is also an indicator of efficiency of regulation and commitment to economic freedoms.

**An Open Trade Regime:** Experience shows that opening markets and expanding trade and investment can accelerate growth. Open markets and access to trade unleash creativity and know-how, multiply economic opportunities, and generate self-sustaining growth and investment cycles. Trade has helped nations as diverse as Singapore and Chile create economic opportunities for millions of their citizens. The MCA looks to the Heritage Foundation's Trade Policy Index to measure a country's trade openness.

The entrepreneurial spirit, when exposed to the world's free market, is not limited by geography, but rather soars in innovation, setting the path for economic growth and poverty alleviation. We have seen that very poor countries can use trade as a platform to progress. Many countries, however, have yet to reap the full benefits of free trade. Although low- and middle-income countries exported close to $2 trillion last year, further trade liberalization would dramatically increase their exports, and hence their growth prospects.

The Doha Development Round, taking place under the auspices of the World Trade Organization, aims to bring down trade barriers worldwide and will create for developing countries vast new opportunities to trade with each other and with developed economies. A central focus of the Doha Round is to work with the countries of the developing world to ensure that they are able to fully participate in the global trading system to expand their trade in agricultural goods in order to round out their diets and alleviate famine. The United States stands as a strong trade leader, exporting and importing over $450 billion in products from the developing world every year. That is more than eight times the amount these countries receive in aid from all sources. We will work with MCA recipient governments to increase their openness to trade, seize additional trade opportunities, and gain the growth benefits.

**A Healthy Climate for Business Investment:** Productive investment is essential for development. MCA development funds will flow toward countries that create a positive business environment for domestic and foreign investment. Since foreign direct investment not only brings capital but can also bring skilled management, new technology, good environmental practices, and knowledge of foreign markets, it is an especially prized development vehicle. Research evidence shows that where good governance and sound economic policies are in place, each dollar of foreign aid invested attracts two dollars of private investment. For business ventures – whether foreign, domestic or joint venture in origin – to be viable, the regulatory environment established by the host government must be conducive to their profitable operation.

There are ample incentives for foreign and domestic business to invest in developing countries. The developing world's markets are growing and their workforce is underutilized and inexpensive. While investment is by its very nature risky, investors prefer that their exposure is limited to normal business risk. They therefore prefer investing in countries whose governments protect against expropriation and ensure that the economic returns from investments may be freely repatriated. The MCA will look at the country credit rating prepared by *Institutional Investor* magazine to assess the attractiveness of potential MCA countries to investors.

## RULE OF LAW AND THE PROMOTION OF ECONOMIC GROWTH

While the rule of law is an essential and measurable MCA indicator of governing justly, it also has a profound influence on a country's economic freedom. Sound, predictable and transparent legal systems must exist to provide the foundation for business confidence and the protection of property rights. In Egypt, notes Peruvian economist Hernando de Soto, the wealth that their poor have accumulated is worth fifty-five times as much as the sum of all direct foreign investment ever recorded there, including the Suez Canal and the Aswan Dam. Reliable legal systems are essential to harness the power of such wealth and to bring to life so-called "dead capital" – the assets of the poor that so often cannot be formally recognized or leveraged to build or expand enterprises.

Enhancing corporate governance and building supportive legal institutions are vital to gaining the trust of a country's citizens in their government and in their economic future. Being assured of the formal recognition of businesses and legal ownership of property, for example, citizens then have incentives to expand both. Advanced technologies and business practices brought into the production process of the developing world can spur employment, eliminate poverty, and bring significant profit incentives to all partners in the joint ventures. These technologies and practices are proprietary to the businesses bringing them, however, and their intellectual property rights must be guaranteed and legally protected by developing country governments. The aim is to promote systems that protect all property owners, whether large or small, domestic or foreign.

## ONE POTENTIAL AREA FOR MCA FUNDING

Agriculture is one of the potential areas for MCA funding, and investments in this sector could have a higher return in countries that are committed to economic freedom. Agriculture has great potential for spurring economic development. Roughly 3 billion people live in rural areas, 1.3 billion of them on what the World Bank calls "fragile lands." In Africa, over 70 percent of people work in agriculture. Worldwide, over 800 million are malnourished. Increasing agricultural productivity in developing countries can lift many in rural areas out of poverty and abolish famine. Huge technological advances have been made in agriculture over the last several decades. By bringing this knowledge to those who most need it, developing countries can embark on the road to food self-sufficiency and rural populations can enter the cash economy.

Developing country governments, however, have to be open to and supportive of new technology. Working cooperatively with governments of MCA countries, MCA funds could be used to develop integrated agricultural programs that could educate local farm communities on how to increase agricultural productivity, provide incentives to develop distribution channels, and develop needed infrastructure. Bangladesh is just one success story, having increased its rice production by nearly 70 percent since the 1970s by employing advanced agricultural methods and technology.

## ACHIEVING DEVELOPMENT

President Bush concluded his announcement of the Millennium Challenge Account initiative with a typical Americanism: "The bottom line for us, and for our developing country partners, is how much development they are achieving." The MCA initiative will only succeed if we select partners that have put in place the policies that allow growth to take place, undertake programs that address the key bottlenecks to development, and hold to the agreed benchmarks that measure progress toward achieving agreed objectives. By requiring these policies in order to qualify for MCA funds and tracking the funds through successful development programs, the Millennium Challenge Account will promote incentives for sound economic policies that will result in economic growth and prosperity in the countries that join us in rising to the challenge. ❏