# ❑ PROMOTING GROWTH AND PROSPERITY IN THE DEVELOPING WORLD THROUGH ECONOMIC FREEDOM

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*The past 50 years of bilateral and multilateral development assistance suggests that increased aid funding without fundamental economic, social and political reforms in poor countries will be ineffective and possibly counterproductive, says economist Brett D. Schaefer. Open markets, support for entrepreneurial activity and adherence to the rule of law are among those key policy reforms that can provide the most reliable path to increased economic growth and prosperity for those countries, he says. Schaefer argues that the Millennium Challenge Account seeks to achieve a "fundamental revolution" in development assistance not only by linking aid to policies that have proven complementary and conducive to economic growth, but also by recognizing that reforms must be crafted and enforced by the aid recipients and not the donor countries.*

For over 50 years, developed nations have spent hundreds of billions of dollars in multilateral and bilateral assistance trying to help poor countries develop. The record of this effort is very disappointing. Aid has more often been ineffective or counterproductive than it has achieved its intended goal of spurring economic growth and development. As a result, poverty remains among the world's most pressing problems, and many recipients of development assistance are today as poor or poorer than they were decades ago.

To many governments and non-governmental organizations, this failing is due in large part to insufficient development assistance. For instance, after President Bush's pledge to increase the United States' development assistance budget by $5 billion annually through the Millennium Challenge Account, the Center for Global Development and the Center on Budget and Policy Priorities criticized:

"The level of spending proposed by the Bush Administration … would still leave aid spending as a share of all government spending and as a share of the economy well below its historical averages."

But the failure of development assistance is not due to a lack of resources. For instance, Organization for Economic Cooperation and Development (OECD) data show that between 1980 and 2000 the United States alone gave over $144 billion (in constant 1999 U.S. dollars) in official development assistance to 97 countries, regions, and territories for which per capita gross domestic product (GDP) data from 1980 to 2000 are available.[1]

These 97 countries had a median inflation-adjusted per capita GDP of $1,076 in 1980 but only $994 in 2000, a decline in real terms.

Compound annual growth in per capita GDP for these countries averaged -0.16 percent, with 12 experiencing negative growth and only four achieving growth over 1 percent.

Clearly, development assistance did not uniformly or frequently lead to strong economic growth. As noted by former World Bank economist William Easterly in his article "The Cartel of Good Intentions," "as many aid-receiving low-income countries had negative per capita growth as positive.... Among all low-income countries, there is not a clear relationship between aid and growth." What is clear from this experience is that simply increasing investment through foreign assistance will not promote growth and prosperity in developing countries.

## THE PATH TO GROWTH AND PROSPERITY

Economic studies, conceding that the level of aid is not the central issue, have focused on what policies are most conducive to economic growth and development. In its *1996 World Development Report: From Plan to Market,* the World Bank observed:

"The state-dominated economic systems of [developing and former communist] countries, weighted down by bureaucratic control and inefficiency, largely prevented markets from functioning and were therefore incapable of sustaining improvements in human welfare."

Subsequent World Bank studies have demonstrated that open markets and economic liberalization provide the fastest, most reliable path to increased growth and prosperity. A 2002 World Bank study titled *Globalization, Growth, and Poverty: Building an Inclusive World Economy* found that increased globalization (defined as trade as a percentage of GDP) from the late 1970s to the late 1990s led to higher economic growth. The more globalized developing countries (24 developing countries with over 3 billion people) achieved average growth in income per capita of 5 percent per year in the 1990s. By contrast, in less globalized developing countries "aggregate growth rate was actually negative in the 1990s." The losers in the age of globalization are the countries that refuse to embrace economic liberalization and the global market.

Contrary to the claims often raised by anti-globalization activists, World Bank analysis found that globalization helps the poor as much as the rich and improves labor and environmental standards in the long run. A June 2001 World Bank study titled *Trade, Growth, and Poverty* found that increased growth resulting from "expanded trade leads to proportionate increases in incomes of the poor … globalization leads to faster growth and poverty reduction in poor countries." *Globalization, Growth, and Poverty* found that while wages may dip in the short term after liberalization, "in the long run workers gain from integration. Wages have grown twice as fast in the more globalized developing countries than in the less globalized ones, and faster than in rich countries as well." Similarly, "despite widespread fears, there is no evidence of a decline in environmental standards. In fact, a recent study of air quality in major industrial centers of the new globalizers found that it had improved significantly in all of them."

The *Index of Economic Freedom*, published annually by the Heritage Foundation and the *Wall Street Journal*, confirms these studies. The *Index* grades 10 factors for 161 countries with 1 being the best score and 5 being the worst score. These factors are: 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. Those 10 scores for these factors are then averaged to give an overall score for economic freedom. Countries are designated "free," "mostly free, " "mostly unfree," and "repressed" based on these overall scores.

As shown in the *Index*, free countries on average have a per capita income twice that of mostly free countries, and mostly free countries have a per capita income more than three times that of mostly unfree and repressed countries. This relationship exists because countries maintaining policies that promote economic freedom provide an environment that facilitates trade and encourages entrepreneurial activity, which in turn generates economic growth.

Analysis by economists Richard Roll of University of California Los Angeles and John Talbott of the Global Development Group supports the conclusion that the path to increased growth and prosperity is for countries to adopt policies that promote economic freedom and the rule of law as measured by the *Index*. Their work demonstrates that the economic, legal, and political institutions of a country explain more than 80 percent of the international variation in real income per capita between 1995 and 1999 in more than 130 countries. Civil liberties, government expenditures, political rights, press freedom, and strong property rights had the most consistent, positive influence on a country's per capita income. The variables having a negative effect on per capita income included black market activity, excessive regulation, poor monetary policy, and trade barriers. Roll and Talbott found a strong relationship between economic freedom and the level of per capita income in a country, concluding that economic freedom is clearly important to a country's development:

"Liberalizations are, on average, followed by dramatic improvement in country income, while substantial reductions in growth typically follow anti-democratic events. We conclude that countries can develop faster by enforcing strong property rights, fostering an independent judiciary, attacking corruption, dismantling burdensome regulation, allowing press freedom, and protecting political rights and civil liberties. These features define a healthy environment for economic activity….

"Economic participants cannot save in a world of inflationary government-sponsored counterfeiting. They cannot compete with state-sponsored monopolies. They cannot trade efficiently with the existence of high tariffs and phony official exchange rates. They cannot easily overcome burdensome regulation and corruption. They cannot capitalize future profits in a world devoid of property rights. And they cannot prosper without economic and personal freedoms."

The study confirms that the rule of law and sound economic policies such as trade liberalization and low inflation are central to increased growth and prosperity.

## MAKING AID WORK

The evidence thus indicates that economic assistance can only spur growth in countries with good economic policies and institutions – in bad policy environments, aid is far less effective and can actually be counterproductive. Taking this experience and analysis on development into account, President George Bush proposed a new development assistance program: The Millennium Challenge Account (MCA).

The MCA represents a fundamental revolution in development assistance because it would provide assistance only to countries with a proven record in adopting policies (good governance, rooting out corruption, upholding human rights, adhering to the rule of law, investing in health and education, and adopting sound economic policies that foster enterprise and entrepreneurship) that have been proven complementary and conducive to economic growth.

This focus on policies that bolster economic growth is appropriate because increased prosperity allows parents the luxury of educating their children instead of making them work to help provide for their families. Prosperity enables individuals to value green spaces for their aesthetic value rather than their potential as fields for crops or trees for fuel. It permits the workforce to worry about the quality of the work environment rather than the lack of employment. And prosperity gives families the means to engage in preventive health practices that lead to longer lives.

Similarly, a fair, strong, and reliable rule of law is necessary to give people the confidence to make long-term investments to improve their lives without fear that those investments will be arbitrarily taken from them. As noted by Peruvian economist Hernando de Soto in *The Mystery of Capital*.

"The poor inhabitants of [developing and former communist nations] – five-sixths of humanity – do have things, but they lack the process to represent their property and create capital. They have houses but not titles; crops but not deeds; businesses but not statutes of incorporation…. the total value of the real estate held but not legally owned by the poor of the Third World and former communist nations is at least $9.3 trillion."

It is the absence of the rule of law that keeps the poor from utilizing these assets for their own benefit.

The MCA is humble in its approach because it accepts that aid alone will not result in increased growth and prosperity and recognizes that bilateral or multilateral donors cannot force a developing country government to embrace reform against its will. A weakness of prior development efforts was trying to force reform. The difficulty of forcing governments to adopt reform is evident in the frequent failures of the International Monetary Fund (IMF) and the World Bank to impose conditionality on recipients. History shows that governments of recipient countries often pledge more than they deliver in return for IMF and World Bank assistance – a conclusion supported by World Bank analysis in *Assessing Aid: What Works, What Doesn't, and Why*, which found "conditionality is unlikely to bring about lasting reform if there is no strong domestic movement for change." The MCA recognizes that reform must be home grown if it is to endure for the long-term. Due to this reality, President Bush's insistence that the MCA should focus its resources on developing countries that have a proven track record in the policies conducive to development may be the most important aspect of the program. Instead of granting assistance to elicit reform, the program will grant assistance to countries that have already demonstrated a willingness to reform, thereby increasing the odds that those funds will be effective.

## A NEW OPPORTUNITY FOR GROWTH AND PROSPERITY

The important lessons here are plain. First, increasing economic growth and individual prosperity through economic freedom must be core goals of development. Second, economic assistance can improve economic growth only in good policy environments. Third, the economic futures of developing countries lie predominantly in their own hands through the policies that they choose to adopt and enforce – long-term policy reform cannot be forced upon them.

By requiring aid recipients to prove their adherence to the policies proven to catalyze development, the MCA constitutes a welcome recognition of the limitations of development assistance while maintaining the spirit of aid by offering a helping hand to the nations striving to help themselves. ❑

1. America gave over $167 billion (in constant 1999 U.S. dollars) in official development assistance to 156 countries, regions, and territories between 1980 and 2000. Per capita gross domestic product data from 1980 to 2000 are available for only 97 of these countries. Official development assistance data are from Organization for Economic Co-operation and Development (OECD), International Development Statistics 2002 on CD-

ROM. GDP data and per capita GDP data from the World Bank, World Development Indicators 2002. A complete list of the data is available at Brett D. Schaefer, *The Millennium Challenge Account: An Opportunity to Advance Development,* Heritage Lecture #753, July 12, 2002, at http://www.heritage.org/Research/TradeandForeignAid/HL753.cfm.

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