

The Millennium Challenge Account: Taking Governance and Growth Seriously

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Thank you for the opportunity to share my thoughts with you today. I am particularly pleased that you chose to include a session focused on the Millennium Challenge Account (MCA) in a conference on sustainable development. Regardless of the particular definition of sustainable development one chooses, economics remains at the core. Thus it is important to pay particular attention to those items that can foster sustained economic growth, or whose absence places economic growth at risk.

As all of you are well aware, on March 14, President Bush announced the creation of a new program for delivering bilateral assistance from the United States to the least developed countries, the Millennium Challenge Account. The President's proposal envisions a 50 percent increase in official development assistance by Fiscal Year 2006, when the MCA is fully funded with its annual appropriation of \$5 billion. The MCA in no way diminishes our long-standing commitments to humanitarian assistance. Instead, this new program represents an additional source of assistance focused on encouraging and rewarding sound policy decisions that support economic growth and reduce poverty.

This morning, I would like to discuss the economic logic underlying the MCA and its role in contributing to the underpinnings of sustained economic growth and development. In the process, I will provide an update on the discussions involving the design of the MCA, and describe the next steps that will be crucial in making sure that the potential of the MCA is fully realized.

Igniting the Engine of Growth

A longstanding question in development economics has been succinctly put by Nobel Prize winner Robert Lucas, who asked why capital does not seem to flow to the poorest countries. After all, in such countries, with investment and growth at very low levels, marginal returns to capital accumulation would likely be high, so capital should flow in from richer countries. Also, domestic citizens in those countries should save and allocate their saving to these same high-return projects.

An important piece of the puzzle is that developing financial capacity for growth is more complicated in practice than in theory. Clearly defined rules of law, accounting, and investor protection are required to make external financing by firms, investment, and growth possible. These linkages are important; research by economists has identified large effects of “good governance” on the cost of capital, investment, and growth.¹ Simply trying to attract foreign capital via efforts at financial liberalization or aid that ignore this critical link to building private-sector financial capacity are unlikely to generate growth. Put differently, building the infrastructure for capital markets improves both the response to inflows of capital and the capacity for domestically-generated growth.

Indeed, over the past 15 years there has been an explosion of research that is beginning to reach a consensus emerging on the fundamental determinants of economic growth. The President’s MCA proposal focuses on these determinants. Good growth outcomes are associated with governments that adhere to three key principles – “ruling justly,” “investing in people,” and pursuing “economic freedom.” Using the MCA to encourage these three facets of sound policy in the poorest economies will ensure that aid is quickly followed by even larger private investment that will do the most to lift millions out of poverty. The role of the MCA will be to serve as a new type of special purpose vehicle within the bilateral aid framework, a special purpose vehicle dedicated to the eradication of poverty.

¹ See for example, A. Demirgüç-Kunt and V. Maksimovic, “Law, Finance, and Firm Growth,” *Journal of Finance* 53 (1998) 2107-2137; Charles P. Himmelberg, R. Glenn Hubbard, and Inessa Love “Investor Protection, Ownership, and the Cost of Capital,” Mimeograph, Columbia University, 2002; and Rafael La Porta, Florencio Lopez-di-Silanes, Andrei Schleifer, and Robert W. Vishny, “Law and Finance,” *Journal of Political Economy*, 106 (1998): 1113-1155.

Establishing the Role of the MCA

Existing bilateral official development assistance appropriately serves many purposes and is used to meet both political and economic objectives. It is therefore not surprising that evaluations of development assistance based on a sole objective are often critical of aid allocations and programs. For example, World Bank analysis concludes that aid is not optimally allocated when measured against the single objective of poverty reduction.² A reallocation of resources could more than double the number of people that could be sustainably lifted out of absolute poverty. Such findings are one reason that observers are often frustrated with the results of aid.

The MCA offers the opportunity to work more effectively toward poverty reduction. This raises the immediate question of how best to eliminate poverty. The answer is at once simple and complicated. First, the simple part: Study after study has shown that poverty is eliminated through economic growth.³ The old saw that a rising tide lifts all boats is exactly right; it is not the case that economic growth simply favors the wealthy over the poor in an economy. The MCA will better address poverty reduction through improved resource allocation while at the same time promoting an environment that is more conducive to growth.

Assessing Policies

Putting the MCA into practice first requires measuring the extent to which governments are undertaking sound policies to enhance growth. President Bush has identified the three key areas of policy to focus upon and since that time an interagency team led by Secretary Powell and Secretary O'Neill has been hard at work examining potential indicators to find those that best measure the quality of these policies. Eventually, the goal is to build a set of indicators that would be used to determine which countries have the best practices, and these countries will benefit the most from MCA support.

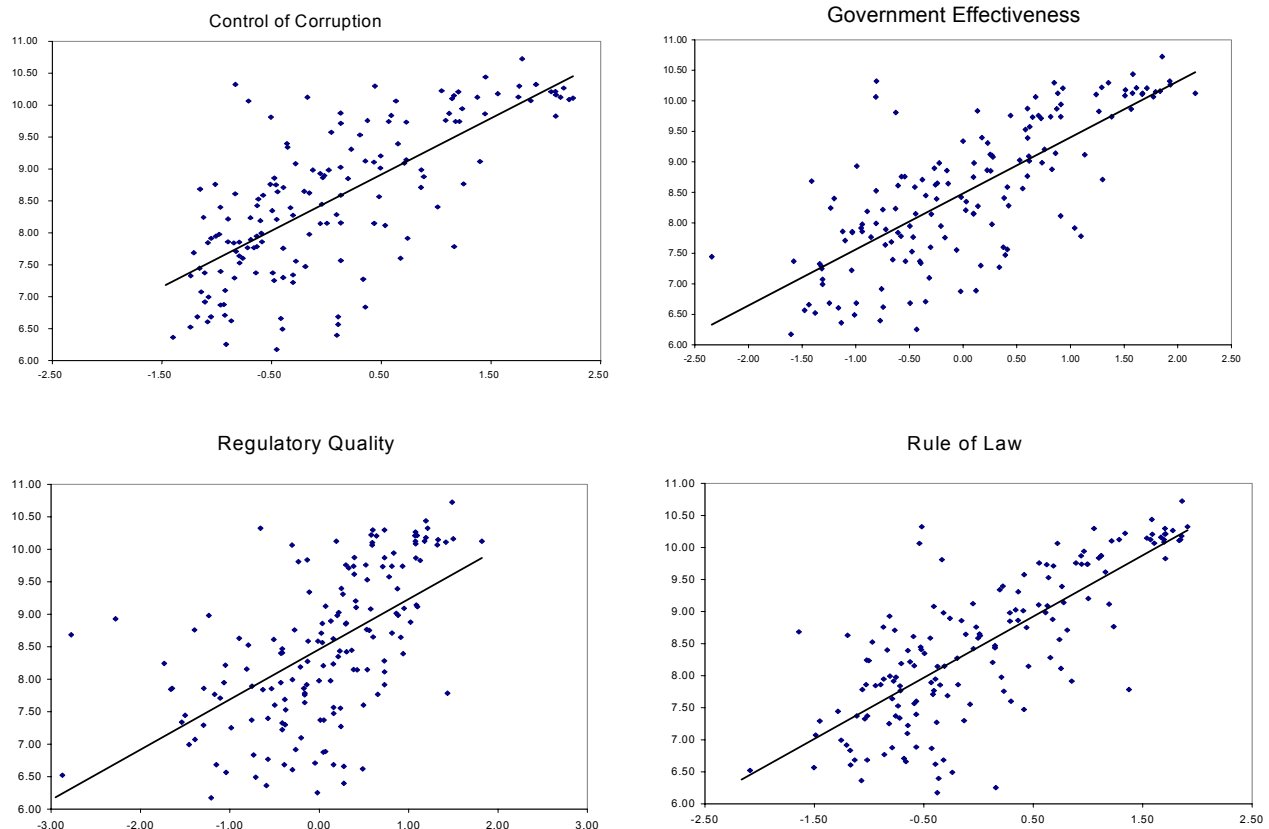
² Paul Collier and David Dollar, "Aid Allocation and Poverty Reduction", Development Research Group Working Paper, World Bank, 1999.

³ David Dollar and Aart Kraay, "Growth is Good for the Poor" World Bank Development Research Group mimeograph, March 2001. Martin Ravallion and Shaohua Chen, "Distribution and Poverty in Developing and Transition Economies: New Data on Spells During 1981-93." *World Bank Economic Review* 11, May 1997.

Although the work of the interagency team is ongoing, examples of the many potential indicators from each of the three areas will help to clarify the concepts behind the MCA. Under “ruling justly,” among those being considered are measures of civil liberties, political rights, enforceability of contracts, judicial independence, corruption, transparency and government effectiveness. World Bank researchers Kaufmann, Kraay, and Zoido-Lobaton (1999) have found a positive and significant link between these indicators of good governance and economic development. For example, they find that were a country to leap-frog ahead (technically, advance by one standard deviation) in the quality of its governance vis-à-vis other countries, it could expect a threefold increase in per capita income.

Governance and Per Capita Income

There is a robust positive relationship between good governance and per capita income across the globe.



Source: Kaufmann, Kraay, and Zoido-Lobaton (2002). Aggregated indexes of governance versus log of per capita GDP at purchasing power parity.

With regard to “investing in people,” under consideration are measures that focus on education and health, such as school completion rates and public expenditures on health care. The report of the World Health Organization’s Commission on Macroeconomics and Health, chaired by my Columbia colleague Jeff Sachs, finds that each 10 percent increase in life expectancy at birth is associated with an increase of at least 0.3 to 0.4 percentage points in economic growth rates. Similar arguments could be used in support of indicators based on educational enrollment or expenditures.

Finally, some indicators of the government’s commitment to “economic freedom” being reviewed are measures of macroeconomic performance, country credit ratings, support for open markets domestically and internationally, and the quality of regulatory policies. Khan and Senhadji (2000), for example, find that inflation rates in excess of 10 percent per annum are associated with lower growth rates in developing economies.⁴ According to their work, an increase in the inflation rate from 3 percent to 30 percent will trim annual growth rates by 0.67 percentage points. Similarly, other indicators under consideration for the category of “economic freedom” are also known to have significant impacts on growth.

Within each group, it is useful to develop criteria for selecting indicators. Among the criteria being considered is confidence in the soundness of the indicator. Other things being the same, one would prefer indicators closely associated with economic growth and poverty reduction. Another important criterion is the transparency of the indicator. Again, other aspects being the same, it is preferable to employ indicators that are easy to understand and explain.

Ensuring the Success of the MCA

The President’s MCA initiative is a new approach to development assistance, and I hope that these examples give you some sense of the kinds of the many variables or indicators that the interagency group is considering to measure a country’s “performance.” A key innovative element of the MCA is that it will challenge countries to improve by rewarding them for good performance. Making sure that the MCA remains focused on providing assistance to good

⁴ Mohsin S. Khan and Abdelhak S. Senhadji, “Threshold Effects in the Relationship Between Inflation and Growth,” International Monetary Fund Working Paper WP/00/110, June 2000.

performers and providing incentives for countries to improve their policies will require a mechanism that makes appropriate and careful use of the measure or measures derived from these indicators.

Although no final decisions have been made concerning how the measures will be derived from the indicators, one possible approach would combine the various indicators into a single index. In this example, the question then naturally turns to how that index will be used. One can imagine two opposite ends of a spectrum that encompass the extent to which the index will determine eligibility and funding. Let me label the two poles with terms that economists have become very enamored of, “rules” on the one end and “discretion” on the other. A purely rule-based approach would use the index of country performance to determine eligibility for the MCA. For example, the 20 countries with the highest index value would receive funding with no exceptions; none of the 20 would be dropped from the list, and no additional countries would be added. In contrast, a purely discretionary approach would use the index as but one input in the eligibility decision, relying on additional information such as need and an assessment of the commitment of the country’s leadership to a reform program.

In practice, ensuring the success of the MCA will require an approach that incorporates both rules and discretion. A purely rules-based approach is impossible, given the inherent limitations in the indicators that will be used to construct a country’s index. First and foremost, time lags in the collection and processing of the variables used to construct the index make it impossible to rely only on the index. Some variables likely to be used in the index will lag by as much as a year or two the actual funding decision for the MCA. In the interim, significant changes could take place that would drastically change the amount of funding that should be made available. For example, a kleptocratic tyrant might stage a successful coup to displace a democratically elected regime that had a record of outstanding performance. In such an instance, providing funding for such a country would violate President Bush’s principles for the MCA. If the “rules” required that funding had to be provided, the MCA would not survive the next budget allocation cycle.

A purely discretionary approach, however, is not practical either. First, current aid policies can be argued to be pure discretion (abstracting from Congressional restrictions, etc.) if the MCA is to be a new approach it must move away from complete discretion. Second, the MCA is meant to encourage and reward good policies, the theme of this conference. The MCA will only achieve this goal if policy decisions are as transparent as possible. Countries that are found to be eligible for MCA funding must know why, so that they can keep following good policies. Countries that are found ineligible must also know why they failed to obtain support, so they can have an incentive to discontinue poor policies and put good policies in place. Under a purely discretionary system, it is impossible to convey to countries this information. This might explain in part the weak relationship between aid and performance.

There is great value in using clear and concrete criteria for selection of countries eligible for the MCA. This information will provide a powerful opportunity for reform in poor countries around the world. This is the “challenge” in the MCA to improve policies and receive MCA funds. Without “rules” it is impossible to provide reliable, transparent feedback to reward good performance and encourage future performance. Given the potential gaps and lags in the indicator data, however, there is a role for discretion. Without “discretion” it would be impossible for the program to make the difficult decisions that should take into account the most up- to-date information and trends toward improvement in a country.

Mapping the Road Ahead

The interagency MCA team continues to work on developing the MCA method, about which I have just spoken, as well as policy and management structure that will guide the MCA. In formalizing the MCA structure, discussions have taken place over the past months with as many interested parties as possible—the private sector, nongovernmental organizations, academics, and current official development assistance donor and recipient nations. Most recently, discussions have started with Congress with a goal of producing draft legislation in the fall.

If the MCA is to achieve its laudable objective of triggering growth by encouraging good governance, it will be important to avoid any earmarking of funds that targets particular

countries, regions or sectors. Maximum flexibility is needed for maximum results. Good performance in the poor nations must be recognized regardless of the region or country in which it is achieved. It must be possible for MCA funds to be put to their best use rather than in the trendiest development sector of the day. Under these conditions, the MCA will represent an exciting new approach to development assistance that will substantially improve the lives of the world's poor.

Thank you, and I look forward to answering your questions.