

MERCATUS CENTER
GEORGE MASON UNIVERSITY

**The Millennium Challenge Account:
Property Rights and Entrepreneurship as the Engine of Development**

Public Interest Comment On the Millennium Challenge Corporation's

***Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries
for Millennium Challenge Account Assistance in FY 2004***

EXECUTIVE SUMMARY

The Millennium Challenge Account (MCA) offers much promise for a new direction in international assistance to less developed countries. With a focus on results, the MCA promises to help those countries that have demonstrated a commitment to Economic Freedom, Ruling Justly, and Investing in People, along the path to prosperity.

The success of this new venture depends on the Millennium Challenge Corporation taking up the charge from the President and Congress to embrace the new way of thinking that motivated the legislation – one that recognizes the importance of locally driven institutional reforms.

For this promise to become reality however, three important changes need to be made to the *Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2004* submitted to Congress on March 5, 2004.

The indicators by which countries will be evaluated for assistance must include due consideration of a country's commitment to:

- A productive **Entrepreneurial Environment**,
- Clearly defined and enforced **Property Rights**, and
- The **Political Capacity to Sustain Reforms**

These concepts are clearly intended by the authorizing legislation and are crucial components for effective implementation of the MCA. However, they are noticeably absent from the current *Criteria and Methodology*.

The importance of these changes cannot be overstated given the potential influence of the MCA. Not only will countries deemed eligible this year receive funds, but these standards will profoundly affect the path of domestic reforms in candidate countries that do not qualify, as they prepare to become eligible in the future.

The Millennium Challenge Account: Property Rights and Entrepreneurship as the Engine of Development is a comment submitted by the **Mercatus Center** at George Mason University's **Global Prosperity Initiative** in the public interest, with the hope that the recommendations it contains will improve the outcome of this momentous policy action.

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Global Prosperity Initiative

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Peter J. Boettke, Paul Dragos Aligica, and Brian Hooks

The Mercatus Center at George Mason University generates knowledge and understanding of how institutions affect the freedom to prosper and holds organizations accountable for their impact on that freedom. The Mercatus Center's Global Prosperity Initiative brings together leading scholars from around the world to address specific problems of institutional and economic development. This comment does not represent the views of any particular affected party or special interest group, but is designed to improve the outcome of the Millennium Challenge Corporation's Criteria and Methodology by bringing contemporary scholarship in the social sciences to bear on the process.

For more information about the Mercatus Center at George Mason University's Global Prosperity Initiative, visit www.mercatus.org/globalprosperity.

The Millennium Challenge Account: Property Rights and Entrepreneurship as the Engine of Development

Public Interest Comment¹

On the Millennium Challenge Corporation's

Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2004

"We must tie greater aid to political and legal and economic reforms. And by insisting on reform, we do the work of compassion. The United States will lead by example. I have proposed a 50-percent increase in our core development assistance over the next three budget years. Eventually, this will mean a \$5-billion annual increase over current levels.

*These new funds will go into a new Millennium Challenge Account, devoted to projects in nations that govern justly, invest in their people and encourage economic freedom."*²

**- President George W. Bush
Monterrey, Mexico, March 22, 2002**

The Millennium Challenge Account (MCA) offers much promise for a new direction in international assistance to less developed countries. As the President emphasized, the new program will demand more accountability from rich and poor nations alike to ensure that aid programs are effective in helping the very people they are intended to help. Of course, the track record of foreign aid in the second half of the 20th century is one of unrealized intentions, as documented in William Easterly's *The Elusive Quest for Growth*.³ The President recognized nothing less when he issued his National Security Strategy which states, "Decades of massive development assistance have failed to spur economic growth in the poorest countries. Worse, development aid has often served to prop up failed policies, relieving the pressure for reform and perpetuating misery. Results of aid are typically

¹ Prepared by Peter Boettke, PhD, Research Director, Paul Dragos Aligica, PhD, Research Fellow, and Brian Hooks, Director, Global Prosperity Initiative, Mercatus Center at George Mason University. This is a Public Interest Comment from the Mercatus Center's Global Prosperity Initiative and does not represent an official position of George Mason University.

² President George W. Bush, remarks at the United Nations Financing for Development Conference: Cintermex Convention Center, Monterrey, Mexico, March 22, 2002, available online: <http://www.whitehouse.gov/news/releases/2002/03/20020322-1.html> .

³ William Easterly, *The Elusive Quest for Growth*, Cambridge, Massachusetts: MIT Press, 2001.

measured in dollars spent by donors, not in the rates of growth and poverty reduction achieved by recipients. These are the indicators of a failed strategy.”⁴

The architects of the MCA are to be commended for recognizing this failure and taking up the challenge of addressing it. Because of their efforts, the rich field of academic research in this area can be fruitfully applied to creating positive change in developing nations.

The MCA is promising because it signals a new way of thinking about development assistance. The focus will be on economic performance rather than geopolitics. The intent is to call on the full participation of the recipient countries to build institutional capacity in the developing world. Eligibility requirements are valuable because they help define precisely the goals of the policy and thus serve to focus activity. What’s more, the MCA recognizes a fundamental economic reality: Incentives matter. Thus, the eligibility criteria will play a key role in guiding domestic policy within threshold countries taking steps to become eligible in the future.

However, the promise of the MCA remains greater than the reality reflected in the *Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2004* submitted to Congress on March 5, 2004. The *Criteria and Methodology* needs to stress more vigorously several key preconditions of economic growth that are underemphasized in the current report. The following comment is submitted with the optimism and encouragement expressed in the preceding statements and the intention that the suggestions contained herein, if adopted, would more closely align the promise of the MCA with the reality.

This comment begins with a brief overview of the *Criteria and Methodology* followed by a section highlighting the key concepts that we suggest must be included in the *Criteria and Methodology*. Then, in Section 2, we examine the role institutions play in enabling each of these key concepts. Section 3 makes specific recommendations for improving the *Criteria and Methodology*, and Section 4 concludes the comment.

Overview of the Criteria and Methodology ⁵

The *Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2004* is the second of three steps spelled out for the Millennium Challenge Corporation (MCC) in the Millennium Challenge Act of 2003.⁶ In February, the MCC acted on the first step by issuing a list of 63 “candidate countries” that meet the base requirements to be considered eligible under the Act. This report specifies 16 indicators of eligibility, divided into three groups – Ruling Justly, Encouraging Economic Freedom, and Investing in People – which will be used to assess the policy performance of individual countries to determine whether they will be invited to submit compact proposals for funding under the MCA. In addition to creating these three categories, the authorizing

⁴ The National Security Strategy of the United States of America, September 2002, pg.21.

⁵ The information in this section is summarized for quick reference from the *Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2004* submitted to Congress by the MCC on March 5, 2004. The full Report is available online: http://www.mca.gov/Documents/methodology_report.pdf.

⁶ Available online: http://www.mca.gov/Documents/MCA_Legislation.pdf.

Act included specific criteria each group should include, to better guide the MCC in its selection of indicators.

The resulting indicators in the *Criteria and Methodology* are:

| Ruling Justly | Encouraging Economic Freedom | Investing in People |
|---|---|---|
| 1. Civil Liberties 2. Political Rights 3. Voice and Accountability 4. Government Effectiveness 5. Rule of Law 6. Control of Corruption | 1. Country Credit Rating 2. 1-year Consumer Price Inflation 3. Fiscal Policy 4. Trade Policy 5. Regulatory Quality 6. Days to Start a Business | 1. Public Expenditures on Health as Percent of GDP 2. Immunization Rates: DPT3 and Measles 3. Public Primary Education Spending as Percent of GDP 4. Primary Education Completion Rate |

Definitions and data sources are also provided in the Annex of the *Criteria and Methodology*.

In order to be considered eligible, a country must perform above the median in relation to its peers on at least half of the indicators in each of the three policy categories. Additionally, it must perform above the median on the corruption indicator. The exception is the inflation indicator, for which an inflation rate under 20% is required. These indicators will be the predominant basis for the determination of eligibility, however the MCC will also consider qualitative assessments and adjustments related to missing data, data lags, or exceptionally poor performance on certain indicators, when assessing countries.

1. Crucial Concepts are Missing from the Criteria and Methodology

We believe key concepts are conspicuously absent from the *Criteria and Methodology*. This is especially troubling considering both the executive and legislative intent of the MCA. These key concepts, on which there is virtual consensus in the academic literature, and which are not captured in the current methodology, are:

- (1) Entrepreneurship,
- (2) Property rights, and
- (3) Political capacity to sustain reforms.

Omitting these key concepts could undermine the MCA effort, particularly given the dual purpose of the eligibility criteria. Not only will it (1) adversely affect the actual selection of countries from which compact proposals will be solicited, it will (2) have a profound affect on the signal sent to threshold countries about which policies they should pursue in order to qualify in the future. This second point is vital, given that perhaps no more than 15 countries will be selected to submit proposals in the first term of the MCA. This means that nearly 50 other countries will be relying upon the signals sent by the eligibility criteria, as they initiate domestic reforms designed to ensure future eligibility.⁷ This signal matters and it is

⁷These figures are taken from comments made during the “Public Meeting on Selection Criteria and Methodology for the Millennium Challenge Account” on March 10, 2004 at the US Department of Treasury. It was estimated that no more than 15 countries would be deemed eligible, which leaves 48 of the original 63

vitaly important that it be clear and concise with respect to the drivers of economic progress and the path to economic reform.

The overall framework presented in the *Criteria and Methodology* focuses too much on macroeconomic indicators as proxies for economic freedom, at the expense of microeconomic incentives: entrepreneurship, private property rights, and the structure of political institutions. The focus on measuring macroeconomic indicators tends to miss the underlying structural, institutional factors that drive economic growth and development.

For example, the physical composition of a 250 lb fat man, and a 250 lb linebacker are surely different, yet concentrating on the aggregate weight of the men misses this fact. While it may be important to know the overall weight of a man, it is at least as important to understand the nuances of the man's health - especially if we're intending to administer strong medicine. Similarly, while it is important to know the overall structure of the economy, before administering strong medicine to encourage economic health and growth it is necessary to understand the microeconomic, institutional makeup of a country.

To put it another way, what we have learned as economists in the last two decades is that while there may be macroeconomic problems, there are only microeconomic solutions. Unfortunately, our tools of economic measurement and our institutions of public policy were developed prior to this understanding and are geared towards providing data and advice, working under the assumption that old theories of economic activity and public policy are correct. The recognition of this misalignment is the impetus for the MCA. But given intellectual and institutional inertia, the MCA risks being captured by the very paradigm from which it is attempting to break free. The overemphasis on macroeconomic indicators tends to cloud the very sources of growth and development at the microeconomic and institutional level that our intellectual and policy attention ought to be drawn to, given what we now know about the mechanics of economic development. Macroeconomic indicators are useful, but used alone they miss the careful nuances of the particular, and risk the failure in development that we've experienced in the past.

In the following section we will briefly outline the importance of these concepts and then, in Section 3, demonstrate how these concepts could improve the *Criteria and Methodology* for determining eligible countries.

2. Robust Institutions Underpin Economic Freedom

The evidence accumulated over the years as a result of research on the foundations of economic development points unambiguously toward the importance of institutions that enable entrepreneurship, define and enforce property rights, and create the political capacity to see that reforms are sustained.⁸ These results are consistent with Adam Smith's

candidate countries ineligible. This meeting was web cast and archives are available online: <http://www.connectlive.com/events/treasury/>. Transcripts of this meeting were not available at the time this comment was published. A complete list of the candidate countries is available in the *Report on Countries That Are Candidates for Millennium Challenge Account Eligibility in FY 2004 and Countries That are Not Candidates Because of Legal Prohibitions*, submitted by the MCC to Congress on February 6, 2004. This Report is available online: http://www.mca.gov/Documents/candidate_report.pdf.

⁸ There is an abundance of literature produced in the last two decades that explores this point, most recently under the heading "New Institutional Economics." For an overview see Douglass North, *Understanding the Process of Economic Change*, Princeton University Press: Forthcoming, and an article with the same title prepared

fundamental insights. In 1759⁹, he wrote that “Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes and a tolerable administration of justice; all else being brought about by the natural course of things.” Unpacking all that is implied in Smith’s statement has been the challenge of more than 200 years of social science. Today, in light of the most recent developments in political economy, one may conclude that Smith’s basic insights have proven correct.

Modern political economy has emerged, especially in the last two decades, within an atmosphere of intellectual frustration as the older paradigms which de-emphasized institutions have given way to one that embeds economic life within concrete political, legal, and social institutional settings. There is general agreement that institutions matter and that their impact on the entrepreneurial processes is crucial for the economic performance of a country. Mancur Olson, one example of the many political economists whose research supports this conclusion, updated Smith’s basic claim when he stated that the large differences in *per capita* income across nations must be explained on the basis of institutional distinctions. The variables associated with many economic modes of growth and development do not help us understand why some nations are rich while others languish in poverty.

“Though low-income societies obtain most of the gains from trade from self-enforcing trades, they do not realize many of the largest gains from specialization and trade. They do not have the institutions that enforce contracts impartially, and so they lose most of the gains from those transactions (like those in the capital market) that require impartial third-party enforcement. They do not have the institutions that make property rights secure over the long run, so they lose the gains from capital-intensive production. Production and trade in these societies is further handicapped by misguided economic policies and by private and public predation. *The intricate social cooperation that emerges when there is a sophisticated array of markets requires far better institutions and economic policies than most countries have.*”¹⁰
(emphasis added)

Guided by the insights of modern political economists like Nobel Prize winners F. A. Hayek, James Buchanan, Ronald Coase, Douglass North, and Vernon Smith, and scholars such as Olson and Hernando de Soto, the MCA holds the potential to refocus the development agenda on those institutional changes required for encouraging the long-term economic growth required to lift the populations of underdeveloped nations from wretched poverty and squalor.

For all its promise of embracing this new thinking there is the risk that the MCA will be held captive by the very intellectual paradigm it is intending to transcend. Unless the crucial concepts of the new thinking that inspired the MCA are also incorporated into the *Criteria and Methodology*, we believe the new program runs the risk of falling into the wagon

for the *USAID Forum Series on the Role of Institutions in Promoting Economic Growth: Forum 7: Institutional Barriers to Economic Change*. June 24, 2003. Available online: <http://www.mercatus.org/pdf/materials/328.pdf>.

⁹ Quoted in, Adam Smith, *The Wealth of Nations*, New York: Prometheus Books, 1776 [1991], p. xliii.

¹⁰ Mancur Olson, “Big Bills Left on the Sidewalk: Why Some Nations are Rich, and Others Poor,” *Journal of Economic Perspectives*, 10: Spring 1996, pgs. 3-24.

ruts of the old policy that neglected the role of institutional structures and entrepreneurship, and that new ideas, despite the best of intentions, will be afforded only lip service.

A. *Entrepreneurship and Economic Freedom*

The MCA rightly emphasizes the important role that policies that demonstrate a commitment to economic freedom play in a nation’s prosperity. The data relating economic freedom and both the level of *per capita* income and the growth in *per capita* income is very strong. Countries that score the best in terms of low inflation, easy taxes, open trade, low levels of regulation, and secure property rights, tend to have both a greater level of per capita income and better rates of economic growth.

Exhibit 5: Economic Freedom and Per-Capita Income

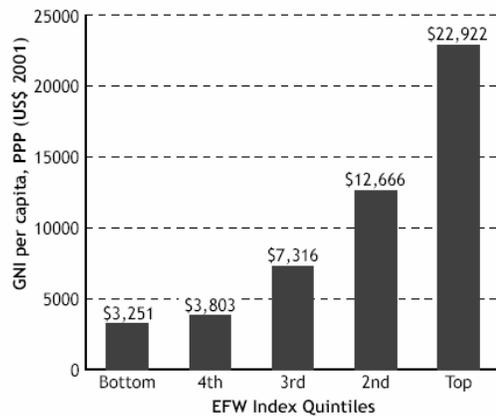
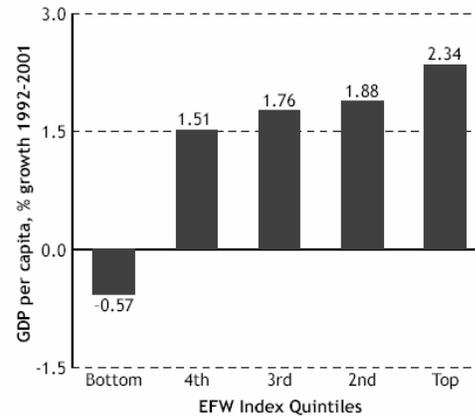


Exhibit 8: Economic Freedom and Economic Growth



Source: Economic Freedom of the World, 2003.¹¹

The relationship between *per capita* income and human flourishing as measured in terms of health and human services, political freedoms, the respect for minorities in society,¹² and environmental quality,¹³ is strong and positively correlated.

The promise of the MCA is that it will be grounded in this compelling evidence, and in the new thinking that has resulted from the accumulation of evidence on the policies of economic freedom and economic growth, development, and human welfare.¹⁴

But we must not lose sight of the precise reason why policies of economic freedom lead to increases in wealth, health, and the enhancement of opportunities to live meaningful

¹¹ James Gwartney and Robert Lawson, *Economic Freedom of the World: 2003 Annual Report*, Fraser Institute, July 2003, pg. 21. Available online: <http://www.freetheworld.com/2003/1EFW2003ch1.pdf>.

¹² Peter Boettke and J. Robert Subrick, “Rule of Law, Development, and Human Capabilities,” *Supreme Court Economic Review*, 2003, and Peter J. Boettke, *Calculation and Coordination*, New York: Rutledge, 2002, appendices.

¹³ Bruce Yandle, Maya Vijayaragharaani, and Madhusudan Bhuttaria, “The Environmental Kuznet’s Curve: A Primer.” Available online: http://www.perc.org/pdf/rs02_1.pdf.

¹⁴ And in fact, a major impetus for the MCA was the recognition of the relationship between policies of economic freedom and national security - the terrorist threat comes from countries that are economically repressed, not those adopting policies of economic freedom – as evidenced in the National Security Strategy of the United States of America, September 2002.

lives. It is because the freedom to choose one's course is essential to unleashing the creative imagination of individuals and realizing the gains from mutually beneficial exchange. Institutions of economic freedom unleash the productive entrepreneurial elements within society. Entrepreneurship is the desired result of policies that demonstrate a commitment to economic freedom; therefore enabling entrepreneurship should be the standard by which we measure progress toward succeeding in this commitment.

Entrepreneurs drive the two most basic functions of economic growth: they seek to take advantage of business opportunities by better allocating resources within an economy, and they seek entirely new ways to use existing resources, thereby expanding the boundaries of economic activity. Alert entrepreneurs facilitate trade between parties with otherwise irreconcilable preferences and resource endowments, and thus improve efficiency within an economy. They identify and develop new technological and organizational opportunities and act as the vital agents of change in a market economy. Economic progress occurs when the entrepreneur accelerates the generation, dissemination, and application of innovative ideas.

Entrepreneurship generates a number of social benefits as well. It is the sole productive solution to combating unemployment and providing individuals with the means to raise themselves out of poverty. Additionally, entrepreneurship tends to beget entrepreneurship and so, given the proper institutional foundation, it is self-sustaining. This occurs because of the knowledge-externalities generated from both successful and failed entrepreneurial gambits. When an entrepreneur establishes a business, valuable information is provided to the market. Other actual and potential entrepreneurs learn what products sell, what marketing strategies work, what general business practices are successful or not, and so on. Even if the new business should fail, new information is passed onto others for them to act upon in the market.¹⁵

An entrepreneurial element is evident in all societies throughout the world as individuals strive to do the best they can in a given situation. But policies matter and can determine whether the entrepreneurial element is directed in positive-sum, zero-sum, or negative-sum games by the institutional context of activity. Put simply, countries that suffer from systemic poverty do so because the incentives in those countries are aligned to reward predation by private and public actors as opposed to productive wealth creation. Because of an institutional deficiency, mutually beneficial exchange in these societies is limited to face-to-face relations, and cannot be extended into the complex network of impersonal economic inter-relationships that exist in an advanced economy.

When the entrepreneurial environment is distorted or constrained, entrepreneurial talent is either directed in unproductive directions (bureaucracy, crime, etc.), or it is directed toward small-scale, albeit productive, uses. In poor countries economic policies create perverse incentives, leading to poor records of economic growth and development. What we see is a disjoint between the *de jure* rules of the game (laws on the books) and the *de facto* way of life that people live (accepted behavior). Individuals in these societies, who could be contributing to the official economy, focus instead on finding ways to avoid detection and hide their wealth from fear of predation by either private or public actors. Informal rules emerge to govern interactions, and various investments are made in the attempt to evade taxation, regulations, and government interference in general. The black market economy

¹⁵ The information on the benefits of entrepreneurship is summarized from Scott Shane, *The Foundations of Entrepreneurship*, Cheltenham: Edward Elgar, 2002, and Peter Boettke and Christopher Coyne, "Entrepreneurship and Economic Development," *Advances in Austrian Economics*, Vol. 6, 2003, pg. 67-87.

and the rise of corruption are both consequences of government prohibition on economic activity. They are also good signals that the entrepreneurial environment is problematic. Each bureaucratic hurdle is an opportunity for a public official to line his pocket with either funds or favors and creates the incentive for entrepreneurs to move their economic activity underground. Modern research in the political economy of economic growth and development has provided evidence that unless these institutional preconditions are set on the right path, foreign aid will be ineffective.¹⁶

We believe that much more attention must be paid to the actual political economy of everyday life as exhibited in the black market and informal sector and that the goal of public policy should be to bring into alignment the *de jure* rules with the *de facto* reality of the economic life of the people of the recipient country. Productive entrepreneurship in poor societies exists on the margins of economic life. To the extent that policymakers are committed to an institutional arrangement that allows entrepreneurs to succeed, an economy will grow. To the extent that entrepreneurs are constrained or their energies are directed toward unproductive activities by their institutional arrangements, an economy will stagnate or decline.

Government has a key role to play in shaping incentives so that entrepreneurs keep their activities above ground, in a legitimate market. This is best done through policy that brings the *de jure* institutions in line with the *de facto*, which is quite different from, say, a policy that chooses favorites to subsidize at the expense of others.¹⁷

Both qualitative assessment and, given the tools currently available, quantitative measurement, of the way entrepreneurial activity is directed must figure prominently into any discussion of economic freedom. The effect that economic policies have on the entrepreneurial environment needs to be at the forefront of a determination of a country's commitment to economic freedom.

B. Property Rights

One of the most important factors determining whether individuals will channel their entrepreneurial spirit in productive ways is the presence or absence of clear property rights. As Hernando de Soto's¹⁸ research has unearthed, the world's poor are sitting on a vast amount of wealth and capital. However, they are unable to use this capital to lift themselves above a subsistence lifestyle because of government policies that create uncertainty over property ownership. These uncertainties prevent trade from expanding beyond close social networks.

The most important public policy that countries can adopt to promote economic growth is the clarification and enforcement of private property rights. Absent such clarification and enforcement, economic activity will tend to be short-sighted and limited in scope and scale.

¹⁶ William Easterly, *The Elusive Quest for Growth*, Cambridge, Massachusetts: MIT Press, 2001.

¹⁷ Svetzovar Pejovich, "Understanding the Transactions Costs of Transition: It's the Culture Stupid," *Review of Austrian Economics*, 16(4) 2003, pg. 347-361, also available in a version prepared for the USAID Forum Series on the Role of Institutions in Promoting Economic Growth: Forum 6: The Interaction Thesis: Alternative NIE Perspectives on Development, April 4, 2003, available online: <http://www.mercatus.org/pdf/materials/217.pdf>, also see Peter Boettke, "Why Culture Matters," reprinted in *Calculation and Coordination*, New York: Routledge, 2002.

¹⁸ Hernando de Soto, *The Other Path*, New York: Harper & Row, 1989 and *The Mystery of Capital*, New York: Basic Books, 2000.

“Property Rights” has too often become the mantra of those with little understanding of the rich institutional framework to which the term refers. This is unfortunate, given the overwhelming evidence that the security of an individual’s property is a pre-requisite for widely shared prosperity. De Soto has breathed new life into our understanding of why this is the case and brought us beyond the tired platitudes into a more certain recognition that development cannot occur without security of property and that its achievement in some of the poorest regions is not beyond our reach.

Individuals in poor societies strive to better their lot in life just as individuals in rich societies do, but the opportunities to do so in a secure, legal manner are constrained. In the rich societies of the world, an entrepreneur does best economically by satisfying the demands of others. Thus, the incentives are aligned for the entrepreneur to discover the best opportunities that are in his interest to discover and, measured in monetary terms, this will be the creation of wealth through gearing production to meet the demands of consumers. In order to achieve the scale and scope in exchange and production that is required for an advanced economy, individuals must be reasonably secure in the protection of their property.

Research in economic history and modern political economy has established that private property rights are essential for economic growth and development for at least the following five reasons:¹⁹

- (1) Recognized private property rights provide the legal certainty necessary for individuals to commit resources in ventures. The threat of confiscation, by either private individuals or public officials, undermines confidence in market activity and limits investment possibilities.
- (2) Clear property rights tend to make decision makers pay close attention to resource use and the discounted value of the future employment of scarce resources. Absent private property rights, economic actors will tend to be short-sighted in their decision making and not conserve resources over time.
- (3) Property rights are the basis of exchange, and the extension of ownership to capital goods provides the basis for the development of the financial markets that are essential for economic growth and development.
- (4) Secure private property rights are the basis for limited and civilized government. The elimination of arbitrary confiscation and the establishment of regular taxation at announced rates enable merchants to calculate the present value of investment decisions and pass judgment on alternative allocations of capital.
- (5) Secure property rights are also the basis for environmental quality and the sustainable use of natural resources. Weak property rights, more than any other underlying cause, are responsible for the “tragedy of the commons” that manifests itself as environmental degradation around the world.²⁰

A country that has not already taken steps to set itself on the path toward recognizing the property rights of its citizens is a country in which development dollars will be wasted.

¹⁹Hernando de Soto, *The Mystery of Capital*, New York: Basic Books, 2000, also see Peter Boettke, “The Political Infrastructure of Economic Development,” reprinted in *Calculation and Coordination*, New York: Routledge, 2002, and L. Birdzell and Nathan Rosenberg, *How the West Grew Rich*, New York: Basic Books, 1986.

²⁰ Bruce Yandle, Maya Vijayaragharani, and Madhusudan Bhuttaria, “The Environmental Kuznet’s Curve: A Primer,” Available online: http://www.perc.org/pdf/rs02_1.pdf .

C. Political Capacity to Sustain Reforms

The final concept we would like to see receive specific attention in the *Criteria and Methodology* is the institutional capacity of a country to implement economic policy. While this point is no doubt assumed in the current eligibility requirements, we contend that it is worth while explicitly to include consideration of whether a country's capacity for political ownership and stewardship of economic reforms is sufficient for the plans laid out in the eventual compact to become reality.

This notion of "policy ownership," which rests on the assumption that the political institutions within a country are robust enough so that good ideas can become good policy, is at the heart of the MCA. The requirement that eligible countries take the lead in designing compacts is certainly a necessary component of realizing domestic ownership of reforms, however it is not sufficient. Even the best-intentioned political actors will be hamstrung in their efforts to implement reforms if the institutions of policymaking within their country are designed to maintain the *status quo*.

Too often bureaucratic inertia or interest-group barriers imbedded in the institutions of policymaking overwhelm any attempt at reform. Would-be reformers face an uphill battle with little promise of reward for success, or worse, sure punishment by those bureaucrats and special interests that have captured the system. These types of barriers can be identified as political economy or "public choice" problems and they point to the very important notion of "policy ownership" as a solution. The domestic actors within recipient countries need to internalize the reforms in order to overcome the interest groups and institutional inertia supporting the *status quo*. Significant empirical lessons can be learned from the study of past attempts to implement economic reforms.²¹

Take the example of Romania and a USAID attempt to streamline the regulatory process associated with starting a business. USAID correctly identified the spider web of official barriers facing would-be business investors and through a three-stage process that included consultation with local officials, thereafter, they initiated reforms. Three years later, very few of those reforms had realized their potential, despite being well-targeted and appropriately modest in their goals.²²

The case demonstrates the crucial significance of the political economy processes surrounding initiatives aimed at identifying and removing barriers to economic activity. There were individuals whose livelihood depended on extracting rents from each activity USAID identified as a barrier to investment and so the incentives were arranged for those individuals to stall or disrupt the reform efforts. A subsequent study undertaken by USAID and the Mercatus Center showed that any economic policy, irrespective of its analytical quality or justification would have been mired and blocked by the maze of interests and institutional inertia that characterized this process. As long as the policy process is not better

²¹ James M. Boughton and Alexandros T. Mourmouras, "Is Policy Ownership An Operational Concept?" IMF Working Paper No. 02/72, 2002. Available online: <http://www.imf.org/external/pubind.htm>.

²² Paul Dragos Aligica, Peter Leeson, and Christopher Coyne. "Extending the Analysis – Romania: Lessons Learned from the Investors Roadmap: Implementation Challenges and An Exploratory Assessment of the Major Barriers to Rural Entrepreneurship from a New Institutional Economic Perspective," prepared for the *USAID Forum Series on the Role of Institutions in Promoting Economic Growth: Forum 8: New Institutional Economics and Development: Case Studies and Applications*, September 17, 2003. Available online: <http://www.mercatus.org/pdf/materials/433.pdf>.

structured, any initiative, no matter how analytically and pragmatically grounded, will likely fail in the implementation process.²³

As a general conclusion a major reason that pro-growth initiatives in countries like Romania haven't been as successful as expected is because the dysfunctional economic policy process generates weak support and a lack of "policy ownership" among potential reformers. The incentives arranged by the system simply do not encourage reformers to take up the cause of, and accept responsibility for, reforms. In other words, absent a strong economic policy institutional mechanism and a strong policy ownership element built into the reform process, assistance efforts are unlikely to achieve optimal results despite having correctly identified the necessary policy changes.

Therefore, any approach to development assistance requires an explicit agenda oriented towards policy capacity building. The MCA candidate countries should be aware that part of the process of absorbing economic aid is the creation of economic policymaking and monitoring capabilities.

3. Recommendation for Improving the Criteria and Methodology

This section makes specific recommendations for integrating each of the fundamental concepts discussed above into the *Criteria and Methodology*.

A. Encourage Economic Freedom by Measuring Entrepreneurship

"We propose a 50 percent increase in the core development assistance given by the United States. While continuing our present programs, including humanitarian assistance based on need alone, these billions of new dollars will form a new Millennium Challenge Account for projects in countries whose governments rule justly, invest in their people, and encourage economic freedom.

Governments must fight corruption, respect basic human rights, embrace the rule of law, invest in health care and education, follow responsible economic policies, and enable entrepreneurship. The Millennium Challenge Account will reward countries that have demonstrated real policy change and challenge those that have not to implement reforms."²⁴

- The National Security Strategy of the United States of America

Each of the elements President Bush cites in the National Security Strategy when referencing the MCA are present in the *Criteria and Methodology*, except one. An indication of a country's commitment to enabling entrepreneurship is noticeably absent from the category of Economic Freedom and we recommend that this be remedied.

²³ See footnote 20.

²⁴ The National Security Strategy of the United States of America, September 2002, pg. 21-22.

The category overall is weighted heavily in favor of macroeconomic stability and the inclusion of an assessment of the “Entrepreneurial Environment” within a country would go a long way towards bolstering the existing micro-indicators. The first three criteria (Country Credit Rating, 1-year Consumer Price Inflation, and Fiscal Policy) are no doubt necessary components of a functioning free economic system, however they are not sufficient to make the determination that a country demonstrates a commitment to economic freedom. While such high-level signals of a country’s stability do have something important to say about the nature of that country’s institutional framework, in the absence of complementary micro-level indicators of the type of economic activity taking place within that framework, it is impossible to conclude that it is a robust and healthy foundation, as opposed to a hollow shell. Simply put, the emphasis on stability should not come at the expense of attention to a commitment to economic freedom.

It is clear that the architects of the *Criteria and Methodology* recognize the need for both macro and micro indicators, which explains the inclusion of the fifth and sixth criteria. But without clearer definition of what is meant by “Regulatory Quality” and “Days to Start a Business,” there is little assurance these criteria will succeed in holding up their end of the balancing act.

In Section 2 of this comment, we demonstrated the fundamental role that entrepreneurship plays as the driving force of economic progress. We strongly urge the inclusion of better-defined criteria that more effectively take the temperature of the overall entrepreneurial environment that exists within a country being considered for eligibility.

The “Days to Start a Business” standard, while important, does not capture some of the most telling information concerning the entrepreneurial environment of a country. To begin with, it only considers one aspect of the entrepreneurial process – the business investment decision (and only one aspect of that decision – the navigability of the official procedures). Crucial components are left out, such as what happens the very next day after the business is opened? Is the financing and property protection available to keep the business operating? To what extent are entrepreneurs foregoing business creation because of the difficulties associated with navigating the complex spider web of official procedures, opting instead for an inherently limited underground existence in the black market?

We recommend replacing the “Days to Start a Business” indicator with a more comprehensive measure of “Entrepreneurial Environment” which would include the World Bank data referenced in Annex A of the *Criteria and Methodology* in addition to other measures that take into account the overall entrepreneurial process.

At this point, there is no quantitative entrepreneurial index that incorporates all of this information, however, quantitative measures of the entrepreneurial environment have been developed by the Annual Global Entrepreneurship Monitor²⁵ and these efforts are currently being expanded to further its reach. The OECD²⁶ and UNDP²⁷ are also engaged in projects along these lines. These existing tools should be considered, along with the World Bank data on the number of days it takes to start a business. We recommend incorporating the following existing quantitative measures into the indicator as well: The number of procedures necessary to register a new firm, the total cost of registering new firms as a

²⁵ “2003 Global Entrepreneurship Monitor,” Babson, Kaufman, London Business School, 2003.

²⁶ A list of the OECD’s activities related to “Entrepreneurship in Developing Countries” is available online: http://www.oecd.org/topic/0,2686,en_2649_33999_1_1_1_1_37461,00.html.

²⁷ “Unleashing Entrepreneurship: Making Business Work for the Poor,” United Nations Development Program, 2004.

percent of GDP per capita, and the country ranking of informal sector activity available in the disaggregated country data from the Wall Street Journal/Heritage Foundation Index of Economic Freedom.²⁸

Additionally, there are many existing sources of qualitative data for particular countries available from the UNDP, World Bank, and European Union country research and regional surveys. This quantitative and qualitative information, once combined will present a much more comprehensive vision of the overall environment facing entrepreneurs than is currently provided for in the “Days to Start a Business” indicator. And as data improves in this area, the indicator will become more complete.

We would, at the very least, recommend that the definition of the “Days to Start a Business” indicator in the Annex of the *Criteria and Methodology* be amended to reference the importance of policies affecting the entrepreneurial process, and that the data source (currently World Bank) be amended to include those listed above.

The value to the determination of eligibility would be significant and the signal to threshold countries that the MCA is concerned not just with the start up of business, but with the overall conditions policymakers have created for entrepreneurs, will encourage attention to the intended result of economic freedom, rather than merely one aspect of a larger process. This change would better reflect legislative intent regarding the MCA and it would also indicate the MCA’s embrace of the latest thinking on economic progress.

In the absence of such a change, and given the proposed methodology which considers a country eligible if it scores well on half of the indicators in each category, one could imagine a country with demonstrated commitments to macro-stabilization but whose house is in disarray at the micro level that matters most to its citizens’ economic well being and prosperity. This is not the sort of country that will be a good steward of MCA funds and this is not the sort of model domestic policy we want to hold up for candidate countries to pursue in order to qualify in the future.

B. Ruling Justly Must Recognize the Importance of Property Rights

The legislative act that brought the MCA into existence leaves no question that Congress values the role that property rights play in creating a stable institutional framework from which prosperity can emerge. Section 607(b)(1)(C) clearly states that countries are to be evaluated based on their demonstrated commitment to “protect private property rights.”²⁹ Therefore, it is puzzling that the indicators do not explicitly include a measure of a country’s progress toward this end.

²⁸ This indicator, in particular, will demonstrate the extent to which entrepreneurs are opting out of the official system and moving underground, a good indication that the institutional environment they face is distorted. This information is available in Marc Miles, Edwin Feulner, Mary Anastasia O’Grady, *The 2004 Index of Economic Freedom: Establishing the Link Between Economic Freedom and Prosperity*, The Heritage Foundation and Dow Jones Company, Inc., 2004.

²⁹ The Millennium Challenge Act of 2003, Section 607(b)(1)(C) states, “A candidate country should be considered to be an eligible country for purposes of this section if the Board determines that the country has demonstrated a commitment to – (1) just and democratic governance, including a demonstrated commitment to – (C) protect private property rights.” The full text of the Act is available online: http://www.mca.gov/Documents/MCA_Legislation.pdf.

The political and economic ramifications of not engaging in the establishment of a property rights regime virtually guarantee failure and Congress recognized this in the careful crafting of the Act. The three indicators currently included under this subsection of the Ruling Justly category in the Criteria and Methodology, are: Civil Liberties, Regulatory Quality, and Rule of Law. These are certainly very important aspects of just and democratic governance, however they do not in any way indicate a country's commitment to a property rights regime. What's more, in the absence of clearly defined property rights, their value is muted.

Take, for example, "Regulatory Quality," which measures some very important concerns. In the absence of clearly defined property rights (or relatively clearly defined, for the purposes of setting a threshold) these aspects, such as "regulations on business, price controls, the government's role in the economy, foreign investment regulation, etc."³⁰ are almost irrelevant. Put another way, property rights will not guarantee that businesses are regulated in a reasonable way, price controls and government do not interfere with a functioning market economy, and foreign investment finds a hold within a country, however, a property rights regime is a prerequisite for these activities to occur. There is no way to fairly apply regulation if property ownership cannot be identified, by definition foreign investments cannot be secure, and there is no standard to judge government interference against, since private activity is not registered. The absence of an explicit measure both as a focal point for policy within threshold countries, and with which to determine country eligibility is difficult to fathom.

Ready made measures of the strength of a country's property rights regime are available from the Wall Street Journal/Heritage Foundation "Index of Economic Freedom"³¹ or the Fraser Institute's "Economic Freedom of the World Annual Report."³² The measures that make up the rankings of economic freedom within the Wall Street Journal/Heritage Foundation Index are presented individually within the report and "Property Rights" is one of them. This measure, on its own, is valuable because it digs down into fundamental issues of a property regime. As the authors explain, "This factor examines the extent to which the government protects private property by enforcing the laws and how safe private property is from expropriation...In addition, it analyzes the independence of the judiciary, the existence of corruption within the judiciary, and the ability of individuals and businesses to enforce contracts."³³

Additionally, new and better metrics are becoming available through the work of Hernando de Soto and the Institute for Liberty and Democracy.³⁴ The former could easily be integrated at the outset and the latter worked into the qualitative aspect of the eligibility determination for countries in which De Soto has worked.

We recommend that a "Property Rights" indicator, tied to the above-mentioned quantitative indicators, be included in the Ruling Justly category. In addition, consideration

³⁰ *Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2004*, Annex A, pg. 6. Available online: http://www.mca.gov/Documents/methodology_report.pdf.

³¹ Marc Miles, Edwin Feulner, Mary Anastasia O'Grady., *2004 Index of Economic Freedom: Establishing the Link Between Economic Freedom and Prosperity*, The Heritage Foundation and Dow Jones Company, Inc. 2004.

³² James Gwartney and Robert Lawson, *Economic Freedom of the World: Annual Report 2003*, Fraser Institute, July 2003. The publication is also available online: <http://www.fraserinstitute.ca/shared/readmore.asp?sNav=pb&id=551>.

³³ See footnote 30, pg. 63-64.

³⁴ Hernando de Soto, *The Mystery of Capital*, New York: Basic Books, 2000.

of qualitative data, such as that currently being produced by De Soto and the Institute for Liberty and Democracy, should figure into the qualitative assessment by the Board when making eligibility determinations. In the event that this is not feasible, we recommend explicitly including property rights and the relevant measurements in the definitions of the “Regulatory Quality” indicator³⁵ in Annex A of the *Criteria and Methodology*.

C. The Qualitative Assessment Must Incorporate Measures of a Country’s Capacity for Sustaining Economic Reform

Our final recommendation hinges on the point made in Section 2 of this comment about a country’s policymaking capacity to implement and sustain economic reform. The notion of making economic policy capabilities one of the targets of evaluation is consistent with the ideas of stakeholder participation and policy ownership that undergird the MCA.

Although this characteristic is difficult to capture in clear-cut indicators, its importance should not be neglected. One of the best measures of a country’s willingness and ability to see reforms through is the effort made to build the institutions necessary for effective policymaking. Countries need the in-house capacity to assess their own needs, priorities, and potential, and to design and implement consistent and effective policies. Policy designs resulting from compacts have no chance of being implemented, revised, and sustained, unless the policymaking system develops the institutional capacity for creativity, analysis, implementation, and feedback.

We recommend this concept be considered along with the other “criteria set out in the Act for which there is either limited quantitative information or no well-developed performance indicator.”³⁶ Without a solid assessment of the capacity of the policymaking capabilities of a candidate country, the risk that funds will be spent on the best of intentions, destined to go unrealized, is great.

4. Conclusion

The MCA brings with it enormous promise and the recognition that what we now know about development must be reflected in U.S. foreign assistance policy. The *Criteria and Methodology*, in particular, present a landmark opportunity to operationalize this promise on two important fronts.

First, these standards will determine whether foreign aid is administered to reward results in those countries which have demonstrated a commitment to the institutions that will pull them out of poverty and into the global economy, and second, they will hold out a beacon for those countries which have not yet made the difficult first steps toward putting their affairs in order. To the extent this second goal is met, it could represent an

³⁵ While we recognize the “Regulatory Quality” indicator is located in the Economic Freedom category, it is one of three indicators referenced in the “Relationship to Legislative Criteria” section of the *Criteria and Methodology*, under Section 607(b)(1)(c) “protect private property rights.” This second-best solution would seem to suffice, however is, in our opinion, less than the ideal of adding a new indicator to the Ruling Justly category, given the location of the property rights criteria in the Act.

³⁶ *Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2004*, pg.2.

unprecedented leveraging of limited funds, given the sheer number of candidate countries that will likely fall short of eligibility, with the chance to compete in following years.

However, as we have presented in this comment, there are three dimensions of crucial importance, which if absent from the *Criteria and Methodology* will almost certainly cause the MCA to founder, like so many well-intentioned efforts in the past. The architecture is in place and the directives from the President and Congress are clear.

(1) The importance of economic freedom depends on the institutional environment facing entrepreneurs who hold the key to economic progress. (2) Property rights are an essential component of this environment; the foundation upon which all other development programs stand, and without which all other development programs fall. And (3) in order to ensure that the compacts produced from this effort have a chance of becoming reality, the institutional capacity to implement the reforms they contain, must figure into any deliberations about the promise they hold.

Minor adjustments can make a major difference in the clarity and comprehensiveness of the signals sent to the developing world. These are crucial changes, but they do not require any fundamental restructuring of the *Criteria and Methodology* as it now stands. These simple, yet important adjustments, once made, will go a long way toward conveying the challenging idea and the evident motivation for the MCA: that development is not only about what governments decree, it is, foremost, about the people who live within those edicts.