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TREASURY UNDER SECRETARY JOHN B. TAYLOR TESTIMONY BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS

Chairman Lugar, Senator Biden, Members of the Committee, thank you for the opportunity to testify today on the Millennium Challenge Account (MCA). My statement will focus on the economic rationale behind the MCA and how it fits well with the Administration's approach to development.

Today there are more than one billion people living on less than $1 a day and nearly three billion living on less than $2 a day. In addition to the tragedy of those living in extreme poverty are those whose lives are claimed by ailments virtually unseen in the U.S. Last year alone 3 million people died for lack of immunization, 1 million died from malaria, 3 million died from water-related diseases, and 2 million died from exposure to stove smoke inside their own homes. In addition, HIV/AIDS has ravaged the populations of developing nations, killing 3 million people in 2002 alone.

The United States is helping in many ways to combat these problems. The MCA is part of the Administration's overall development strategy, as Administrator Natsios and Under Secretary Larson describe in their testimony. The MCA is designed specifically to catalyze the policy reforms that are the foundation of economic growth and poverty reduction.

Development Assistance and Productivity Growth

Sustainable poverty reduction can only be achieved via economic growth, which is primarily determined by productivity growth. Productivity is the amount of goods and services that a worker produces per unit of time with the skills and tools available. If you want to reduce the number of countries with low per capita incomes, then you have no choice but to increase productivity in those countries. And the higher the rate of productivity growth, the faster poverty will decline. Simply put, the ticket out of poverty is higher productivity jobs.

Productivity depends on two things: capital per worker and the level of technology. If there are no impediments to the flow and accumulation of capital and technology, then countries that are behind in productivity should have a higher productivity growth rate. They should catch up, and we have seen many countries catching up over the years – such as South Korea, Chile, and Botswana. However, many of the poorest nations still have had low and stagnant productivity and income, and they are not catching up. More and more evidence has been accumulating that this is due to significant impediments to investment and the adoption of technology.

These impediments can be grouped into three areas. First, *poor governance* — the lack of rule of law or enforceable contracts and the prevalence of corruption — creates disincentives to invest, start up new firms, and expand existing firms with high-productivity jobs. This has a negative impact on capital formation and entrepreneurial activity. Second, *weak health and education systems* impede the development of human capital. Workers without adequate education do not have the skills to take on high-productivity jobs or to increase the productivity of the jobs they do have. Third, *too many restrictions on economic transactions* prevent people from trading goods and services or adopting new technologies. Poor economic policies, state monopolies, excessive regulation, and the lack of openness to trade are all examples of restrictions that reduce the incentives for innovation and investment that are needed to boost productivity.

The Administration's approach to assisting developing nations to overcome these impediments and thereby increase their productivity growth is to increase aid, reward better performance, and measure results. All three must be simultaneously implemented; two of three alone would not succeed. As the MCA clearly represents a significant increase in aid levels, I want to focus on how the MCA will reward better performance and measure results.

Rewarding Better Performance

President Bush's vision of the MCA recognizes the importance of rewarding pro-growth policies. He categorizes these policies as ruling justly, investing in people and encouraging economic freedom. The MCA provides an incentive for countries to adopt good policies that will benefit them in three distinct ways:

i. These policies, in and of themselves, will increase growth;
ii. These policies will create an environment conducive to foreign and domestic investment; and
iii. Development assistance will be more effective in good policy environments.

Following President Bush's leadership, the Administration sought to develop a set of indicators that will be used to measure a country's commitment to pro-growth policies. An interagency group with representatives from Treasury, State, USAID, OMB, Commerce, CEA and NSC worked intensively for several months evaluating a wide range of possible indicators. As part of this process, we met with representatives from other donor countries, developing countries, non-governmental organizations (NGOs), universities, think tanks, the private sector, and other interested parties to gather their ideas.

As a first step we needed to decide which set of countries would be eligible to compete for MCA funds. Our proposal is to expand the number of countries eligible as funding ramps up. In FY'04, countries eligible to borrow from the International Development Association (IDA), and which have per capita incomes below $1,435 (the historical IDA cutoff), will be considered. This is currently 74 countries. In FY'05, all countries with incomes below $1,435 will be considered, which adds another 13 countries. In FY'06, all countries with incomes up to $2,975 — the current World Bank cutoff for lower middle income countries — will be eligible to compete as a separate pool. This group currently consists of 29 countries. It is important to note that countries prohibited from receiving assistance by current statutory restrictions will not be eligible.

Eligible countries will qualify for funding based on their policy performance in the categories of ruling justly, investing in people and encouraging economic freedom. In an attempt to objectively quantify performance in these three categories, we considered a variety of potential indicators.

Ultimately, we selected 16 based on their relationship to growth and poverty reduction, the number of countries they cover, their transparency and availability, and their relative soundness and objectivity. These indicators are not set in stone and may change in the future if problems with them emerge or better indicators become available. To qualify as a better performer, a country will have to be above the median on half of the indicators in each of the three policy areas.

Governing Justly: There is a growing literature on the importance of strong political institutions and good economic governance to successful development.

1) *Civil Liberties:* Freedom House evaluates freedom of expression, association and organizational rights, rule of law and human rights, and personal autonomy and economic rights.

2) *Political Rights:* Freedom House also evaluates the prevalence of free and fair elections of officials with real power; the ability of citizens to form political parties that may compete fairly in elections; freedom from domination by the military, foreign powers, totalitarian parties, religious hierarchies and economic oligarchies; and the political rights of minority groups.

3) *Voice and Accountability*: The World Bank Institute has designed a set of indices that aggregates existing quantitative assessments of governance from a broad range of sources. One of these indices attempts to measure a country's ability to protect civil liberties, the extent to which citizens of a country are able to participate in the selection of governments, and the independence of the media.

The policies incorporated in the previous three indicators should be seen as ends in their own right apart from their impact on growth. Additionally, freedom of expression and of the media allow civil society to effectively monitor the government and reduce corruption and more subtle rent-seeking behavior. Free and fair elections make governments accountable to the entire country rather than to a narrow power base, thus making them more responsive to development needs.

The remaining three indicators are produced by the World Bank Institute. These indices are formed by aggregating surveys from 15-20 different sources, similar to Voice and Accountability:

4) *Government Effectiveness*: Good governance includes the provision of quality public services, civil servants who are competent and independent from political pressures, and credible governments that make good on their commitment to produce and implement sound policies and deliver public goods.

5) *Rule of Law*: This index attempts to measure the extent to which people have confidence in and abide by rules of society, the incidence of violent and non-violent crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts.

6) *Control of Corruption*: With respect to this indicator, President Bush made it clear that MCA funds should only go to the most transparent and least corrupt countries. To meet the President's concerns, we have determined that those countries which fall below the median on this indicator will be considered ineligible for MCA funds, absent material change in their circumstances.

Investing in People: In terms of measuring a country's commitment to educating its citizenry and providing basic health care, we were particularly concerned that a country's income level not preclude it from qualifying, yet we also wanted to provide an incentive for countries to focus on key policies that contribute to growth. Our proposal, therefore, includes two budgetary input measures, which governments can control and rapidly change. However, more money does not always lead to better results. Consequently, we have included two output measures that more accurately reflect improvement in the policy environment over time and are key to sustainable development.

1) *Public expenditure on health as a percent of GDP:* These data are being provided directly by the recipient government.

2) *Immunization rate for DPT and measles:* The UN's World Health Organization publicly compiles and annually releases data on immunization rates for nearly all member countries. Immunization rates can be associated with growth because labor productivity increases when workers are not out sick or caring for ill family members.

3) *Total public expenditure on primary education as a percent of GDP:* These data are being provided directly by the recipient government.

4) *Primary Completion Rate:* The World Bank and UNESCO compile data that measure whether children are attaining minimum education levels. A higher level of education increases labor productivity.

Encouraging Economic Freedom: The MCA will measure a country's level of economic freedom based on its performance in implementing prudent macroeconomic and microeconomic policies, as well as creating the conditions necessary to attract investors.

1) *Country Credit Rating:* Institutional Investor magazine produces a semi-annual survey of bankers' and fund managers' perceptions of a country's risk of default. Our belief is that such a survey is an important indicator of the views of the private sector. In addition, an improved credit rating usually leads to a lower cost of capital and greater domestic and foreign direct investment.

2) *Inflation*: High inflation distorts relative prices and discourages long-term investments. Also, as the poor hold a higher percentage of their wealth in cash, they are disproportionately hurt by the erosion of their purchasing power. Of the 16 indicators, this is the only one where performance is not judged relative to the median. Instead, a country must have inflation of less than 20% in order to pass the indicator.

3) *Budget Deficit/GDP:* As a measure of fiscal policy, we use a country's overall budget deficit averaged over a three-year period. The data for this measure will be provided directly by the recipient government, cross-checked with other sources, and made publicly available. Among other impacts on growth, a high budget deficit crowds out private sector investment and can lead to inflation.

4) *Days to start a business:* The Private Sector Advisory Service of the World Bank Group works with local lawyers and other professionals to examine specific regulations that impact business investment. One of their studies measures how many days it takes to open a new business. Bureaucratic barriers to business formation that go beyond protecting society not only hinder entrepreneurship but may exist to preserve the economic rents of political cronies.

5) *Trade Policy: The Heritage Foundation's Index of Economic Freedom* measures a country's openness to international trade based on average tariff rates and non-tariff barriers to trade. Open economies — those with low to moderate trade barriers and exchange controls — tend to grow faster than more closed economies.

6) *Regulatory Quality Rating:* The World Bank Institute (see section above on Governing Justly) measures the burden on business arising from, among others, licensing requirements, labor regulations, and bureaucratic corruption. Excessive regulations and their arbitrary application deter investment and raise the cost of doing business, thereby hindering job creation and reducing growth.

While these indicators meet all of our criteria, there may still be gaps or lags in the data, or trends not reflected in the data, which may be material for assessing performance. To correct for these possibilities, the MCA Board of Directors will look behind the numbers to make a final recommendation to the President on qualifying countries.

Measuring Results

Aid effectiveness requires not only better performance but also a focus on measuring results. This is a core component of the Administration's development strategy and is one that we have pushed in the Multilateral Development Banks (MDBs). For example, the U.S. made part of its financial commitment to the IDA-13 replenishment in the form of an incentive contribution that will reward the World Bank for increasing the use of various diagnostic tools (such as reviewing the policies of developing countries in the areas of financial accountability, procurement, public expenditure management, and poverty analysis) as well as making progress towards a set of development indicators (in health, education, and private sector development). The agreement also called for the initiation of a performance measurement system which will develop ultimately into a common set of outcome indicators that can be compared across countries.

The MCA furthers this focus on measuring results by making accountability for results an integral part of every activity for which MCA funds are used. Americans are by nature a generous people but they want to see results from their funds that are devoted to development, and their support for providing foreign assistance will only increase if those results are demonstrated in a convincing and straightforward manner. By measuring concrete results, we can focus our efforts on what really matters: helping poor people around the world escape from poverty and lead better lives. The approach helps us cut through bureaucratic layers, ignore non-essentials, and concentrate on development problems that must be solved. It is a way to maximize the benefits of our funds.

MCA contracts will state in quantitative terms the expected outcomes of individual activities and overall country assistance. We will require a clear strategy for gathering baseline data and measuring progress towards stated results and assessing the reasons for success and failure. We will also require projects to be structured in a way that steps up or cuts back funding contingent on achieving results. In addition, evaluation of results will allow the MCA to incorporate lessons learned into ongoing and future operations. In keeping with the MCA's commitment to transparency, all monitoring and evaluation reports, as well as the terms of each contract, will be made public in the U.S. and in the host country. Furthermore, we will continue to monitor country commitment to MCA selection criteria.

In addition to sector specific monitoring, we will also be concerned with the broader policy environment. The Millennium Challenge Corporation will monitor overall budget data to determine whether recipient governments are using MCA resources in a complementary manner with their own domestic and other development resources.

Coordination of assistance with other donors will be vital to the success of the MCA. Each recipient country will be responsible for managing coordination among the MCA and other donors to maximize impact and avoid duplication of efforts. The effort to align MCA country contracts and MDB assistance with each country's Poverty Reduction Strategy Paper (PRSP) or other development strategy will also help coordinate development assistance.

Conclusion

For many years, we have all heard about the importance of aid effectiveness. The MCA represents this country's greatest opportunity to transform rhetoric into an operational action plan. The MCA has the ability to challenge countries to demonstrate performance, to achieve results, and most importantly to assist their people in having a better opportunity to pursue a better life for themselves and their families. I urge your favorable consideration of the "Millennium Challenge Act of 2003."