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Millennium Challenge Corporation (MCC)

A NEW APPROACH TO DONOR ASSISTANCE

In January 2004, the U.S. Congress passed special legislation to establish a new approach to donor assistance in the form of a new program under a new, semi-governmental corporation, the Millennium Challenge Corporation. First, we should consider the principles, intent, and the methodology of this new MCC approach. Second, we should consider its actual implementation and critiques, including the inevitable operational compromises, problems and resolutions, and concerns. To enhance the brevity of this document, each item below is abbreviated. Much more detail is available for any of the following elements.

Principle, Intent and Methodology of the MCC Approach

1. Pay for performance not promises. "The MCC's mission is to reduce global poverty through the promotion of sustainable economic growth." In a departure from traditional assistance, the MCC program rewards the poor countries whose governments have already made the "right" but politically and economically difficult policy choices to enable growth and poverty reduction and then actually implemented them. It does not, as in the past, "pay" for promises of reform or "policy dialogue" aimed at reforms. For that reason, the number of eligible countries is relatively few, but they are to be well-rewarded by the MCC. Because of the time lag between the implementation of the "right choices" and their consequences in higher growth and a better life, it is assumed that the MCC rewards or benefits will help convince the publics of these countries of the value of the "right choices" before the systemic value of the choices vests in future growth. Put differently, the present MCC benefits would also mitigate the (temporary) hardships attendant upon these "right choices" before their permanent benefits are manifested in growth and poverty reduction. Finally, the MCC benefits would create incentives---the hoped-for "MCC effect"---for other countries to make similar "right choices."

2. The four areas of "right choices." To qualify for the MCC benefits, a country must have made "right choices" in four "policy categories": Economic Freedom; Investing in People; Ruling Justly; and Control of Corruption, which, the MCC believes, are the basic criteria for sustained economic growth, poverty reduction, and aid effectiveness. Together, according to the MCC's theory, these will reduce poverty through sustainable growth. Unfortunately, countries do not naturally choose these policies either (a) because they require investments now and returns much later, so the pain comes too long before the gain, or (b) because their elites do not believe in the connection between these investments and later returns, or, more likely, (c) because their empowered elites gain personally from authoritarianism and closed markets in which they control the political economy of the state and, in effect, benefit personally

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from corruption and "rent seeking" (i.e. capturing income or "rents" by manipulation, for example through monopolies or political positions, rather than by productive activity). So, if there are attendant rewards, perhaps they will instead make the "right choices" instead.

3. Measure choice and performance objectively (the "indicators"). Traditional foreign assistance allocations are often affected by foreign policy considerations. To ensure that the MCC program is devoted entirely to incentivizing "right choices," the decision about whether a country qualifies under the four policy categories is determined not by the MCC staff or the MCC board of directors, but (in order to avoid MCC bias or foreign policy considerations) primarily by a set of "objective" indicators compiled and published regularly and transparently by organizations other than the MCC, like the World Bank, the World Health Organization, UNESCO, Transparency International, and Freedom House. The country's Economic Freedom performance is measured by 5 elements: inflation, trade policy, fiscal policy, regulatory quality, business startup, and land rights and access. Performance on Investment in People is measured by 5 elements: immunization rates, public expenditure on health, public expenditure on primary education, girls' primary education completion rate, and natural resource management . Governing Justly is measured by 6 elements: civil liberties, political rights, voice and accountability, government effectiveness, and rule of law. Corruption has one composite measure. (See Table 1 for the full list of indicator sources.) A country must score above the median "among the peers" in its economic class---lower income or lower-middle income---on half of the indicators for Economic Freedom and for Ruling Justly, on 3 out of the 5 indicators for Investing in People, and above the median on the one Control of Corruption indicator (the so-called "hard indicator" because corruption has such a devastating effect on growth and poverty reduction). If the country fails to meet that standard in any policy category, it may still be eligible if it has demonstrated that it has already taken concrete actions to address the problem or that the specific indicator data did not accurately reflect its current policy performance. However, while the decisions are primarily made on the basis of objective indicators, the MCC board of directors can qualify those calculations by its own judgment.

4. Focus on lower-income countries. Because the MCC program is directed at poverty alleviation, at least 75% of its resources must be allocated to lower-income countries (LICs) and no more than 25% to lower-middle-income countries (LMICs). Originally 100% had to be invested in lower-income countries but that rule was relaxed in 2006 to broaden the number of potentially eligible countries by including some lower-middle income countries, which are also likely to be better performers on economic growth, on poverty reduction, and on the MCC indicators.

5. In the eligible countries, fund projects that will reduce poverty through growth. Although countries must qualify for MCC investments on the basis of four policy categories, the MCC investments themselves are directed at poverty reduction. (Of course, a credible argument can certainly be made that Investing in People or Ruling Justly will reduce poverty, which is why they are qualifying policy categories in the first place but there are no full programs in these areas.)

6. Require "country ownership" of conception, design and implementation. Because country ownership is important for the success of foreign assistance and because the MCC investments are made only in countries that have made the "right choices," the investment programs should be designed not by the donor staff, as in traditional foreign assistance, but by the host governments of those countries "in consultation with

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their citizens---including women, non-governmental organizations, and the private sector." The MCC requires that substantial public consultation is required before the program can be submitted for approval. The program must also be "able to measure both economic growth and poverty reduction" and to be "implemented, managed and maintained by the country." So, once a country qualifies on the four policy categories, the country (through its government and citizens) is asked to design its own such program, which it submits to the MCC. When both sides concur on the program and its poverty-reduction potential, they sign an agreement, a "compact," to implement the program, preferably within at most 5 years.

7. Provide enough funding to justify the "right choices" and also have a transformative effect on poverty reduction. Because the country has made the "right choices" and has designed the Compact Program itself, and because the MCC invests so much more in the Compact Program than traditional assistance programs----up to U.S. $500,000,000 (€350,000)---within 5 years, the Compact Programs are supposed to have a transformative effect on poverty reduction.

8. Limit the implementing bureaucracy, especially of the donor. To maximize the transformative effect of the Compact Program, the MCC's total global staff is kept small, originally 100, then increased to 200 and then increased again to total of 300. However, that total of 300 direct MCC staff does not include consultants nor does it include, for each country, the local organization that implements the Compact Program (called the "accountable entity") operating under the direction of the resident (usually 1-2) MCC staff members and that is normally approved by the host country legislature and executive.

9. Monitor, measure, and evaluate project impact and effect. Throughout its implementation, the Compact Program is monitored, measured, and evaluated according to objective indicators which are part of the compact agreement.

10. Ensure transparency of the entire process. The entire process--- the objective indicators for qualification, the formulation/design of the Compact Program, the deliberations of the MCC board, and the implementation of the Compact Program---is totally public and transparent. For example, the MCC's website contains the indicators, the votes of the MCC board, the details of the Compact Projects, and so forth.

Actual Implementation and Critiques

The principles and intent of the MCC program has, perhaps inevitably, been affected by the realities of implementation and by various compromises. The gap between theory and actual performance has also given rise to critiques of the MCC program.

- Compact funding is too small and five years is too short to produce a transformative effect. Some 18 compacts worth approximately $6.3 billion (€4.6 billion), an average of about $350 million (€250 million)/compact, had been signed by the end of 2008. Although these compacts are orders of magnitude larger than traditional assistance programs, poverty transformations are difficult, multi-dimensional, and long-term. True transformations are unlikely to be able to be purchased in five years by $350 million (€250 million), except in quite small countries, which may be why so many of the MCC countries are small. To date the total population of all the Compact Countries is 209 million, slightly more than the population of Brazil. The total gross domestic product of all the Compact Countries is $472 billion (€334 million), slightly more than the GDP of Pakistan. (The size of the compact countries is summarized in Table 2. The size and dates of the actual compacts is summarized in Table 3.) However, Indonesia, and the Philippines, both much larger countries, have qualified for a compact. To date, there have been

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no substantial, measureable results on poverty reduction, although it is still early.

- Lower-income countries are particularly difficult to transform. The path for lower-middle-income countries is somewhat easier, but still difficult. The larger the middle class, the greater the probability for growth, if only because the middle-class is itself the result of "good policies."

- The MCC incentives are asymmetric. The MCC effect depends on the assumption that its rewards will provide incentives for government officials in poor –performing countries with the "wrong policies" to change the policies. But in many such countries, those government officials are the personal beneficiaries of the "wrong policies," especially corruption. They gain personally or politically from the "wrong policies." It is unlikely that they will sacrifice their personal power and benefits for even a large assistance program that will benefit the general public rather than benefitting them personally. If they were willing to sacrifice personal benefit for general benefit, they would probably have adopted the "right policies" without the MCC program.

- Do the MCC indicators really indicate? Although they may be expressed in numerical terms and therefore may seem neutral and impartial, most "objective" indicators depend, in good measure, on subjective judgments and on the objectives of the institutions that are collecting—or defining and formulating---the indicators. So "objective" really means "independent of MCC" or "non-MCC" rather than truly "non-subjective." In the absence of independent, predictive and truly objective indicators, perhaps that is as good as one can expect, and so the indicators are presumed to be predictive of sustainable economic growth.

- Lagging indicators. Apart from whether the indicators are predictive of sustainable economic growth, they almost always lag behind performance, and in both directions. They look worse than reality when countries are moving in the "right direction" and they look better than reality when countries move in the "wrong direction." So the MCC decisions are likely to be "lagging" ones as well, and in both directions.

- Judging on the mean, not absolutely? A country qualifies for an MCC Compact not on some absolute scale of the indicators, but by being above the mean "among its peers." So its performance is "above average" on the indicators for a majority of "policy categories." In short it is "relatively" good performer. But does relatively good performance really indicate future development success, especially if most of the countries in the country class (lower income or lower-middle income) are poor performers? Doesn't it just mean that the country is better than most of the others, although it may be a poor performer? If so, doesn't that violate the basic premise of the MCC program: only reward the really good performers, those that have unambiguously made the "right, hard choices" and are therefore likely to enjoy sustained economic growth and poverty reduction?

- How many good performers are there? Running out of good country candidates. If there are relatively few really good performers, using an absolute rather than a relative scale, perhaps there are just not enough good performers to warrant such a large, multibillion-dollar program. Perhaps the MCC program should be smaller and concentrate solely on the few really good performers rather than compromise on those that are just above average. Moreover, since those really good performers have already been identified, perhaps the MCC program should be ended. However, because the MCC program was located in a separate, independent agency and because the Bush Administration placed so much emphasis on the MCC innovation, the MCC staff has every incentive to find more countries to qualify and possibly to dilute the original concept. Perhaps the MCC program should have been temporary and managed by a small staff with special authorities and a limited lifespan in an already-existing agency to concentrate only on the really good performers.

- Corruption as a "hard" indicator. A country qualifies for an MCC Compact Program when it is "above the mean" in half or more of the indicators in three "policy categories" but above the mean on the single indicator for corruption, because corruption has had such a devastating effect on development. The mis-direction of public goods into private hands (especially in those countries with large natural resources) has crippled so many countries, even if they have "good policies" in other areas. But because so many countries suffer from serious corruption, the number of MCC countries will be smaller than if corruption were treated as just one of four areas. Is it wise to place so much emphasis on corruption? It is wise if the indicators are supposed to predict / foretell good development performance. Like the use of relative indicators, removing the necessity of qualifying on corruption, would increase the number of eligible countries, but compromise the rigor and predictability of the MCC program's incentivizing the "right choices" that are likely to produce sustained economic growth, reduction in poverty, and developmental success.

- Discretion in choosing compact-eligible countries. Although a country is supposed to qualify above the mean on the "objective" indicators," the MCC Board of Directors has discretion to waive the indicators and use its best judgment to award MCC compacts to counties that do not absolutely qualify purely on the basis of the "objective" indicators. According to a Brookings Institution analysis, the Board "declared a few countries eligible that came close to but did not fully meet the performance standard," In perhaps the most well-known case, the MCC Board exercised this discretion by encouraging and then approving a Compact Program with Georgia in 2005, the year after the Rose Revolution. Because the MCC indicators lag behind reality and because the new Government of Georgia had begun reforms and was committed to additional ones, an MCC Compact was justified, according to the board, notwithstanding the indicators. Without doubt, that leaves wide open the possibility of awards based on foreign policy, not purely developmental, criteria. To what extent did Georgia receive an MCC compact for foreign policy reasons or because the MCC Board believed that the indicators were lagging true performance and potential? To what extent is a compromise of the "purity" of the MCC principles and intentions justified in order to advance the donor's foreign policy objectives? To what extent, if foreign policy considerations do weigh substantially, does the MCC program look too much like traditional assistance programs? To what extent, on the other hand, should such decisions be merely mechanical and not take into account the lag of indicators or an honest, although subjective, judgment that a particular country's development path is better than the indicators would predict?

- Slow disbursements. The MCC has actually disbursed only approximately 25% of its planned disbursements, so perhaps a slower rate of funding is appropriate. It takes a long time to design and negotiate a Compact Program and even longer to disburse funds to implement it responsibly. In one way, a slow disbursement rate is commendable if the MCC is taking time to ensure a successful program. Judging assistance by disbursement rates is the traditional (and many argue, a flawed) measure, if the purpose of assistance is effectiveness. However, there is some doubt in Congress that the MCC's slow disbursements are primarily the result of aid effectiveness, and in any case, it would suggest that Congressional appropriations should be slowed to match the MCC's disbursement rate.

- Emphasis on agriculture and infrastructure in Compact Programs. Eligible countries have typically chosen high-profile public works programs or programs that appeal to a large number of their citizens, for example infrastructure programs (roads, bridges, etc.) or agriculture programs. Few have chosen social sector programs. Are the chosen programs the best ones to maximize poverty reduction, or are they the best programs to maximize political support? And are they supported by the MCC staff because they are capital-intensive and have high disbursement or "burn" rates?

- Backsliding. What happens when a country qualifies for an MCC program, but later changes policies or performance in "regressive" ways that would disqualify it if it were not already an MCC program recipient? There have been at least two such cases of "backsliding," Honduras and in Madagascar. The MCC requires any such country "to demonstrate efforts toward improvement by developing and implementing a policy improvement plan to address the concern(s) …and to demonstrate its commitment to meeting eligibility criteria." The remediation plan is developed and submitted in the first year, implemented no later than the second year, and reviewed for compliance with MCC criteria in the third year. Presumably the MCC would suspend its Compact Program if the country were still out of compliance after the third year, but there have not yet been any such cases. Should the MCC suspend its Compact Program if a country regresses and does not come back into "compliance"? What if the Compact Program is an infrastructure program, like a road or a bridge or a water system? Should the program be abandoned? What would happen to the 30 kms. of road or the half-built water system? Would it be a monument to MCC failure and an embarrassment to the country? But if the MCC takes no action, if there are no disincentives to "backsliding," wouldn't the incentive be to qualify and then go back to old ways? Would suspension be a signal to the citizens and a warning to other countries? The MCC assumption is that, once on the right track, inertia will keep it there. How valid is that assumption and what should happen if the assumption is unwarranted? What should the MCC do if there is backsliding?

- Risk-aversion. Some argue that the combination of country design and ownership of the MCC compact program and the desire of the MCC bureaucracy to demonstrate success has led to bland, non-risky programs like those of traditional assistance programs, not like the original, lofty principles and intentions of the MCC. Are roads, bridges, and budget support really what the MCC was intended to provide? To repeat, are they really more directed to gain public support for the host government than to get maximum development results?

- How different, really, is the MCC program from a traditional assistance program? Putting together the subjective judgments, the relative rather than absolute scale for good performance and "right choices," the discretion provided to the MCC board, the risk aversion, the disinclination to suspend or at least reduce programs in backsliding countries, the slow disbursement, the asymmetric incentives is the MCC really as innovative as originally intended? Does it look in practice too much like its traditional assistance program cousins? And if not, how likely is it to achieve its objective of global poverty reduction, or more likely, significant poverty reduction in the Compact Countries? And finally, given the relatively few number of good performing countries, how much room is there for other countries to replicate the MCC?

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Table 1:
Indicators, Policy Categories, and Sources for determining MCC country eligibility

Indicator	**Policy Category**	**Source**
Civil Liberties	Ruling Justly	Freedom House
Political Rights	Ruling Justly	Freedom House
Voice and Accountability	Ruling Justly	World Bank Institute
Government Effectiveness	Ruling Justly	World Bank Institute
Rule of Law	Ruling Justly	World Bank Institute
Control of Corruption	Ruling Justly	World Bank Institute
Immunization Rates	Investing in People	World Health Organization
Public Expenditure on Health	Investing in People	World Health Organization
Girls' Primary Education completion Rate	Investing in People	UNESCO
Public Expenditure on Pri-mary Education	Investing in People	UNESCO and national sources
Business Start Up	Economic Freedom	IFC
Inflation	Economic Freedom	IMF WEO
Trade Policy	Economic Freedom	Heritage Foundation
Regulatory Quality	Economic Freedom	World Bank Institute
Fiscal Policy	Economic Freedom	national sources, cross-checked with IMF WEO
Natural Resource Manage-ment	Investing in People	CIESIN/Yale
Land Rights and Access	Economic Freedom	IFAD / IFC

Source: MCC

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Table 2: MCC Compact countries by population and GDP

	Compact country	**Population**	**GDP (in PPP terms)**
1.	Armenia	2,967,004	18,920,000,000
2.	Benin	8,791,832	12,840,000,000
3.	Burkina Faso	8,988,091	17,820,000,000
4.	Cape Verde	429,474	1,635,000,000
5.	El Salvador	7,185,218	43,940,000,000
6.	Georgia	4,615,807	21,600,000,000
7.	Ghana	23,832,495	34,040,000,000
8.	Honduras	7,792,854	33,630,000,000
9.	Lesotho	2,130,819	3,370,000,000
10.	Madagascar	20,653,556	20,760,000,000
11.	Mali	12,666,987	14,480,000,000
12.	Mongolia	3,041,142	9,557,000,000
13.	Morocco	34,859,364	137,300,000,000
14.	Mozambique	21,669,278	18,950,000,000
15.	Namibia	2,108,665	11,230,000,000
16.	Nicaragua	5,891,199	16,830,000,000
17.	Tanzania	41,048,532	54,260,000,000
18.	Vanuatu	218,519	983,200,000
		208,890,836	**$472,145,200,000**

Table 3. Compacts by Size and Year
Source: Brookings Institution

Country		Type	Amount				
			FY 2005	FY 2006	FY 2007	FY 2008	Total 2005-2008
1	Madagascar	LIC	110				
2	Honduras	LIC	215				
3	Cape Verde	LIC	110				
4	Nicaragua	LIC	175				
5	Georgia	LIC	295				
6	Vanuatu	LIC		66			
7	Benin	LIC		307			
8	Armenia	LMIC		236			
9	Ghana	LIC		547			
10	Mali	LIC			461		
11	El Salvador	LMIC			461		
12	Mozambique	LIC			507		
13	Lesotho	LIC			363		
14	Morocco	LMIC			691		
15	Mongolia	LIC				285	
16	Tanzania	LIC				698	
17	Namibia	LMIC				305	
18	Burkina Faso	LIC				481	
Total		**LIC**	**905**	**1156**	**2483**	**1769**	
Number of compacts			**5**	**4**	**5**	**4**	**18**
Average Compact Size			**181**	**289**	**497**	**442**	**351**

Gerald Hyman Senior Adviser and President of Hills Program on Governance Center for Strategic and International Studies former Director, USAID Office of Democracy and Governance