MCA Monitor

Subsequent Compacts Are the Future of the Millennium Challenge Corporation

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May 2014

Summary

The Millennium Challenge Corporation (MCC) is at a crossroads. Many of its early compacts—large-scale, five-year grants that support country-led solutions to poverty reduction through economic growth in a select set of poor but well-governed countries—are coming to a close. Moreover, there are few new countries emerging as viable partners. In response to this dynamic, MCC is increasingly entering into second compacts with countries. Though MCC's founding legislation expressly allows MCC to enter into one or more follow-on compacts, some reservations about this approach persist, particularly among some stakeholders in Congress and US development NGOs. It is time, however, to end the debate about second compacts for MCC and to expand the conversation to a broader notion of subsequent compacts.

Opposition to second compacts basically revolves around two premises. The first is that the need for a second compact is a sign that the first compact failed. The second is that engaging with a country on an ongoing basis eliminates the distinction between MCC and other forms of US foreign assistance. This paper presents five arguments that seek to address these and other remaining concerns and demonstrate why MCC should retain the flexibility to pursue subsequent compacts going forward.

The MCA Monitor provides rigorous policy analysis and research on the operations and effectiveness of the Millennium Challenge Corporation. It is part of CGD's Rethinking US Development Policy Initiative that tracks efforts to reform aid programs and improve aid effectiveness.

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Center for Global Development

Introduction

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Opposition to second compacts basically revolves around two premises. The first is that the need for a second compact is a sign that the first compact failed. The second is that engaging with a country on an ongoing basis eliminates the distinction between MCC and other forms of US foreign assistance. The following five arguments seek to address these and other remaining concerns and demonstrate why MCC should retain the flexibility to pursue subsequent compacts going forward.

Five Arguments That Address Concerns About Subsequent MCC Compacts

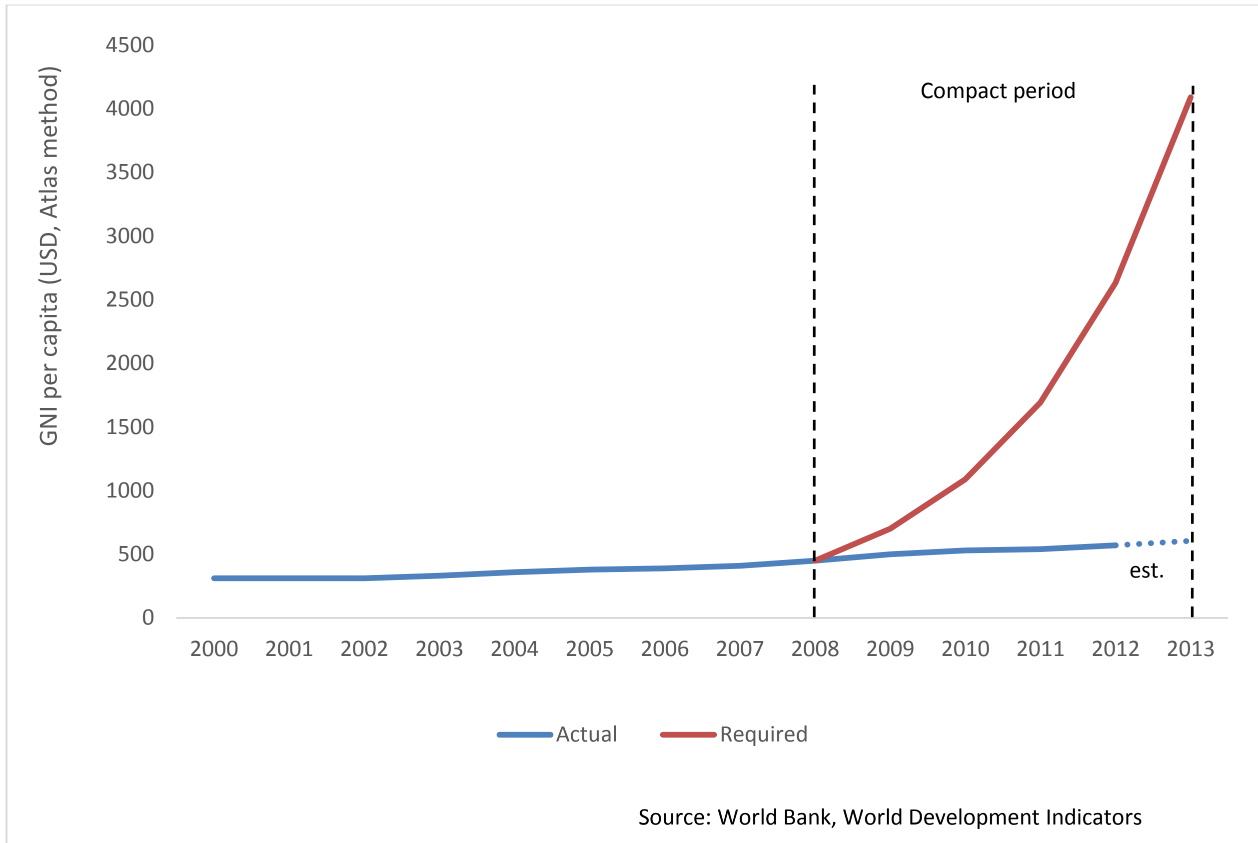
(1) Compact Success Does Not Mean "Transforming" a Country

In its early days, MCC officials stressed the "transformative" or "transformational" nature of their approach. However, they did not define what these terms meant, or could reasonably mean, in practical terms. As a result, a wide range of interpretations of what this should mean emerged, including the notion of "one and done". In other words, if a compact were "successful", then the country would not need future MCC assistance. However, no donor, and certainly not a single compact, can ever be expected to have this type of "transformative" effect. A transformation from "developing" to "developed" cannot be expected to occur within just five years, the timeline of an MCC compact. Nor can it be expected to occur at the cost of only $350 million, the average size of an MCC compact.

By illustration, Tanzania (currently eligible for a second compact) would have needed to increase its per capita income by *over 900%* to reach upper-middle income status at compact completion from its compact-entry level in 2008. Put another way, as illustrated in Figure 1, Tanzania's per capita income would have had to increase by *over 50% per year* within the five-year compact period (2008 to 2013). For MCC's $700 million compact to have transformed Tanzania to upper-middle income status, it would need to have generated, along with all the other factors that contribute to growth in the country, over one hundred and fifty billion dollars in increased income.[1]

[1] This is a rough, illustrative figure rather than a precise estimate. It is calculated by differencing the GNI per capita (Atlas method) for Tanzania in 2008 multiplied by the current population of Tanzania from an

Figure 1 – Required Change in Per Capita Income to Transform Tanzania into Upper-Middle Income Versus Actual Performance



Simply put, it is a wildly unrealistic expectation to think a single compact can transform a country in this way. However, it is important not to dismiss the real benefits that MCC compacts can and have achieved. Realistically, a successful compact is one that generates increased incomes for poor beneficiaries and helps a country address some important constraints to growth, setting the stage for sustained, increased economic activity. Subsequent compacts can then help tackle the next set of constraints.

(2) Consecutive Partnership Does Not Mean Continuous Support

By putting into practice a number of principles of aid effectiveness, MCC was designed to deliver aid differently from traditional US assistance models. Within this context, one notable distinction is the time-delineated partnership MCC has with partner countries, compared to the historically open-ended relationships that characterize traditional US development assistance. One concern about subsequent compacts is that the longer-term partnership makes MCC's operations too much like USAID's standard engagement model, which typically provides similar types of assistance to countries on a largely continuous basis over multiple decades.

It is true that MCC's strict five-year compact timeline is an important feature. It provides incentive for timely implementation by the partner country, creates a clear exit from each compact investment, and forces reassessment of whether or not to continue engagement with a country (a follow-on compact is not

estimated 2013 income ceiling for lower-middle income countries (Atlas method) multiplied by the current population of Tanzania.

automatic; a country must earn it by maintaining good policy performance and implementing its first compact well). The importance of the timeline, however, is in its application to each compact, not to MCC's relationship with a country. Subsequent compacts are not simply continuations of prior investments. Each compact will be informed by a new analysis of constraints to growth, and, as a result, the focus of the second compact may well be different than the first. As Figure 2 shows, MCC often finds that the sectors it supported in the first compact no longer emerge as key constraints, plausibly due in part to its work in those areas.

Figure 2 – Second Compacts Focus on Current Constraints to Growth[2]

	First Compact Focus	Second Compact Focus
Cape Verde	— Infrastructure (bridges, port) — Watershed management, agricultural support — Private sector development (access to credit, microfinance)	— Water, sanitation, hygiene — Land management (land rights, land information systems)
Georgia	— Infrastructure (roads, gas pipeline, municipal water) — Enterprise development	— Education (general, vocational, tertiary)
Ghana	— Agriculture — Infrastructure (roads) — Rural development (education, water/sanitation, electrification)	— *Energy sector**
El Salvador	— Infrastructure (roads) — Small farm/business support — Human development (education, water/sanitation, electricity)	— Human capital (education, skills) — Investment climate — Infrastructure (roads)
Tanzania	— Infrastructure (roads, airport) — Energy sector — Water sector	— *Energy sector**

** Compact still in development*

(3) Other Aid Effectiveness Principles Govern MCC's Approach

In addition to the compact's time limit, there are several other important ways that MCC operationalizes aid effectiveness principles, regardless of how many compacts MCC pursues with a particular country. In fact, subsequent compacts in a single country enable MCC to institutionalize and strengthen these practices as part of a longer-term development partnership. This should be welcomed, not discouraged.

- It has a ***focused objective*** of poverty reduction through economic growth. This largely allows MCC to pursue welfare outcomes in a more targeted way than if its development goals were blended with political objectives.
- It takes ***country ownership*** to a higher level. MCC funds are not earmarked, and eligible countries develop proposals for how they will use MCC funding. In part due to these dynamics, MCC investments align far better than those of other US Government agencies with what

[2] Morocco and Benin are also developing second compacts, but the projects are not yet identified.

ordinary citizens in partner countries identify as their top priorities.[3] Country ownership also extends into compact implementation, with partner countries taking the lead role.

- It focuses its investments on ***high quality, cost-effective programs*** that are selected for funding based on rigorous methods to assess their economic justification. MCC's partner countries use growth diagnostics to identify their binding constraints to growth, and MCC uses economic rate of return analysis (i.e., cost benefit analysis) to identify cost-effective projects to address those constraints. While almost all aid projects yield some benefit, MCC's processes seek to ensure that its investments generate *sufficient* benefits to justify the project's costs. MCC is not the only donor to use these tools, but it is the only one to apply them systematically.
- It is a leader in thinking about ***results***, from linking ex-ante cost benefit analysis of projects to performance targets, to setting new standards for comprehensiveness, rigor, and transparency around evaluation and learning.
- It is serious about ***good governance***, assessing countries' policy performance in a transparent, evidence-based way. MCC provides grants only to those countries that meet certain criteria, and it suspends or terminates funds if the quality of governance substantially deteriorates.
- It is at the cutting edge of foreign assistance ***transparency***.[4] MCC systematically publishes the tools it uses to inform its investment decisions; quarterly updates of how compacts are progressing toward their targets; and the results of evaluations that show the extent to which MCC funds achieved their objective.

(4) Subsequent Compacts Capitalize on Institutionalized Relationships

Countries with prior experience developing and implementing an MCC compact have a better understanding of MCC's model, policies, and requirements. This can smooth the compact development process for future partnerships. For instance, partner countries understand that economic evidence will drive the focus of the compact (potentially lessening the time MCC spends deflecting weak proposals). They know how to conduct consultations and understand MCC's requirements for high-return investments.

The development of a second compact with Georgia illustrates this point well. Based on the prior compact partnership, the Government of Georgia understood how to conduct public consultations around the compact proposal in a more nuanced and effective way, in particular with the Georgian business community. In turn, Georgian businesses were highly aware of MCC, making for a much more meaningful dialogue. In addition, the strong relationship MCC built with the Government of Georgia during the first compact enabled the two partners to more easily negotiate changes to the initial proposal to end up with a high quality compact, focused on deeply complicated constraints to growth.

(5) The Best MCC Partner Countries Are Increasingly Those in Which It Is Already Working

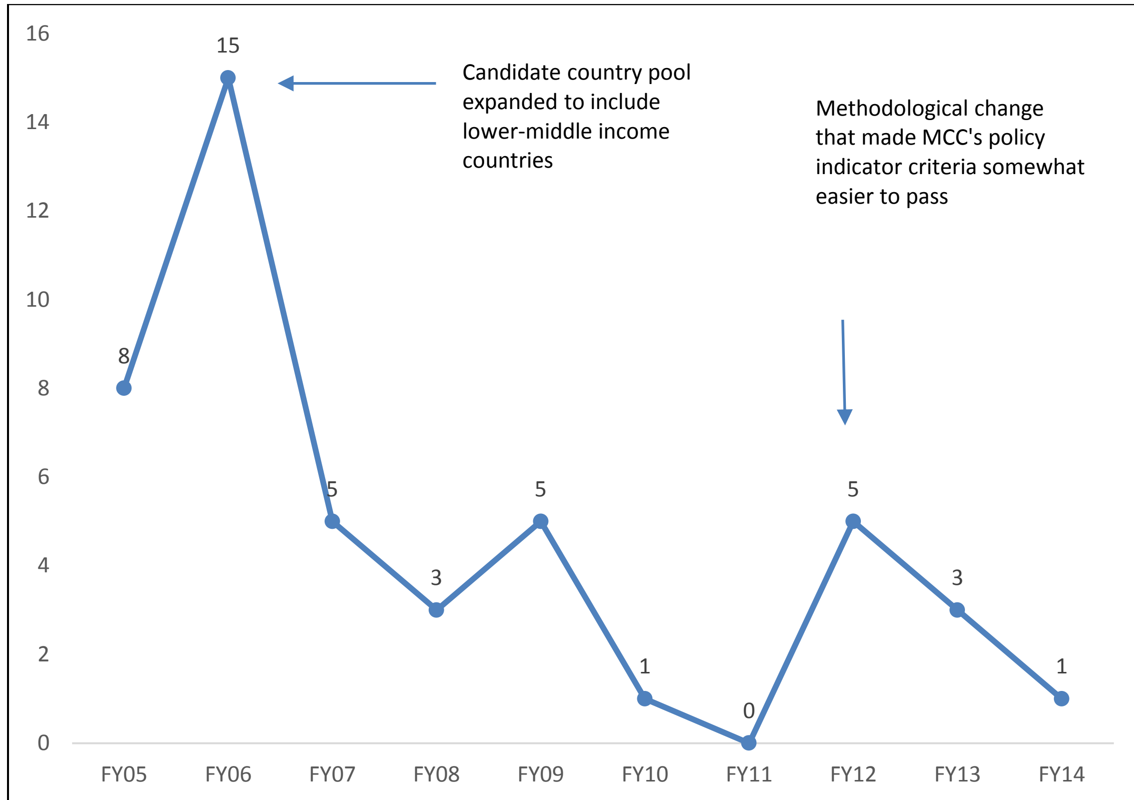
MCC was established to work only with relatively well-governed poor countries. To identify the best places, according to these criteria, to invest its scarce resources, MCC uses an indicator-based "scorecard" of country policy performance to assess how well low and lower middle income countries rule justly, invest in their people, and encourage economic freedom. Experience over the last decade has illustrated that the universe of countries that meet the minimum conditions for MCC eligibility based on these policy

[3] Benjamin Leo. 2013. "Is Anyone Listening? Does US Foreign Assistances Target People's Top Priorities?." CGD Working Paper 348. Washington, DC: Center for Global Development.

[4] MCC ranked first among 67 donors on Publish What You Fund's 2013 Aid Transparency Index. http://ati.publishwhatyoufund.org/index-2013/explore-the-data/

criteria changes very little from year-to-year. As Figure 3 shows, few new countries pass the indicator criteria in any given year. Of the handful of newly passing countries, only roughly half end up passing on a consistent basis (i.e., more than just one or two years), and nearly a quarter are micro-states (population <1 million). Simply put, there are not many strong *new* contenders for MCC eligibility emerging.

Figure 3 – Number of New Countries Passing MCC's Eligibility Indicator Criteria for the First Time



The alternatives for expanding the list of MCC partner countries beyond current and former compact countries include the following options, most of which are undesirable or impractical for a variety of reasons.

- ***Making it easier to meet the policy performance standards for eligibility.*** Each year only around a third of MCC candidate countries pass the indicator criteria for eligibility. Altering the indicators used and/or the rules that determine what constitutes minimally acceptable performance could result in a higher proportion of passing countries. For example, MCC could lower the passing thresholds for its indicators or eliminate one or both of the "hard hurdle" criteria related to corruption and democracy. Relaxing the democracy requirement would allow up to six additional countries to could pass the scorecard; eliminating the corruption hurdle would enable around ten new countries to pass.[5] Of course, any changes to the eligibility rules would most likely result in a one-time increase in the number of countries that pass. For MCC to have a regular pipeline of newly passing countries, the policy performance criteria would have to become increasingly easier and easier to pass. This approach would clearly produce strong

[5] Based on performance on the country scorecards for Fiscal Year 2014.

opposition. Some stakeholders, including members of Congress, believe that the current bar for policy performance is already low.[6]

- ***Allowing wealthier countries to compete for eligibility.*** Currently, only low and lower-middle income countries are candidates for MCC assistance.[7] Expanding the pool to include upper-middle income countries, which would require a legislative change, would give the agency more options for partner countries. However, while many upper-middle income countries have large pockets of poverty, most of them have far more access to other sources of capital than do low income countries and should not be high priorities for the kind of pure grant financing that MCC offers.[8]
- ***Choosing more micro-state partners.*** MCC has passed over a number of small (mostly island) countries that have demonstrated fairly consistently good performance on MCC's policy indicators.[9] A case could be made for greater MCC engagement in some of these countries in the future, though issues related to scale and efficiency would require consideration. But if MCC were forced to work only with *new* countries that pass its scorecard criteria, it would largely transition into a grant window for micro-states.
- ***Working with sub-national units.*** This approach might be worth exploring; however, there are a number of important, practical challenges. Legally, MCC can select just part of a country, such as a province or a city, as an eligible entity, though it has never done so in practice. This option would provide MCC the ability to work with a relatively well-governed locality within a country that, as a whole, may not meet MCC's policy performance criteria. One important challenge to this approach is determining how MCC would select sub-national units for prospective partnership. MCC has long stressed the importance of using high-quality, transparent, and broadly comparable data to evaluate countries for eligibility. This type of information does not exist for sub-national units across developing countries. For instance, how would MCC compare the policy frameworks of the 36 Nigerian states, let alone compare them with a city in India? For this practical reason, this approach is unlikely to be a simple or comprehensive way to expand the set of MCC partners.
- ***Entering into regional compacts.*** This is another approach potentially worth exploring, but it is also far from straightforward. In theory, regional compacts make good sense since a number of constraints to growth may be cross-border, like transportation infrastructure and customs systems. In practice, there are a number of challenges. First, MCC lacks the legal authority to select regions or groups of countries in a way that would facilitate regional compacts.[10] While MCC

[6] For example, the joint explanatory statement accompanying the Fiscal Year 2014 omnibus appropriations bill says, "There is concern that anti-corruption indictors for eligibility are not sufficiently rigorous, and do not properly reflect adherence to the rule of law in candidate countries including the influence of criminal enterprises and enforcement of private sector contracts."

[7] For Fiscal Year 2014, low and lower-middle income countries are those with a per capita gross national income (Atlas method) of $4085 or below.

[8] For instance, in Brazil, which has one of the highest rates of income inequality in the world, ten percent of the population lives on less than $2 per day. Yet the country maintains an investment grade credit rating and in 2012 took in $76 billion in foreign direct investment net inflows, the largest volume in the world after the United States and China (source: World Bank World Development Indicators).

[9] By illustration, Samoa, population 184,000, has passed MCC's policy criteria for eligibility for seven of the nine years it has been an MCC candidate country.

[10] Legally, MCC cannot select a region as an eligible entity. Nor can it engage in concurrent compacts, a potentially better way to undertake a regional approach. Concurrent compacts would enable MCC to

can theoretically pursue a regional approach through individual compacts in neighboring countries that are simultaneously eligible, coordinating the timing of separate agreements can be difficult. In addition, getting eligibility right, again, is a significant challenge. While there may be groupings of contiguous countries that all meet MCC's policy criteria for eligibility now, it is hard to predict when MCC may need to suspend or terminate assistance to a country based on a deterioration in policy performance. Suspension of one party could potentially jeopardize the entire regional compact. In addition, it is somewhat arbitrary to define a region based on performance on MCC's policy criteria. For instance, it may not make sense to have a West African regional compact without key regional players like Nigeria and Cote d'Ivoire, neither of which currently meet MCC's policy criteria for eligibility.

All this suggests that there are basically two categories of real alternatives to subsequent compacts. Either MCC must shift away from its mandate to work exclusively with poor, well-governed countries or it will shut down operations, probably within the next ten years. Neither of these is the right choice. MCC is meant to pick the best places to put its resources. On the whole, it is currently partnering with the right set of countries, many of which will continue to be strong partners in the future. If these current partners maintain good governance and work well with MCC to reduce their country's binding constraints to growth, disqualifying them from further support solely on the basis of having had a compact in the past is counter to the core aid effectiveness principles that MCC espouses.

Second Compacts Are Different; They Should Be More So

Subsequent compacts are different from first compacts in several important ways. At the same time, MCC could go further in several areas, which are outlined below.

(1) ***The eligibility criteria are harder.*** In addition to passing the already difficult indicator criteria, a country must also have demonstrated a strong track record of performance on its first compact. In particular, MCC looks at the nature of the country's partnership, whether the country complied with MCC policies and standards, and whether it demonstrated commitment and capacity to achieve results. While MCC does not publish information about countries' performance on these criteria, this secondary eligibility filter was likely the factor that excluded Mozambique and Mongolia from second compact eligibility.

How could MCC go further? Much of how MCC selects countries is very transparent; however, it makes public very little information on countries' first compact implementation record. MCC should strive to be more transparent about these performance assessments and explain how it weighs the various criteria. Until it does so, it will be hard for external observers to know where (and how consistently) MCC draws the line for what is acceptable compact implementation performance.

(2) ***They leverage more non-MCC resources.*** Countries entering into a second compact are expected to contribute their own budgetary resources towards achieving compact objectives. For low income countries, this means contributing at least 7.5% of the total MCC contribution. For lower-middle income countries, the counterpart financing minimum is 15%. In contrast, for first compacts, low income countries have no resource contribution requirement. Lower-middle income countries do, but the minimum amount is not specified.

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have with a single country both a nationally-focused compact and a separate regionally-focused compact linked in content and timing with similar compacts in neighboring countries.

How could MCC go further? Because MCC's objective is to reduce poverty through economic growth, the agency should make private co-financing a priority for second compacts. In recent years, MCC has begun systematically analyzing opportunities for private sector involvement in the design and implementation of all its compacts. However, this process does not guarantee private sector partnership. MCC should continue to identify and confront obstacles to increasing private sector engagement and explore how better to create incentives to bring in private investment, particularly in second compacts. In turn, Congress should emphasize the importance of compacts leveraging private funds and request that MCC report on the success of its efforts to link its investments with private financing in countries pursuing second or subsequent compacts.

MCC Engagement Should Not Be Indefinite

MCC should not be arbitrarily limited to a set number of compacts per country. It should retain the flexibility to have follow-on compacts (in the absence of a deterioration in policy performance or weak commitment to compact implementation by the partner country) until it no longer makes sense for MCC to support country-led solutions to growth in that country. However, in exchange for this flexibility, MCC should define the conditions that would suggest it should wind down its engagement with a particular country.

There are a number of possible criteria that MCC could consider. The most obvious of these is the income level of the partner country. Since, by law, MCC can only work with low and lower-middle income countries, MCC will no longer enter into new agreements with countries once they reach upper-middle income status. Even if MCC were to use income as the sole criterion for determining when to end a bilateral partnership, it would mark a somewhat radical departure from traditional modes of US Government development assistance; of the more than 100 countries in which USAID works, nearly a third are upper-middle or high income.[11]

However, income level should not necessarily be the only criteria MCC considers. Other relevant factors could include: (1) whether a country is both creditworthy and has sufficient access to local and international credit markets; and (2) how levels of private investment have changed, thereby impacting the broader development finance environment.

Conclusion

It remains important to engage MCC on the issue of subsequent compacts. However, the pressure should be focused on ensuring that MCC does them well, instead of forcing the agency to refrain from doing them. Subsequent compacts—with countries that continue to pursue good governance and have a strong track record of partnership with MCC—are the right way forward for the Millennium Challenge Corporation.

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[11] According to USAID's "Where We Work" website, it works in 114 countries, 34 of which are upper-middle or high income based on 2012 World Bank income data (GNI per capita, Atlas method) and income level definitions. Regional offices or multi-country locations are excluded. Pacific islands are counted individually; Nauru is excluded due to lack of comparable income data.