The MCC Between a Rock and a Hard Place:
More Countries, Less Money and the Transformational Challenge

Sheila Herrling and Steve Radelet
October 26, 2005

The Board of Directors of the Millennium Challenge Corporation (MCC) will meet on November 8th to select countries eligible to apply for FY2006 funding. It will face a bittersweet situation. On what should be a positive note, more countries have met the standards for MCC selection.[1] Applying MCC eligibility selection criteria, round three of country qualification shows 33 countries that meet the mark – 25 countries from the original lower-income (LIC) group and 8 countries from the new lower middle-income (LMIC) group. This should be good news for the MCC and the development community at large – more countries with a demonstrated, strong commitment to development are ready for the targeted, innovative, transformational funding promised by the MCC. However, the challenge facing the MCC Board this year is how to implement its vision of being transformational in MCC eligible countries on a budget well below the $5 billion originally promised by President Bush,[2] and with an American Congress and public focused on the growing deficit, the war in Iraq, and poverty reduction at home due to Hurricane Katrina. The tension between more qualifying countries, the desire for larger compacts, and limited funding puts the MCC between a rock and a hard place.

This note examines the challenges facing the Board as it seeks to support a growing number of good performing countries with substantial, results-based funding while maintaining consistency and transparency in its decision making process. It also lays out several options for managing these challenges. This is a companion note to "Round Three of the MCA: Which Countries are most likely to Qualify in FY 2006."

<u>Getting Out from under the Rock</u>

Transformational impact: patience and bold investment

The MCC's vision was to be transformational in its partner countries. Its FY2006 budget presentation to Congress stated: "the MCC must focus its available resources to fulfill its

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[1] Steve Radelet, Kaysie Brown, and Bilal Siddiqi, "Round Three of the MCA: Which Countries are most likely to Qualify in FY 2006?" Center for Global Development, October 17, 2006. See http://www.cgdev.org/doc/mca%20monitor/country%20selection/Round3_MCA.pdf

[2] The MCC only requested $3 billion for FY06; Congressional mark-up for FY 2006 is currently at approximately $1.75 billion.

mission of supporting transformative development programs. MCA is intended to provide a significant policy incentive to candidate countries by commanding the attention needed to galvanize the political will essential for successful economic growth and sustainable poverty reduction, and needs substantial resources to have that incentive effect."[3] Being transformational will require a commitment to ***invest boldly*** and to ***be patient.***
In announcing the MCA, President Bush declared that

> "This new compact for development can produce dramatic gains against poverty and suffering in the world. I have an ambitious goal for the developed world, that we ought to double the size of the world's poorest economies within a decade… This will require tripling of current growth rates, but that's not unprecedented."

Fulfilling this vision requires investing boldly in poverty reduction through ***substantial investments*** in targeted programs. But to date, the MCC's investments have not been substantial. If the MCA is intended to "provide to candidate countries a significant policy incentive large enough to command attention and galvanize political will," it will have to be one of the biggest donors in the country as well as one of the most effective in terms of delivering real poverty reduction results on the ground. While it is still too early to measure results, we can compare the financial size of MCC programs to the country's economy, total aid, aid per citizen and programs funded by other donors. To date, the MCC has signed compacts with 5 countries:

MCC Compact	Compact - annual average (current US$ m.)	MCC donor rank by size	Compact, % 2003 GDP	Compact, % 2003 ODA/OA	Compact per capita (current US$)
Madagascar ($110 m over 4 years)	27.5	7th	0.5%	5.1%	1.63
Honduras ($215 m. over 5 years)	43.0	5th	0.6%	11.1%	6.17
Cape Verde ($110 m. over 5 years)	22.0	2nd	2.8%	15.3%	46.84
Nicaragua ($175 m. over 5 years)	35.0	7th	0.9%	4.2%	6.39
Georgia ($295.3 m. over 5 years)	59.1	3rd	1.5%	26.9%	11.52

These amounts may indeed achieve important results on the ground, and the fact that they are grants is an important feature. To some extent, the small early programs may simply reflect the prudent ramping up of a new program, and it is important that these early program are of high quality. However, they are simply not large enough to bring about the kind of transformational change originally envisioned for the MCC. MCC programs are competing with a multitude of other funders and programs within a comprehensive country-driven poverty reduction and growth strategy. Within that larger strategy, size matters in terms of prioritizing the scarce in-country resources (both financial and

[3] See http://www.mcc.gov/about_us/key_documents/FY06_Budget_Justification.pdf.

human) necessary to yield results. The beauty of the MCC as an effective foreign assistance instrument is that eligible countries have already passed the performance hurdle – they are the most capable and committed governments policy-wise and in terms of using aid effectively – and they be held accountable for achieving results. These are precisely the countries that merit the risk of providing substantial amounts of aid over a long period of time to put them on a path of sustained development.

Since the initial compacts were signed, several key supporters have pushed the MCC to be more ambitious in its scale and scope. The pressure on the MCC to move faster and implement larger programs is perhaps best exemplified by remarks by House International Relations committee Chairman Henry Hyde in April:

> "The same observers who once received this initiative with such optimism now feel under whelmed by the cautious pace and modest scope of the MCA…[a series of $100 million compacts] are unlikely to provide the necessary clout to fundamentally change poor economies…The incremental approach and lack of urgency in the implementation of this initiative belies the original vision."[4]

To fulfill the vision of being transformational and to respond to these pressures, the MCC will need to consider shifting to larger compacts.

Being patient means recognizing that development takes time even under the best of circumstances. Research has shown that in countries that graduated from IDA, it took, on average, 10 years for aid flows to decline to 50 percent of their peak level, and another 10 years to decline to 25 percent.[5] Ultimately, patience is a virtue and best performers should expect to be rewarded. Continued funding to successful compact countries will be a challenge for the MCC as new countries become eligible and demand scarce resources.

But how to be transformational with more countries and less money?

Although the Board is unlikely to select all of the 33 countries eligible to apply for FY2006 funding, it is likely to choose more than the 17 it selected last year. Coupled with what is looking like an annual operating budget of $2-$3 billion, the Board needs to start thinking strategically about how best to effect transformational change and to achieve the results necessary to sustain Congressional support. Ultimately, this means rethinking the number of countries and the size of compacts, while upholding transparency in decision making. While there may be adequate funding in FY 2006 given the pace of compact development, the real crunch will hit in FY 2007, and it is time to start planning ahead.

[4] Opening Remarks of Chairman Henry J. Hyde before the Full Committee Hearing on "Millennium challenge Account: Does the Program match the Vision," April 27, 2005, http://wwwc.house.gov/international_relations/109/hyde042705.pdf
[5] See Clemens and Radelet (2003) http://www.cgdev.org/wp/cgd_wp023.pdf

There are several options for addressing the tensions between the growing number of qualifying countries, compact size, and budget constraints:

***Redouble efforts to secure funding closer to the original $5 billion per year*.**

The Administration and MCC supporters should fight hard for its $3 billion FY 2006 request and work diligently to document MCC success both in compact countries and as an innovative foreign assistance provider to support a request for the full (originally projected) $5 billion for FY 2007. To make that happen, however, Congress needs to be convinced that substantial additional funds are essential for the MCC to achieve its goals. With the amount of funding already approved ($2.5 billion in FY 2004 and FY 2005), and the small number of compacts signed, it is hard for Congress to see why substantial additional funding is necessary at this time. As Congressman Hyde observed in April:

> "The President's request is to add $3 billion in 2006 to the unspent $2.5 billion from the past two years. This total would require the equivalent of 27 compacts at $200 million each to be negotiated, approved and signed in the next 20 months before the funds would be exhausted. Signing even half that number of compacts before the end of fiscal year 2006 would be a triumph over the current pace. Combined with the prospect for billions more coming on line in 2007, it seems we have more funding than program. I would prefer that Congress be under pressure to catch up and fund a success, than need to justify funding for a potential one."

To some extent, then, future funding is in the hands of the MCC. If the program is ever to achieve funding close to the $5 billion originally envisaged, the MCC must increase both the pace at which it approves compacts and the size of those compacts. The Board has now approved 5 compacts, meaning there are 12 countries for which there is no compact. Eleven of those countries were selected for the MCA 16 months ago, which should have been sufficient time to design a compact, but very few additional signings appear to be on the near-time horizon. And pressure will increase in FY2006, with new countries passing the tests. The next 6-8 months will be crucial for the MCC to accelerate the pace. At the same time, Congress needs to have confidence that the compacts will be of sufficiently high quality for the MCC to achieve its goals of growth and poverty reduction. Balancing the tension between speed, size and quality will not be easy, but it is essential if the MCC is ever to grow to its full size and achieve its ambitious goals.

Larger compacts in fewer countries.

If the MCC does not receive substantially larger funding, a decision by the MCC to prioritize larger, bolder investments may mean investing in fewer countries. If funding ultimately levels off at $2-2.5 billion, the MCC will not be able to fund transformational programs in more than 15-20 countries. Thus the Board will need to find a way to select a subset of the 35 countries that now meet the qualification standards. Such a decision would need to be accompanied by transparent and defensible adjustments to the eligibility and selection criteria.

The most obvious first step (and, frankly, this step should be taken regardless of a decision to focus on larger compacts) is to delay consideration of LMICs, perhaps indefinitely. The biggest poverty reduction bang for the MCC buck is not going to be had by providing grants to countries that are three times richer than the original lower income group. Indeed, most of the LMIC have graduated from other aid programs and have access to private sources of finance. In the face of competing demands of less money and more eligible countries, the LMICs should go.

A different approach would be for the Board to only select a subset of the countries that pass the qualifying hurdles. For FY 2005, the Board chose only 14 of 24 countries that passed the tests. The problem, however, is if the Board is not transparent about the reasons countries are not selected, the selection process could be seen as an arbitrary process, thereby losing its credibility. In turn, this could undermine the incentives for countries to strive to pass the indicators hurdles.

One clear option would be to introduce a hard democracy hurdle similar to the current one for control of corruption. It is perfectly reasonable for an American aid program intended to support a select number of countries to target that aid to democracies. In past years, a number of non-democracies and questionable democracies that passed the indicators were not selected by the MCC Board. The formal response provided was that the Board invoked the "substantially below" exception for cases where a country performs substantially below the median on at least one indicator. When used this way, as time goes on, "substantially below" looks increasing like a politically-correct way out instead of a transparent pass or fail test. Introducing a hard democracy hurdle – scoring above the median on the voice and accountability indicator, for example – would reduce a lot of the exceptions made and would publicly recognize that the Board is putting more weight on being a democracy.

Introducing such a hurdle would significantly reduce the number of exceptions made by the Board. For FY 2005, had such a hard hurdle been in place, 7 countries would not have made the tests: Bhutan, China, Djibouti, Egypt, Mauritania, Swaziland, and Vietnam. The MCC did not choose these seven even though they had made the tests. For FY 2006, from the lower income group Bhutan, China, Egypt, and Vietnam would not pass the hurdles (with Armenia and Uganda just passing), while from the lower middle income group Jordan and Tunisia would be eliminated. Uganda will be an interesting case to watch this year as it fully passes the indicators for FY2006 qualification but has democracy watchers concerned with Constitutional changes allowing President Museveni to run again for another term.

The MCC may face claims of changing the goalposts from developing countries, but nimble organizations must both adapt to fiscal realities and refine policies based on operational lessons. Ultimately, huge success in fewer countries is more likely to bring about the kind of transformational change for which the MCC is striving and will garner greater confidence by Congress and the American public to support bigger budgets and more countries in future years.

Smaller compacts in more countries.

Another option would be to fund smaller compacts in more countries. Should the MCC move in this direction, it would need to cede its mission to be transformational. If, for example, the Board selects 24 countries for FY2006 funding of, say, $2 billion (probably an optimistic figure in this budget climate), the average country compact is about $80 million. Now, $80 million can certainly fund some good, small poverty reduction projects that will make a difference to people on the ground. But, as Chairman Hyde said last April, it's "unlikely to provide the necessary clout to fundamentally change poor economies."[6] The promise of the MCC was that it would be innovative, entrepreneurial and transformational. Pursuing this approach runs the risk of making it just another development program, which would beg the question of why we should incur the operational costs of a separate agency.

Clear deadlines.

The MCC could provide more certainty and remove some of the tension around having more eligible countries with less funding by setting some clear deadlines for the proposal process. First, as soon as a country submits a first draft of a compact proposal, the MCC should commit to providing feedback on a very timely basis, such as within 30 days. Too often countries have waited several months to receive feedback, which has slowed the process. Second, the MCC should institute two deadlines each year for proposal submission, followed by two Board meetings in which decisions would be made on all submitted proposals. For example, the MCC could announce its country selections in October, and announce deadlines for proposal submission by (something like) April 1 and July 15. The Board would then meet in early May and early September to decide on proposals submitted by the April 1 and July 15th deadlines, respectively. This timing would provide countries more than 5 months to prepare their proposal for the first round, and more than 9 months for the second round, which should be ample time to conduct consultations, prepare proposals, receive some initial feedback from the MCC, and submit revised proposals. In its May meeting, the Board would make firm decisions to either approve or disapprove all proposals submitted by the April deadline. Disapproved proposals could be revised and resubmitted in time for the September Board meeting, along with proposals from countries that were not able to finalize submissions for the earlier deadline.

These kinds of deadlines, which are common practice among many foundations, would help focus the attention of both recipients and MCC staff, speed the process, and provide certainty to the status of all countries. It would also create some competition within the group of selected countries with the MCC funding the best (not necessarily all) of the proposals submitted to it. This would help an MCC facing limited budgets to ensure that

[6] See http://wwwc.house.gov/international_relations/109/hyde042705.pdf.

the best compacts were funded. While recognizing it may be difficult to operationalize at first, it has the potential to distinguish and reward those eligible countries most committed to and prepared for MCC programs. In essence, it becomes another standard of best performance.

An opportunity to be transformational here at home.

There is a lot riding on the success of the MCC and its promise for reducing global poverty and reshaping the business of foreign assistance. With a $3 billion request, a mark-up that halves that request, and budgetary pressures within Congress to cut spending to fund tax cuts, the war in Iraq and rebuilding post-Hurricane Katrina, the MCC needs to forge key alliances in Congress and galvanize broader public support. A small up-front investment in engaging with Americans on the successes of MCC and the broader importance of foreign assistance to pursuing larger U.S. strategic interests may pay off in the long run. Being transformational abroad may mean bringing transformational change in the attitudes of Americans to show that helping responsible governments get stronger, offering their own people hope for a better future, is a smart investment in America's own security