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Exit: How Long Should the MCA Commitment Last?

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The countries that qualify for the MCA in its early years will not remain in the program forever. MCA countries will continue to receive funding based on meeting the broad qualification criteria, using new money effectively, and need—that is, degree of poverty, as approximated by income level. Correspondingly, there are three scenarios in which qualifying countries could exit from the MCA:

- a decline in rating on the broad qualification requirements,
- showing poor results on funded activities, and
- graduating as incomes rise above the threshold level.

Depending on the circumstances, each of these has different implications for MCA funding.

“Bad” Exit 1: Losing Qualification Status

Occasionally, a country qualifying for the MCA in one year will fall short of meeting the requirements in subsequent years. How should the US

This chapter draws heavily on Clemens and Radelet (2003).

government react in these circumstances? The answer should depend on the particular circumstances that led to the failure to maintain qualification. In extreme cases where the country experiences a coup d'état, becomes engaged in a major conflict, or takes a sudden turn away from sensible policy choices (e.g., Zimbabwe in recent years), it makes sense to immediately stop all MCA funding. In some cases, this may involve stopping funding midway through a three-year contract. Depending on the circumstances, the US government could shift to other (smaller and less flexible) mechanisms to fund some activities in the country (e.g., through USAID) or cease funding altogether. Although such a step would severely disrupt MCA programs, large amounts of aid could be wasted if the environment in the country suddenly turned sour.

A different judgment will be required if a country gradually slips from meeting the qualification requirements without a major discernible event. That is, how should the US government react if a country that qualifies for, say, three or four years in a row slips below the hurdle requirements in a subsequent year? In this case, an immediate cessation of MCA funding would be unwise. If a country has slipped only marginally, MCA assistance is likely to still be effective in enhancing growth and reducing poverty. This would be especially likely if monitoring and evaluation of MCA-funded activities in this country show good results, even if the country has slipped from the top qualification rankings. Abruptly eliminating existing funding for ongoing programs could unnecessarily disrupt these programs and yield less effective results for monies already expended. For example, it would not make sense to abandon a school construction program midcourse because a country slips marginally off the MCA list.

Moreover, a country could drop off the qualification list simply because of data errors. That is, weaker performance in the indicators need not mean a true weakening in policy and institutional performance, as discussed in chapter 3 (Kaufmann and Kraay 2002a). Nearly all the qualification indicators—no matter how they are ultimately chosen—are simply estimates of the real situation and, as such, are estimated with margins of error (sometimes large), as discussed in chapter 2.

However, even with these considerations in mind, simply continuing full funding to a country that has slipped below the qualification standards would be unwise. To the extent that a weakening in the ratings indicates a true weakening of performance, it is crucial to send clear signals to the recipient country that it is in danger of losing its MCA funding. The entire basis of the MCA is to allocate significant funds to countries with good performance, and the program would quickly lose its effectiveness if aid continues to be allocated to countries where performance is slipping.

Thus, the administration will need to strike a balance between sending the right signals about supporting good performance and unnecessarily disrupting worthwhile ongoing activities. These considerations suggest that when a recipient country slips marginally below the broad qualifica-

tion requirements, the US government should, as the first step, partially reduce funding. MCA funding need not be all or nothing. The US government can take advantage of gradations of funding to strike the right balance, keeping in mind the potential waste from sudden, large changes in aid levels.¹

For example, consider a recipient country that completes a three-year contract and meets all the benchmarks but just misses qualifying in the year a new contract would be negotiated. Since an abrupt cancellation of all funding could seriously damage ongoing projects, it would make more sense to negotiate a new contract with a reduced level of funding that would be adjusted up or down during the subsequent three years depending on the country's meeting the qualification requirements. In the first year, when the country misses the qualification requirements, funding could be at 75 percent of the full level. If in the second year the country again fails to qualify (but continues to meet performance benchmarks for the program), funding could drop to 60 percent, and in the third year it could drop to 50 percent. If the country continues to miss the qualification requirements after the third year, MCA funding should cease (other types of smaller-scale funding could continue). If, however, the country again meets the qualification requirements in the second or third year, funding could increase to the full level.

"Bad" Exit 2: Poor Performance on Funded Activities

A different situation will arise when a country continues to meet the qualification requirements but misses the performance benchmarks on particular projects. The reaction of the US government to missed benchmarks should depend on the precise events and the extent of the problem. For example, if a country regularly misses benchmarks on its education program but continues to do well in its health program, full funding for the health activity should continue. Or if a government fails to meet its benchmarks but NGO programs remain on track, the NGO programs should continue full force. When benchmarks are missed, a graduated approach could be taken, depending on the extent of the problem. A few missed benchmarks should lead to a partial reduction in funding, while severe problems could lead to stopping the funding altogether. If the MCA uses broad program funding rather than project funding, it would be possible

1. Recent research by staff of the International Monetary Fund (IMF) has shown that, in the past, aid flows worldwide have been so volatile and unpredictable that stated aid commitments are a statistically poor predictor of actual aid flows. They stress the deleterious impact of unpredictability on macroeconomic planning and management in poor countries seeking stability (Bulír and Hamann 2001, Bulír and Lane 2002).

to reduce funding partially (say, provide 90 percent of baseline funds) if some benchmarks are missed, and to further reduce funding if problems persist. The flip side could be an incentive system: if a country meets all the benchmarks for, say, two reporting periods in a row, it could receive an increase in funding of 5 to 10 percent, as long as it puts forward a strong plan for how it would use the extra funds. As in many other aspects of the MCA, strong monitoring and evaluation mechanisms will be necessary for this process to work effectively.

As mentioned in chapter 5, the MCC must be judicious in its decisions about reducing funding. As with venture capital firms, investments in aid-funded projects are risky, and some may fail, even with governments that are fully committed and making the best efforts toward success. Countries should not be deterred from trying new, innovative ideas because of a concern that they might lose their larger MCA funding. In making decisions about reducing funding, the corporation must consider both the detailed outcomes on specific activities and the bigger picture as to whether a country as a whole is continuing to perform at high levels.

“Good” Exit: Graduation after Good Performance, but How Long Will It Take?

Over time, the most successful countries within the MCA will maintain their qualification status, use foreign assistance effectively, and achieve sustained economic growth and poverty reduction. Eventually these countries will achieve income levels such that they can graduate from the MCA, seek other sources of funding, and allow other countries to enter the program. When a country does graduate successfully, the administration should taper off funding over time—perhaps three years—to finish ongoing activities and facilitate adjustment to other sources of funding.

While a small number of MCA countries with relatively high incomes could graduate relatively quickly, for most MCA countries—even with continued good performance—graduation is many years away, implying a relatively long-term commitment of US funding. According to the administration’s proposal, the initial income ceiling for MCA eligibility is per capita income of \$1,435 (calculated at official exchange rates). Consider an MCA country with per capita income of \$450 dollars, about the average of the 87 countries with incomes less than \$1,435 that will be eligible for the MCA. If this country achieves an extraordinarily rapid 7 percent per capita growth rate (implying overall economic growth of around 9 percent), it will take it 17 years to reach per capita income of \$1,435. With a still strong annual per capita growth rate of 5 percent (implying overall growth of 7 percent), it would take about 24 years for it to reach \$1,435. Several potential MCA recipients start at even lower income levels. For a country starting at \$300 per capita, with 7 percent per capita growth, it

will take 23 years to reach \$1,435, and with 5 percent growth, it would take 32 years. To take a specific example, consider Ghana, a prime candidate for the MCA, with current per capita income of \$350. If it does everything right and achieves per capita growth of 7 percent per year, it will take Ghana 21 years to reach per capita income of \$1,435.

In other words, even under the best of circumstances in which MCA countries work hard, make positive steps, and use aid effectively, it will be many years before they will graduate from the ranks of low-income countries. Make no mistake—the outcomes described above would be extraordinary development successes. These timetables are a reminder that countries cannot reduce poverty overnight, even if they do everything right.

The MCA Candidates of the Past: Aid Patterns in IDA Graduates and the Marshall Plan

What can be learned from the experiences of other countries about the duration of aid funding? One way to investigate this question is to look at individual country stories. Botswana may be the most relevant case for the MCA countries. In the mid-1960s, it had a per capita income of about \$400 (in 2000 dollars). The combination of the discovery of diamond deposits, able economic management, and strong democratic political institutions led to average real per capita economic growth of 6.8 percent between 1965 and 2001, one of the highest growth rates achieved anywhere in the world. Botswana's per capita income is now well over \$4,000. In the 1960s, it received significant foreign assistance, averaging around \$70 per capita per year and over 19 percent of GNI. Aid flows gradually declined to around 13 percent of GNI in the 1970s and 6.4 percent of GNI between 1986 and 1990. More recently, aid/GNI in Botswana declined to 1.6 percent between 1996 and 2000.

More can be learned from looking at groups of countries that once received large aid flows and no longer do. Two groups of countries that represent aid success stories can be looked at for guidance. The first consists of the recipients of aid under the United States' post-World War II European Recovery Program, known as the Marshall Plan. In the years immediately after the war, a massive and unprecedented burst of foreign aid to Europe and Japan was accompanied by excellent economic performance among its recipients. Of course, the Marshall Plan differed from current aid programs in many ways. Perhaps most importantly, it was aimed at reconstructing already developed economies rather than spurring development in low-income countries. Thus, both the magnitude of funds to be absorbed and the duration of the program differed significantly from current programs. Nevertheless, a review of the data is instructive.

The second group of countries is the graduates of the concessional arm of the World Bank, the International Development Association (IDA). In

the past four decades, 32 countries that once were IDA-eligible have “graduated” from its ranks. Ten have since returned to IDA eligibility, leaving a group of 22 countries that have to some degree—after receiving large amounts of aid—significantly and lastingly raised their standards of living.² Figure 8.1 shows how the 22 IDA graduates rate on several widely used measures of policy and institutional quality. They have demonstrated systematically better indicators than their peers. Figure 8.2 shows that at the same time, the IDA graduates have raised incomes, lowered infant mortality, and improved educational coverage faster than other developing countries. If the Nixon administration had picked a group of MCA recipient countries, it would not have done badly by picking these 22. As a group they represent the best case of our experience with aid effectiveness in low-income countries.

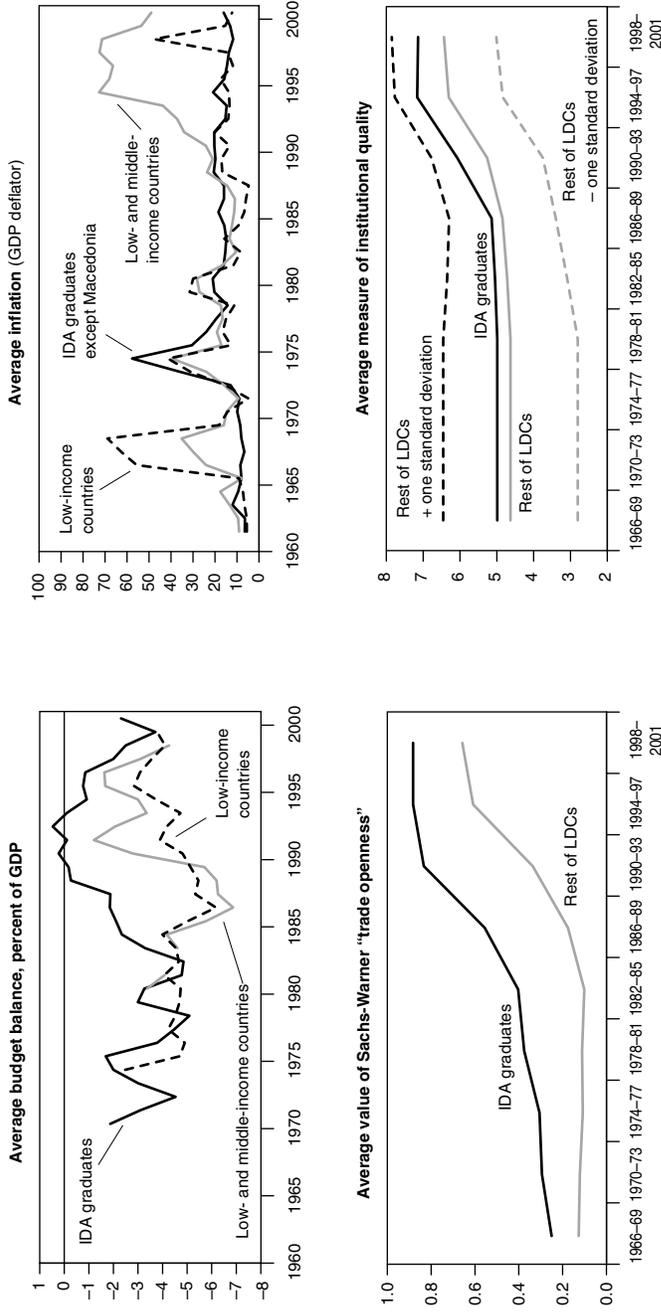
Figure 8.3 compares the aid receipts of the IDA graduates with those of the Marshall Plan recipients—both measured as a fraction of national income (top graph) and in dollars (bottom graph). Unlike the Marshall Plan countries, IDA graduates did not all begin receiving aid simultaneously. To make the two comparable, we track aid in each IDA graduate starting in the year that it received the most aid. Thus, the dark line corresponding to point “5” on the horizontal axis represents the average aid level among IDA graduates five years after each individual country’s all-time peak in aid. The grey line above point “5” represents the average aid level among Marshall Plan recipients in 1951 (five years after the peak in aid as a fraction of national income) or 1952 (five years after the peak in dollars of aid).

Several stylized facts immediately emerge from these graphs. Measured in dollars (after accounting for inflation), the IDA graduates received less aid than the Marshall Plan countries. Relative to their incomes, the IDA graduates received more—much more—than their European counterparts. However, few received aid in excess of 10 or 15 percent of national income over a sustained period. (Note that the 18.7-percent-of-GDP illustrative figure of total aid flows calculated for the potential MCA recipients in table 7.1 is at the upper end but not out of the IDA graduates range.) The IDA graduates required moderate, sustained aid flows for a longer time than the Marshall Plan recipients. Ignoring the negative values of net aid (as Europe began to pay the United States back), the “half-life”³ of aid as a fraction of national income was 10 years for the IDA graduates but only

2. The 22 countries that have permanently graduated from IDA since 1960 are Botswana, Chile, China, Colombia, Costa Rica, Dominican Republic, Ecuador, Equatorial Guinea, El Salvador, Jordan, South Korea, Mauritius, Former Yugoslav Republic of Macedonia, Morocco, Papua New Guinea, Paraguay, St. Kitts and Nevis, Swaziland, Syria, Thailand, Tunisia, and Turkey.

3. The half-life is the number of years it takes for the quantity to decline to half its initial value while decreasing at an exponential rate. The half-lives measured here omit negative aid values and allow each country’s exponential curve to intersect the y-axis at an idiosyncratic point (in other words they include “country fixed effects”).

Figure 8.1 Policy and institutional measures, IDA graduates and other country groups

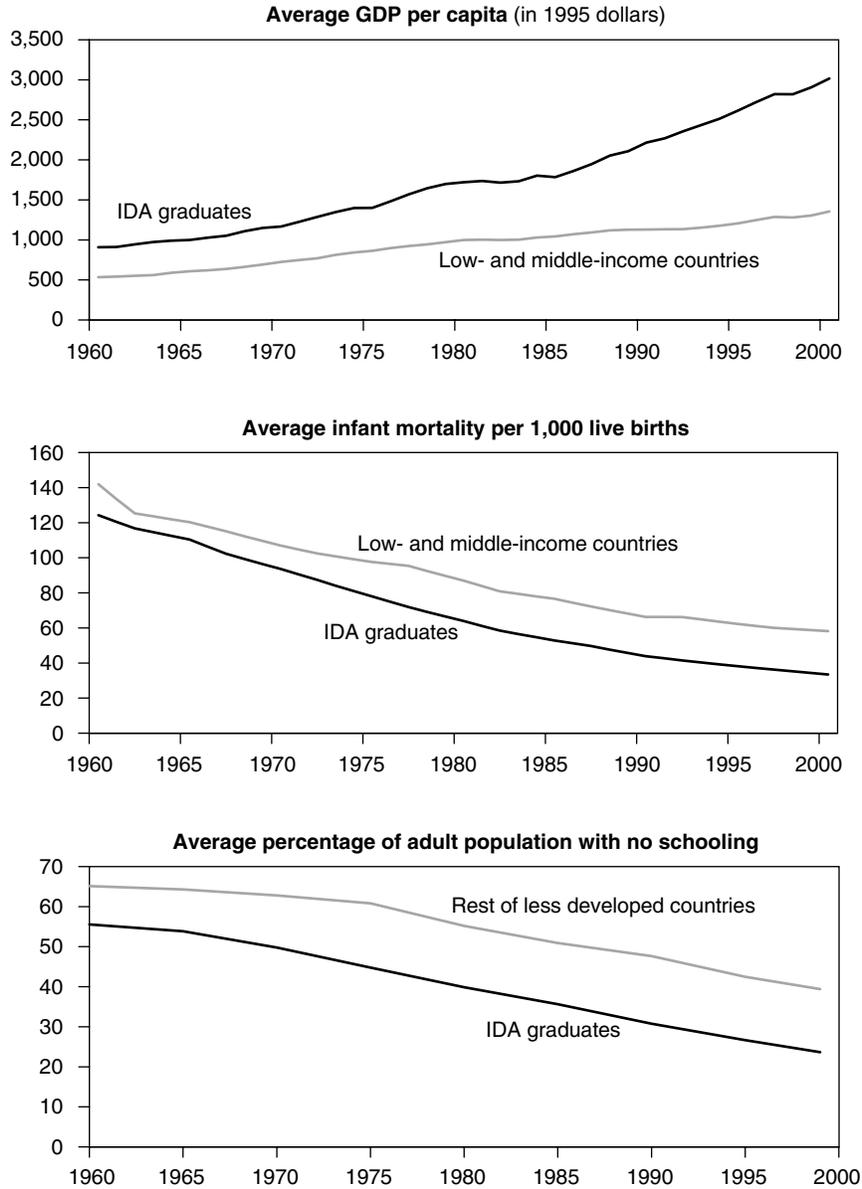


IDA = International Development Association (of the World Bank)
LDCs = less developed countries

Note: Averages are unweighted.

Sources: For budget balance and inflation: World Bank, *World Development Indicators 2002*; for Sachs and Warner measure of openness: Harvard University Center for International Development, updated with Center for Global Development calculations. The institutional quality measure is from Steven Knack and Philip Keefer (1995).

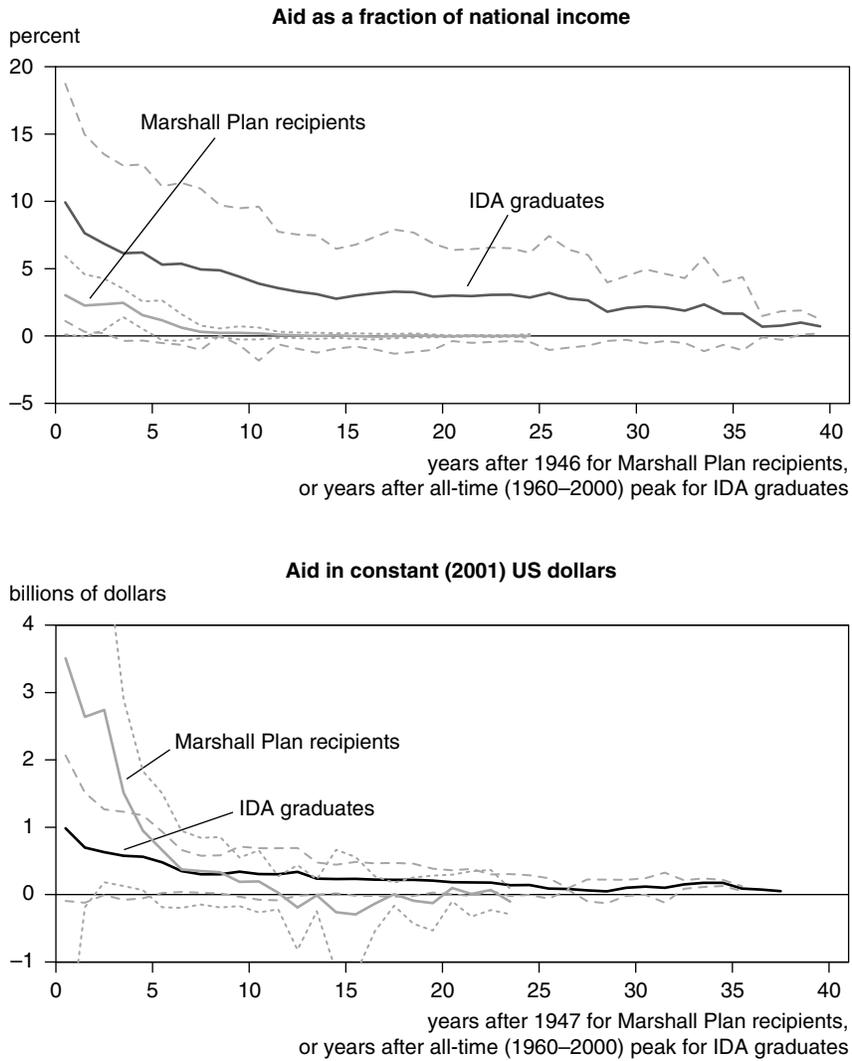
Figure 8.2 Selected development outcomes, IDA graduates and other countries, 1960–2000



Note: Averages are unweighted.

Sources: For real GDP per capita and infant mortality: World Bank, *World Development Indicators 2002*; for percent of adult population (age 25+) with no schooling: Barro-Lee International Data on Educational Attainment, provided by Harvard University Center for International Development.

Figure 8.3 Aid receipts, Marshall Plan countries and IDA graduates



Notes: Lines with dashes or dots are one standard deviation above and below the mean.

Since much of their aid dynamics were determined by transitory strategic events, outliers Equatorial Guinea and Jordan are omitted from the upper figure, outlier Syria is omitted from the lower. The Marshall Plan recipient countries shown are Austria, Belgium and Luxembourg (treated as a single recipient), Denmark, France, Germany, Greece, Japan, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, and the United Kingdom. Averages are unweighted.

Sources: For Marshall Plan net financial flows: US Bureau of the Census (1975), *Historical Abstracts of the United States: Colonial Times to 1970*, Bicentennial edition, Part 2 (Washington: US Department of Commerce), pp. 873–75; for post-1960 net aid data: OECD Development Assistance Committee, *Creditor Reporting System*.

3.7 years for the Marshall Plan countries. That is, in the IDA graduating countries it took 10 years for aid flows to diminish to 50 percent of their peak and 20 years to diminish to 25 percent of their peak (two half-lives), but only 3.7 years and 7.4 years, respectively, in the Marshall Plan countries. With aid measured in dollars rather than as a share of income, the half-life was 12.2 years for IDA graduates and 5.4 years for the Marshall Plan countries.

Implications for MCA Contracts

How long should the US government be committed to well-performing MCA countries? There is a clear tension surrounding the issue of contract length and possible renewability in the MCA. On the one hand, donor dependency is a real problem in many low-income countries, with recipients expecting that donors will continue funding for many years. It is in no one's interest—neither the donor's nor the recipient's—for the qualifying countries to become overly dependent on large aid flows from the MCA. This dependence could undermine the incentives to establish sound public finance institutions, including building a robust revenue base and a corresponding long-run level of expenditures. In the extreme, this concern would suggest that MCA funding be for a very short period of time, perhaps the length of only one or two contracts, and then be terminated. On the other hand, development is a long process even under the very best of circumstances, and to be successful some programs require a modicum of certainty in their long-term financing. No country can build a sustainable health system in three to four years. This concern would suggest assuring recipients of continued funding, so long as the specified results are achieved.

Neither of the extreme positions is correct. It is clearly unrealistic to assume that activities initiated under the MCA will be self-sustaining once the initial contract term ends. There is no way that the MCA can provide new financing of \$200 million to \$250 million for three to four years and expect that activities will be completed or alternate financing will become available. Indeed, even holding out the threat of eliminating funding after one contract cycle would undermine the effectiveness of the program. Recipients would respond by writing proposals for only short-term, quick-start projects that can be completed quickly, even if these are not the most cost-effective and relevant from a development perspective. Key programs that require a longer commitment would not be proposed, as recipients would fear being stuck with large costs that they would be unable to cover realistically in the short run. Although some people might advocate a very short term for MCA funding, it would be inconsistent with the fundamental concepts of the program to reduce funding to a low-income country for arbitrary timing reasons as long it continues to meet eligibility requirements, achieve specified benchmarks, and attain successful results.

However, as said earlier, it would be unwise to imply that MCA funding will continue forever. The right balance is to create the expectation that successful programs will receive continued funding at decreasing levels.

One lesson from the Marshall Plan countries and the IDA graduates is that the idea that it would be sufficient to give a sudden, massive, and short-lived burst of aid to the MCA countries is probably wishful thinking. The Marshall Plan countries—with their superior legal and institutional frameworks, levels of education, public health, and so on—were weaned from aid in just a few years. Not so in the case of IDA graduates, which required decades of sustained aid flows that declined gradually.

MCA flows should follow the same pattern, based on contracts of about three years with recipient countries. Funding for new programs may need to be ramped up during the initial period for them to reach their full scale. But after this initial scaling-up period, for a country that continues to qualify and meet performance standards, the amount of funding during each subsequent grant cycle should gradually decline. Where programs successfully achieve results and continued funding is necessary, the expectation should be that a new contract with less funding would follow. A reasonable goal would be to reduce the dollar amount to each recipient by half over 12 years (similar to the magnitude of reduction to the IDA graduates). As a rule of thumb, the second three-year contract should be about 85 to 90 percent of the first, and so on, so that after 12 years MCA funding would be between 40 to 60 percent of its original level. This ramp-down should be a general guideline, not a hard-and-fast rule. Funding for some activities can be ramped down faster, while for others it will take more time. The monitoring and evaluation process will be critical in establishing appropriate levels of subsequent funding.

In sum, different strategies will be necessary for countries that exit the MCA for different reasons. Countries that lose broad eligibility because of a clear negative event (such as a coup d'état or war) should lose MCA funding immediately, whereas those that marginally slip from the eligibility ranks could continue to receive partial funding during an interim period to improve performance. Countries that retain broad eligibility but show poor results on funded activities could redirect funds to more promising activities or lose funding altogether if evaluation results are generally poor. Countries that maintain broad eligibility and show strong results on funded activities should retain substantial MCA funding until they reach the MCA income ceiling. In most cases, income graduation will require a decade or more of sustained effort. MCA flows should decline gradually during this period to minimize aid dependence. These approaches will strike the necessary balances between providing strong support to successful countries, ensuring that MCA funds are put to their best use, and sending a strong signal to recipients that funding will continue as long as, and only as long as, they meet the requirements of the program and use their aid effectively.

