MCA Monitor Analysis

From Challenge to Opportunity:
A Proposal to Adjust the MCC's Candidacy Selection Method

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Summary: The Millennium Challenge Corporation's (MCC) candidate selection process uses designations for low income and lower middle income countries that are impeding the overall intent of the MCC's legislated mandate to work with well-governed poor countries. A technical adjustment to how graduation from low income to lower middle income classification is calculated is needed to fix a problem that will otherwise get worse.

The Millennium Challenge Corporation (MCC), now six years old, is a flagship U.S. foreign assistance program designed to support objectively selected, well-governed poor countries.[2] The MCC has overcome growing pains that accompany any new aid program but today faces new challenges: showing results while maintaining the integrity of its mission and, importantly, its selection model.

Countries are first selected as *candidates* for MCC funding according to income categories. This large group of candidate countries then competes for MCC funding against indicators measuring country policies for ruling justly, investing in people, and economic growth. Once countries are scored against the indicators, they can be selected by the MCC board as *eligible* for MCC assistance.

MCC's authorizing legislation required a focus on the best-performing low income countries in its first two years. But beginning in FY2006, the legislation permitted the MCC to augment its candidate pool by including lower middle income countries. In 2006, this meant 32 lower middle income countries were added to the 81 low income countries as possible MCA countries.[3] Lower middle income countries can receive at most 25 percent of MCA funds in any given year. This funding cap was legislated to ensure that the majority of MCA funds are reserved for the "poorest" countries.[4]

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[2] Sheila Herrling, Molly Kinder, and Steve Radelet, "From Innovation to Impact: Next Steps for the Millennium Challenge Corporation" (2009), http://www.cgdev.org/content/publications/detail/1420905.
[3] Figures represent all countries within the designated income category, including those legally prohibited for statutory reasons.
[4] World Bank designations for low income countries (LICs) and lower middle income countries (LMICs) are widely used in international development policy discussions to distinguish between the two income categories, and these definitions and terms are incorporated into the MCC legislation. These classifications are problematic in the case of the MCC, for reasons explained in

But three aspects of the candidacy selection system as currently structured threaten to undermine the overall intent of the MCC legislation in a way that poses significant policy challenges to the effectiveness of the MCC:

1. The number of eligible low income candidate countries has declined and is likely to continue to shrink—even though countries that are said to have "graduated" from lower income status may continue to have high levels of absolute poverty.

2. The income line that the World Bank uses to divide low income countries (LICs) from lower middle income countries (LMICs) responds to factors that may not reflect substantial changes in poverty or income levels and that can lead to abrupt graduations and unpredictability in the MCC compact pipeline.[5]

3. The combination of abrupt graduations that may not reflect reductions in poverty, a 25 percent funding cap on spending in lower middle income countries, and an MCC budget that is much smaller than envisioned when the MCC was created substantially constrains the MCC from doing what Congress intended: working in partnership with well-governed, poor countries to reduce poverty and increase economic growth.

Policy Recommendation: **The MCC is exploring options to address these issues so that it has a robust pool of well-governed poor candidate countries to compete for MCC assistance. CGD's MCA Monitor proposes that the MCC redefine the lower income candidate pool as the 75 poorest countries according to gross national income (GNI) per capita. This proposal would address the current challenges while giving the MCC flexibility to work with the best-performing poor countries with the greatest potential for poverty reduction and economic growth.**

Current Income Category Selection Challenges

1. The number of eligible low income candidate countries has declined and is likely to continue to shrink—even though countries that are said to have "graduated" from lower income status may continue to have high levels of absolute poverty.

The MCC defines its candidate country categories according to the World Bank definitions for LICs and LMICs.[6] While there were 81 low income country candidates in 2006, there are only 63 in FY2010 (Figure 1). The sharpest drop in MCC eligible low income countries took place between FY2009 and FY2010, shrinking the pool by 10 candidate countries. If the same number

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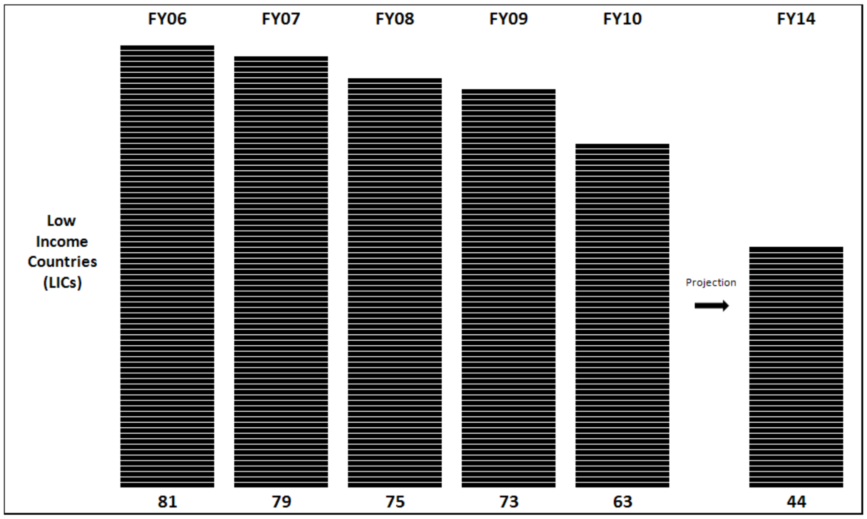
this note. To minimize confusion, we use the terms LICs and LMICs exclusively to refer to the World Bank classifications, and write out the terms lower income countries and lower middle income countries in other instances.

[5] GNI per capita can change due to real income growth, but it can also change due to exchange rate appreciation, changes in inflation rates, and technical adjustments to the data.

[6] The historical ceiling of the International Development Association (IDA) determines those countries classified as LIC. LMICs are defined at their lower bound by the IDA ceiling and at their upper bound according to the most recent edition of the World Bank's World Development Report.

of countries changed income groups in the next five years, the low income candidate pool would shrink to only 44 countries in FY2014.[7]

Figure 1: Shrinking low income country candidate pool



This shrinking number of low income countries with which the MCC can work would not be a problem if the graduating countries were really rising out of poverty. In reality, however, countries may graduate from LIC to LMIC status even though conditions have changed little. As the pool of low income countries shrinks, countries that might not otherwise have qualified (think Kenya or Sierra Leone) could face less competition and find themselves near the top of the candidate pool. While the poverty levels of these countries fits the MCC criteria for assistance, the good-governance standards of the countries in this shrinking pool may increasingly come in to question.

The MCC's mandate is to work with well-governed *and* poor countries. Other U.S. aid mechanisms are in place to deal with fragile and post-conflict states and geostrategic allies. The MCC was designed to work with countries that do not have access to other sources of development finance or capital. To fulfill this legislative mandate, the MCC must have access to a robust pool of well-governed *and* poor candidate countries with which to work. The current criteria threaten to undermine this intent.

2. The income line that the World Bank uses to divide low income countries (LICs) from lower middle income countries (LMICs) responds to factors that may not reflect substantial changes in poverty or income levels and that can lead to abrupt graduations and unpredictability in the MCC compact pipeline.

Another challenge with the current MCC candidate pool system is the resulting unpredictability that comes from an absolute income line dividing LICs and LMICs. This income cutoff point can

[7] Nineteen countries moved out of the LIC pool from FY2006 to FY2010: 18 countries moved up to become LMICs and 1 country graduated out of MCC candidacy. If the same number of countries moved out of the LIC pool in the next five years, then 44 countries would be left.

lead to abrupt graduations that disrupt MCC compact pipeline planning and, more importantly, derail or significantly hinder compact development for individual countries.

FY2010 exemplifies this problem: both the Philippines and Indonesia moved from the LIC to the LMIC group. Both countries were in compact development after being selected as eligible in FY2008 and FY2009, respectively. However, moving into the LMIC category in FY2010 subjected them to a different peer group with elevated indicator medians and a significant resource cap. Thus, both countries went from doing very well on the indicators in FY2009 to failing in FY2010, not because they experienced policy slippage, but because they were moved to a different pool.[8] In fact, had both countries remained in the LIC pool for FY2010, they would easily have passed the indicators test. The failing status of the Philippines and Indonesia had the potential to throw a wrench into compact plans, but the MCC received a temporary legislative fix to amend the issue, this time.[9] Without taking any steps to avoid this unintended consequence of the sharp income cutoff, the uncertainty that comes with country graduation will impede both individual country compact development and MCC planning and compact management. Temporary fixes are not an appropriate measure to be invoked every time this happens.

Graduation to a higher income category does not always mean, therefore, that there is a real change in income growth or poverty, which makes the subsequent limitations seem more arbitrary. GNI per capita can change due to real income growth, but it can also change due to exchange rate appreciation, changes in inflation rates, and technical adjustments to the data.

3. The combination of abrupt graduations that may not reflect reductions in poverty, a 25 percent funding cap on spending in lower middle income countries, and an MCC budget that is much smaller than envisioned when the MCC was created substantially constrains the MCC from doing what Congress intended: working in partnership with well-governed poor countries to reduce poverty and increase economic growth.

The abrupt graduation of MCC countries that are in the process of developing compacts with the MCC, combined with the 25 percent funding cap and importantly, a smaller overall MCC budget, further constrains the MCC from working with well-governed poor countries. The MCC was initially envisioned to have $5 billion in its third year of existence; allowing for $1.25 billion to be spent on lower middle income countries. With current total MCC funding levels closer to $1.2 billion per year, the amount available to these countries is *much* smaller than intended (only $300 million) and severely restricts the MCC's ability to keep working with a select number of well-performing and still poor countries that graduate from low income to lower middle income status while working with the MCC. Had the MCC received the higher funding levels, it would have had much more flexibility to deal with the graduation issues.

MCC compact countries that have graduated from LIC to LMIC since FY2006 include Morocco, Armenia, Georgia, Vanuatu, Indonesia, the Philippines, and Ukraine. As is evidenced by the

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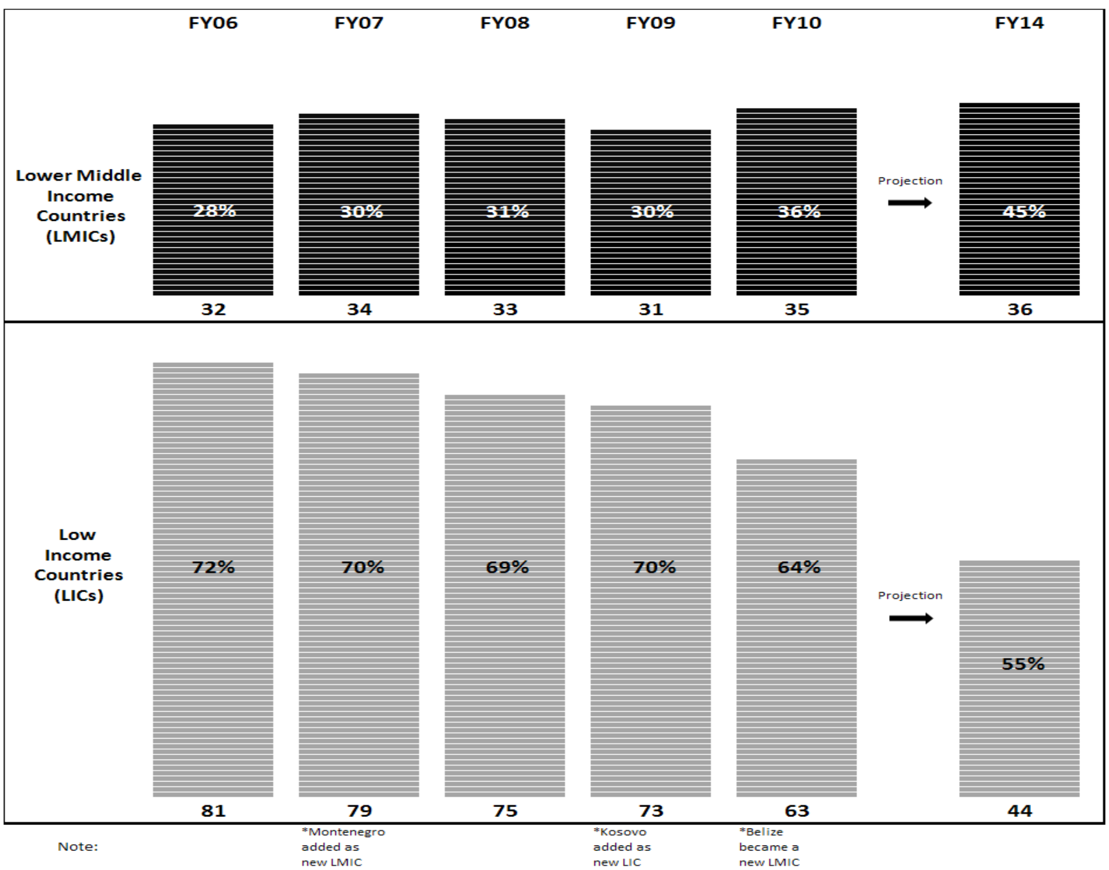
[8] In FY2009, Indonesia easily passed the indicators test, and the Philippines would have passed except for scoring in the 47th percentile on control of corruption.

[9] The MCC received a legislative fix for FY2009 candidate countries which states: "a candidate country transitioning out of 1 of the income categories [LIC or LIMC]…shall be allowed to retain its candidacy at the lower income category for the year of its transition and for 1 subsequent fiscal year." Source: FY2010 State Final Appropriations Bill.

number of compact countries that have moved from LIC to LMIC status, many of the well-performing countries with which the MCC is and should be partnering graduate into the LMIC group during the life of their MCC–partner country relationship. Most of these countries have consistently shown good policies in the areas of economic freedom, ruling justly, and investing in people. Cape Verde, a LIC when originally selected as compact eligible, graduated to LMIC before it had the chance to sign its compact and is now the first-ever country to be selected for a second compact. Similarly, Georgia and Vanuatu are LMICs on course to being possible candidates for a second compact but which signed their first compacts as LICs. The issue is perhaps most pronounced with countries like Indonesia and the Philippines that were selected as MCC eligible when they were LICs, and in the process of developing their compacts—which takes time in order to reflect adequate country ownership and participation—have graduated to the LMIC category. Without the FY2009 temporary legislative fix, they would have been penalized with smaller amounts of available funding simply because their income per capita happened to be a few dollars over the threshold.[10]

Figure 2: Increasing lower middle income country candidate pool, relative to the entire pool



The cap impedes the MCC's ability to continue working with these better-performing countries that arguably are still amongst the poorest in the world. For example, the Philippines—a new LMIC as of FY2010—has a poverty level of 45 percent. This means that almost 41 million

[10] For instance, in FY10 the Philippines was a mere $35 over the $1855 GNI per capita cutoff for LICs.

Filipinos live on less that $2 a day, equal to the number of poor in Tanzania and over twice the number of poor as in Mozambique.

A New Proposal to Overcome Challenges and Maintain the MCC Mission

In light of these challenges—and the fact that this trend is likely to continue—we propose a new way to define for MCC purposes the criteria for the candidate pool of lower income countries and lower middle income countries. We recognize that any proposal to amend the MCC candidacy process needs to be simple, transparent, and politically feasible while allowing the MCC the opportunity to work with the best-performing poor countries.

The proposal: Redefine the MCC lower income candidate pool to be the 75 poorest countries according to gross national income (GNI) per capita.

Instead of using the historical ceiling of the International Development Association to determine those countries classified as low income, the pool would simply be the 75 countries ranked at the bottom of the GNI per capita list. Further, we propose redefining the 76th poorest country in a given fiscal year to be the lower bound of the MCC lower middle income pool, while keeping the upper income cutoff defined according to the most recent edition of the World Development Indicators. As in the current model, countries that graduate from lower middle income to upper middle income (UMIC) will continue to do so and thus graduate out of MCC candidacy.

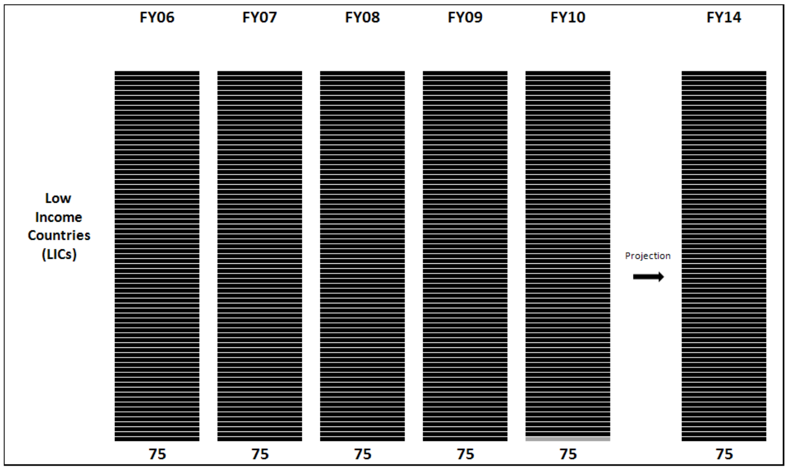
This proposed system has dual benefits: the number of MCC lower income countries stays constant at 75 countries per year, while the MCC lower middle income group decreases as countries graduate out of MCC candidacy. According to our projections, the lower middle income pool could become almost nonexistent—only five countries—as countries graduate into upper middle income status. (Figure 5 shows the complete composition of country groups under our proposal beginning in FY2006.) Well into the future, the MCC lower income country group also will diminish as countries start to exceed the per-capita GNI upper bound to be considered as an MCC candidate. By this mechanism, the MCC would remain true to its original mandate of working itself out of business.

The advantages of such a scheme correspond to the current challenges:

1. **There will be a stable number of candidate lower income countries and the MCC will be able to continue to serve the best-performing poor countries.**

The proposed change prevents the MCC lower income country group from decreasing in number, at least until there are no further lower middle income countries with which to work. Because the pool is stabilized, the opportunity for countries to become "artificial passers" due to a small LIC pool is eliminated. The proposal allows the MCC to continue to serve the poorest, defined now as the 75 countries with the lowest income while still allowing countries to graduate entirely out of the program. If we look at FY2010, twelve countries that that would have been classified as lower middle income are instead moved into the MCC lower income cohort in our proposed system. For FY2010, this would mean that the Philippines, Indonesia, Paraguay, Vanuatu, Timor-Leste, and Georgia would all be classified as lower income countries.

Figure 3: Under new proposal, there is a constant number of candidate low income countries



2. Graduation from lower income to lower middle income categories will be less erratic and will better reflect growth of GNI per capita.

If all countries grow at the same pace relative to one another, the MCC lower income category stays relatively fixed. It is only when an individual country outpaces the growth of another similar country that it is able to graduate into the MCC lower middle income category.

Under the current MCC system, ten countries graduated from LIC to LMIC status in FY2010; only Turkmenistan graduates from lower income to lower middle income under the new proposal (see Table 1). Again, if we look at the Philippines and Indonesia, the problem of abrupt graduation is solved as they remain lower income countries in our proposed system. The reduction in graduations applies to all years, and thus the possibility of needing temporary fixes is reduced.[11]

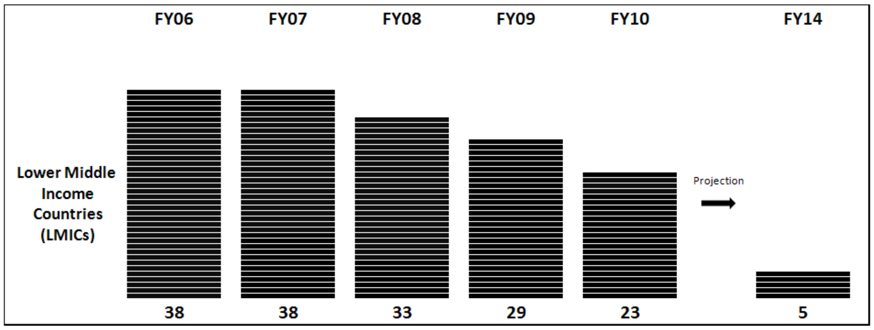
3. Under the proposed system, the lower middle income pool shrinks, making the legislated 25 percent cap a more realistic and appropriate limit.

As explained, we project that by FY2014 in the new system, there would be only five MCC lower middle income countries eligible for MCC funding. Further, the 75-country lower income group keeps many of the countries that would have graduated. Much of second compact funding

[11] The MCC currently has pending legislation (which is likely to pass) to make the temporary three-year gradual graduation fix permanent. The permanent fix, however, will only apply to those countries that move from LIC to LMIC status.

is then freed from the lower middle income cap restraint and the allocation of countries more closely matches the allocation of funds. Had the proposed system been implemented for FY2010, 25 percent of the funds would have been available to 23 countries and 75 percent would have been devoted to 75 countries of the lower income category.

Figure 4: The lower middle income country pool decreases

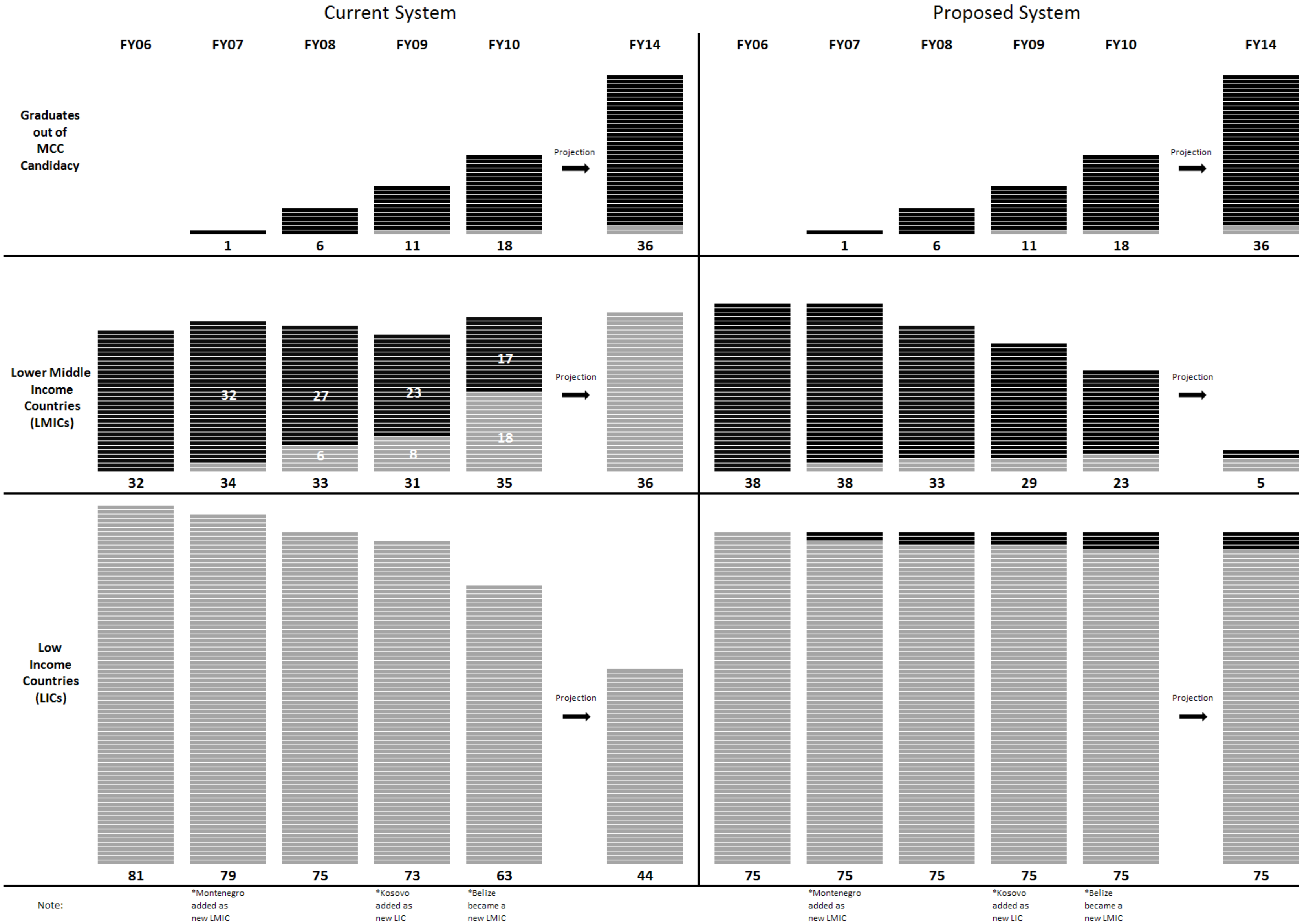


Conclusion:

While it will take both political will and a clear communications effort with partner countries and the U.S. Congress, adjusting the MCC lower income definition to the poorest 75 countries improves transparency and helps the MCC to meet its intended legislative mandate. While the administrative challenge of abrupt graduation will not vanish, it will become much rarer and more likely to reflect a real improvement in well-being of the population. Should this high level of growth occur for any given country, the move to a higher income category is warranted and should result in access to a smaller pool of resources.

Adoption of this proposal would require amending the MCC authorizing legislation. Such legislative changes should not be undertaken lightly. Indeed, one of the valuable characteristics of the MCC is that it has the latitude to make mid-course corrections without legislative changes, so long as these are in keeping with the spirit and intent of the MCC. Importantly, a technical fix in grouping MCC *candidate* countries will not dilute the MCC's ongoing process of determining which countries are *eligible* to develop compacts and receive funding. And in this case, legislative changes are both necessary and appropriate to enable the MCC to live up to the legislation's original intent: reducing poverty and promoting economic growth in objectively selected, well-governed poor countries.

Figure 5. The Current and Proposed MCC Candidate Pools Compared



Note: The grey rectangles represent low income countries as of FY2006 while the black rectangles represent lower middle income countries as of FY2006.

Table 1. Changes in the MCC Candidate Countries

Current System

	FY06 – FY07	FY07 – FY08	FY08 – FY09	FY09 – FY10
Graduates out of MCC Candidacy	• Romania	• Brazil • Bulgaria • Kazakhstan • Montenegro • Serbia	• Belarus • Cuba • Fiji • Jamaica • Suriname	• Algeria • Bosnia and Herzegovina • Colombia • Dominican Republic • Macedonia • Namibia • Peru
LIC → LMIC	• China • Morocco	• Angola • Armenia • Azerbaijan • Ukraine	• Georgia • Vanuatu	• Bhutan • Indonesia • Iraq • Kiribati • Paraguay • Philippines • Republic of Congo • Timor-Leste • Turkmenistan • Syria
LMIC → LIC				
Other	• Montenegro added as LMIC		• Kosovo added as LIC	• Belize added as new LMIC

Proposed System

	FY06 – FY07	FY07 – FY08	FY08 – FY09	FY09 – FY10
Graduates out of MCC Candidacy	• Romania	• Brazil • Bulgaria • Kazakhstan • Montenegro • Serbia	• Belarus • Cuba • Fiji • Jamaica • Suriname	• Algeria • Bosnia and Herzegovina • Colombia • Dominican Republic • Macedonia • Namibia • Peru
LIC → LMIC	• Armenia • Kiribati	• Azerbaijan • Angola		• Turkmenistan
LMIC → LIC	• Egypt • Syria	• Vanuatu • Kiribati		• Micronesia
Other	• Montenegro added as LMIC		• Kosovo added as LIC	• Belize added as new LMIC

Note: To determine income levels for this simulation, we used data as given by the World Development Indicators database by the World Bank. We used data current at the time MCC selected income group categories. This pertains to the published July updates of GNI per capita figures (Atlas method) for all years except for FY2006 where we used the April 2006 document. To rank countries whose income levels are presented as a range, we took the lower bound estimate. Tuvalu was assigned LMIC status in all years as supplementary sources roughly estimate its income level to be $2500 per capita.