# Regional and Sub-National Compact Considerations for the Millennium Challenge Corporation

Sarah Rose

September 2014


## Summary

With MCC entering its second decade, there are active questions about what it can do to expand its impact. One question is to ask how MCC might expand the set of partners with which it works. MCC was established to work only with relatively well-governed poor countries, and experience shows that the set of countries that meet these criteria does not change very much over time. MCC is already working in most of the countries that meet its criteria for good governance and there are few strong new contenders emerging. Because of this, many of the best prospects for future MCC partnerships will be subsequent compacts with countries that have a good track record of compact implementation.

There are other options worth considering, including regional compacts and sub-national compacts. From a development perspective, there are a number of reasons these two approaches make sense. However, there are a number of practical challenges to implementing each of them in accordance with MCC's model and guiding principles. While these are not necessarily insurmountable barriers, they are significant enough to make neither regional nor sub-national compacts clear, straightforward choices for MCC to expand its partnerships. MCC should be given the green light to explore these approaches but, as a first step, MCC should articulate how it would address these uncertainties. This note outlines the case for each approach, the practical challenges associated with each, and the policy options for pursuing them, including Congressional actions.


The MCC 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.

Sarah Rose is a senior policy analyst with the Rethinking US Development Policy Initiative at the Center for Global Development (CGD).

Center for Global Development

## Introduction

With MCC entering its second decade, there are active questions about what it can do to expand its impact. One question is to ask how MCC might expand the set of partners with which it works. MCC was established to work only with relatively well-governed poor countries, and experience shows that the set of countries that meet these criteria does not change very much over time. MCC is already working in most of the countries that meet its criteria for good governance and there are few strong *new* contenders emerging. Because of this, many of the best prospects for future MCC partnerships will be subsequent compacts with countries that have a good track record of compact implementation.[1]

There are other options worth considering, including regional compacts and sub-national compacts. From a development perspective, there are a number of reasons these two approaches make sense. However, there are a number of practical challenges to implementing each of them in accordance with MCC's model and guiding principles. While these are not necessarily insurmountable barriers, they are significant enough to make neither regional nor sub-national compacts clear, straightforward choices for MCC to expand its partnerships. MCC should be given the green light to explore these approaches but, as a first step, MCC should articulate how it would address these uncertainties. This note outlines the case for each approach, the practical challenges associated with each, and the policy options for pursuing them, including Congressional actions.

## Regional Compacts

### The Case for Regional Compacts

- Growth constraints are often cross-border in nature, such as insufficient or inefficient trade and transportation infrastructure.
- MCC often invests in projects like infrastructure that have an inherent regional component to them but cannot fully exploit this characteristic.[2]
- Many developing country officials are pursuing regional development approaches based upon trade agreements, commercial code harmonization, customs harmonization, etc.

### Practical Challenges

- ***Eligibility – Defining the Region:*** While there are pairs or groups of contiguous countries that currently meet MCC's scorecard criteria for eligibility, these might not always make the *most* sense as a "region", especially if it is not where the most important cross-national or regional constraints to growth occur. For instance, Tanzania has three adjacent southern neighbors that are or have been compact eligible (Malawi, Mozambique, and Zambia).[3] However, Tanzania has much deeper economic and

[1] Rose, S. (2014). Subsequent Compacts Are the Future of the Millennium Challenge Corporation. MCA Monitor Analysis. Center for Global Development: Washington, DC.

[2] In a number of compacts (for instance, Tanzania, Honduras, Nicaragua), MCC has built roads up to a national border and then stopped.

[3] Malawi and Zambia are currently implementing compacts. Mozambique completed a compact in 2013 but is not currently eligible for a second compact though it meets the scorecard criteria.

historical ties with its northern and western neighbors, which are part of the East African Community (Kenya, Uganda, Rwanda, Burundi). None of these countries currently meet MCC's scorecard criteria. Would all parties to a regional compact need to meet the scorecard criteria to be included, or would MCC make certain exceptions? Does the region need to be defined at the eligibility phase or could it be determined based on the findings of the constraints to growth analysis of an eligible country?[4]

- ***Suspension/Termination Considerations:*** There are a number of questions about the implications of suspension/termination in the context of a regional compact. Would the entire regional compact be suspended/terminated based on the actions of one party? Would MCC suspend/terminate just the activities in the particular country? What if the economic viability of the regional project were contingent upon the activities in the suspended/terminated country taking place? Past MCC experience highlights that this is a practical concern. In several prospective regional compact groupings (Central America, West Africa, Southern Africa), at least one of the countries per grouping has been suspended or terminated by MCC at some point.[5]
- ***Implementation Responsibility:*** Under MCC's current model, the host country government implements the compact via a specific governmental unit established to undertake this task, coordinate with government ministries, and ensure accountability. For regional compacts, this accountability mechanism will often become more diffuse, with multiple stakeholders.
- ***Structuring Incentives:*** It is already difficult for MCC to negotiate complex political issues as part of a bilateral partnership in which the gains from the compact investment accrue primarily to the recipient country. What can help make multilateral negotiations successful when one party may have reduced incentive to undertake necessary but difficult political reforms if the benefits accrue disproportionately to another party?

**<u>Congressional Policy Options</u>**

- ***Status Quo:*** Currently, MCC can theoretically pursue regional approaches through individual compacts in neighboring countries that are simultaneously eligible. However, this requires careful and difficult coordination around the timing of eligibility decisions and the separate, bilateral compact development processes.
- ***Concurrent Compacts:*** Alternatively, Congress could provide MCC with concurrent compact authority. Currently, MCC can have just one compact at a time per eligible country. If forced to choose between a national compact and a regional compact, many countries (particularly coastal economies) may opt for a compact that is largely or entirely focused on addressing domestic priorities. Concurrent compact authority would

[4] MCC's standard bilateral engagement with a country starts at selection for eligibility (based on scorecard performance). Shortly thereafter, the country (with support from MCC) is required to undertake a constraints analysis to identify the country's binding constraints to growth and provide a focus for the proposed compact investments. For a regional approach, there could be two options for identifying the pairing or group of countries that would make up the region: at selection and after the constraints analysis. The first option would entail selecting a group of countries as a region and conducting a constraints analysis for this pre-defined group. With the second option, MCC would continue its standard practice of selecting single countries as eligible, and then, should the constraints analysis reveal a regional constraint to growth involving one or more neighboring countries, decide whether to additionally select those countries as eligible to participate in a regional compact.

[5] These include Nicaragua, Honduras, Mali, and Malawi.

enable MCC to pursue regionally focused projects linked to neighboring countries' compacts while simultaneously advancing a distinct nationally focused compact.[6]

- ***New Regional Compact Facility:*** Congress could establish a new dedicated MCC facility for advancing regional projects, which would be based upon customized performance-based selection criteria. Several multilateral development banks, such as the World Bank and African Development Bank, have similar performance-based facilities.[7] However, the implications for MCC's core country-based business model would need to be carefully considered.

## Sub-National Compacts

**<u>The Case for Sub-National Compacts</u>**

- Some countries that do not meet MCC's eligibility criteria (which largely measures national performance) may have state, municipal, or other local governments that are relatively well governed.
- Relative development levels are often unevenly distributed throughout a country, with large pockets of poverty concentrated within sub-national regions.

**<u>Practical Challenges</u>**

- ***Eligibility – Identifying Strong Performers:*** Determining how to select prospective sub-national units is far from straightforward. MCC has long stressed the importance of using high-quality, transparent, and broadly comparable third-party data to evaluate countries for eligibility. This type of information does not exist for sub-national units within nor across most developing countries for many policy areas of interest. In practical terms, MCC would have significant difficulty systematically and impartially comparing policy performance among 36 Nigerian states. Comparing the performance of these states to that of cities in India or counties in Kenya could be even more complex. There are some options MCC could pursue though none fully address this challenge. For instance:
  - *Considering sub-national data on MCC scorecard indicators:* If a country falls short on the scorecard criteria due to its performance on indicators for which sub-national governments have their own data[8], MCC could potentially consider those local units for eligibility. However, data from sub-national units are often not vetted by international institutions, which raises material questions about data quality. In addition, there are only a few countries that currently would fall into

[6] By illustration, the regionally focused compact could include transportation-related projects (e.g., roads and customs harmonization) that improve linkages with neighboring countries. The nationally focused compact could focus upon other priorities that arise from economic constraints analyses.

[7] The World Bank and African Development Bank concessional finance windows (IDA and AfDF) both have regional project carve outs from their core performance-based allocation system. These regional project carve outs receive a specified percentage of total available resources (e.g., 25 percent). Regional projects are then considered on a first-come basis according to a set of performance-based filters. For instance, the AfDF has a scorecard system that ranks proposed regional projects according to program quality and potential development impact, as well as policy performance and programmatic track record of proposed participating countries.

[8] Examples include: health expenditures, primary education expenditures, girls' primary education completion rates, and immunization rates.

this category. Of the 43 candidate countries that did not meet MCC's scorecard criteria in FY2014, the corruption and/or democracy hard hurdles were responsible for 40 of those failures.[9]

- *Considering if a country falls short on scorecard indicators that primarily reflect national-level policymaking rather than local-level governance:* If a country falls short on indicators that reflect national policies over which sub-national units have little or no control[10], MCC could consider that country for a sub-national compact. However, there remains the challenge of identifying which sub-national units within that country would be best positioned for compact selection. As with the aforementioned option, there are few countries for which the binding constraint to passing the scorecard relates to indicators that measure only national-level policy.

- ***Reduced Country Ownership:*** One of the pillars of MCC's core model is that country ownership is important. As part of this, MCC gives countries the responsibility to identify the growth constraints to target and the projects to address them (with guidance and input from MCC). As part of this process, the national government determines where within the country MCC investments will take place. Working with sub-national units could preserve many key aspects of local ownership (the sub-national government would presumably still lead the process of project identification), but giving MCC the task of selecting the localities in which it would work takes this important decision away from a democratically elected national government. Whether that is the right role for MCC to take in the context of country ownership is an important question to consider. To move forward, MCC would need to determine the right way—in the absence of a formal bilateral agreement—to bring the national government into key processes such that its support of *local* ownership does not undermine the fundamental concept of *country* ownership.
- ***Conditions Precedent:*** Most development agencies understand that successful program implementation requires policy contributions by country partners.[11] A compact with a sub-national entity could presumably include policy requirements within the respective government's control. However, this may be somewhat limiting in practical terms, particularly where sub-national governments' powers are more limited. How, in the absence of an agreement with the national government, would sub-national programs address potential policy or institutional bottlenecks that exist at the national level?[12] Would limiting investments only to opportunities that would not require national-level legal/policy changes to achieve impact be too constraining?.

[9] Data measuring these issues are not currently available for most sub-national units within developing countries.
[10] Examples include trade policy and the time required to establish a new business.
[11] All MCC compacts include "conditions precedent", and the impact MCC believes its investments can achieve (along with cost-effectiveness considerations) is highly contingent upon the partner country fulfilling its obligations.
[12] Many MCC compacts have included conditions precedent that requires changes in national law. For instance, MCC has, through its investments, helped encourage the passage of: changes to the rural landholding law in Benin, laws to promote access to improved seed varieties in Ghana, gender equality laws in Lesotho, and policy changes to increase funds for road maintenance in El Salvador and Ghana.

- ***Size Considerations:*** In most countries, sub-national units will be relatively small in terms of population and potential development impact. There are important efficiency considerations when it comes to working on a smaller scale, and MCC and its board of directors have often chosen not to select small countries that otherwise meet MCC's eligibility criteria.[13] In practice, this means that many countries' sub-national units will be excluded from consideration based on size, or that sub-national units will be chosen based on size rather than policy performance criteria.[14]

**<u>Congressional Policy Options</u>**

- ***Status Quo:*** 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. General support/encouragement to MCC to consider sub-national compacts would provide increased impetus for staff to think through options to operationalize them.
- ***Concurrent Compacts:*** Concurrent compact authority would enable MCC to have a national and sub-national compact in the same country (i.e. a compact with Tanzania and a compact with Kigoma, an administrative region). However, this does little to expand MCC's pipeline of partners beyond existing countries. In addition, it is unclear what benefit it would achieve beyond simply increasing the funds to a particular country, since MCC's national partnerships all entail selecting particular regions/localities for the compact's physical investments.

[13] This is not universally true. MCC has had compacts with Vanuatu (population 250,000) and Cape Verde (population 500,000). It has passed over others like Samoa and Guyana which have had (at least for some period of time) relatively consistently good performance on MCC's scorecards.

[14] For example, a capital city is selected as eligible since it is the only substantially populous city within the respective country.