A Note on the MCC Selection Process for 2005

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On August 31st, 2004, the Millennium Challenge Corporation (MCC) announced some modest changes in the process it will use to select countries for MCC eligibility in FY 2005.[1] This brief note appraises those changes, focusing on the "school completion rate" and "inflation" indicators. It comments on possible future changes in the process, both in terms of the indicators and the country candidate list. It also discusses the Board's use of discretion in going beyond the indicators, with particular reference to some of the decisions made for the first-round qualifying countries as announced in May 2004. A companion paper will examine the new set of indicators and the countries most likely to qualify in round two. The main conclusions are as follows:

- The change in indicators from the overall primary school completion rate to the girls' primary school completion rate should be supported.
- The change in the inflation hurdle from 20% to 15% is not of great concern, but a further reduction to 10% in future years is unwarranted and cannot be supported by the research on the link between inflation and growth in low-income countries.
- The candidate country list should not be expanded to include countries with incomes between $1,465 and $2,935 as was originally envisioned until the President proposes and Congress approves significant additional funding close to the original $5 billion figure.
- In the spirit of transparency and accountability, the MCC Board should announce publicly its rationale for its country eligibility decisions for each country (not just some) when these vary from the indicators approach.
- The Board should resist making decisions on eligibility based on political considerations, as apparently was the case with Georgia in round one. Countries deserving of U.S. assistance to support political transitions should receive funds from programs designed for that purpose, not from the MCC.

Changes to the Selection Process

Girls' primary school completion rate. The MCC will replace the overall primary school completion rate with the girls' primary school completion rate. This is an important and positive change. There is substantial evidence linking higher levels of girls' education to a range of development outcomes, including improved health, education, and economic growth. In very simple back-of-the envelope tests using the MCC data, girls' primary school completion is strongly associated with lower infant mortality and higher levels of literacy, both with one percent statistical significance (after controlling for the level of income). It is also positively correlated with economic growth, but not with statistical significance as measured at conventional levels. Adding this indicator sends an important

[1] http://www.mcc.gov/public_affairs/press_releases/FY05%20Selection%20Process.pdf

signal to recipient countries about the importance of girls' education. In the future, the MCC should consider adding the girls-to-boys enrollment ratio as a new indicator, which would put further emphasis on this important area.

The quality of the new indicator is comparable to that of the old. Of the 83 countries used to calculate the median, 65 have the overall completion rate and 64 have the girls' completion rate. Both the old indicator and the new one are several years out of date for some countries, which is a concern, but this problem does not seem to be significantly different with the new indicator. The median primary completion rate for girls' is 66.4 percent, as against 69.5 percent for the whole population. Overall, the change to the new indicator has only a small impact on the selection process because the two data series are very highly correlated. Only two countries that were above the median on the old indicator do not pass the new one: China (because of missing data) and Cambodia. Two others would not have passed the old indicator, but are above the median on the new one: Honduras and Lesotho (both of which already qualified for the MCA in round 1).

Inflation. The MCC has changed the inflation hurdle from 20% to 15%. This is a more puzzling change. The original intent of the indicators was to use them to separate good policy performance from poor in terms of the relationship between key policies, growth, and other key development outcomes. For most indicators, while there is strong evidence of a positive association with growth, there is little evidence of a particular level which separates good policy from poor policy. Thus, the median level is used as an arbitrary measure. However, on inflation, while there is substantial research showing that very high rates of inflation are strongly associated with low growth, there is much less evidence that in developing countries differences in inflation rates below 20% have much effect on growth.[2] This was the key reason why the original ceiling was set at 20%.

The MCC announcement of the changes stated that the inflation ceiling was modified "to make it a more meaningful test of a country's economic policies." It is unclear what this means. Perhaps there was some discomfort that in round one 68 of the 75 countries passed the hurdle. But since the original hurdle was established on the basis of strong research evidence, the fact that so many countries pass the hurdle should be a reason to celebrate, not move the hurdle. The purpose of the hurdle is not to "weed out" countries for the purpose of having fewer qualifiers, but to distinguish those with good policies from those with poor. Lowering the inflation hurdle seems aimed more at the former rather than the latter.

In and of itself, reducing the inflation ceiling to 15% makes little difference. For the current round, whereas 65 of 70 countries pass the 20% test, 64 pass the 15% test. Of greater concern are reports that the MCC is considering reducing the ceiling further to 10% next year. Only 51 countries have inflation rates below 10%, meaning that 13

[2] Michael Bruno and William Easterly (1998) find a negative association between inflation and growth only when inflation exceeds 40%. Christoffersen and Doyle (1998) find a negative impact of inflation on growth beginning only at 13% in the transition economies of Eastern Europe. Kahn and Senhadji (2000) estimate 20% inflation as the upper end of the 90% confidence interval for the point at which inflation begins to have a negative impact on growth in developing countries.

countries are between 10-15%. This group includes Ghana, where inflation was nearly 15% in 2002 and GDP growth was 4.5%, and increased to over 5% in 2003. It makes little sense to penalize these countries in the absence of strong evidence that inflation rates between 10% and 15% have a negative impact on growth. *The MCC should not reduce the inflation rate below 15% in the future*.

Country Candidate List. As expected, the MCC will expand the list of candidate countries to include all countries with per capita incomes below $1,465 that are eligible to receive US foreign assistance. 83 countries meet the income cutoff, of which 70 are also eligible to receive US foreign assistance.[3] By comparison, in round 1 (which included the extra stipulation that countries be categorized as IDA-eligible by the World Bank) 75 countries made the income/IDA requirements (with an income cutoff of $1,415), of which 63 were eligible to receive US assistance.

Four countries that made the income requirement for round 1 have experienced an increase in per capita income such that they are now above the ceiling and are no longer candidate countries: Albania, Bosnia and Herzegovina, Cape Verde and Tonga. Of the four, only Cape Verde was declared an eligible country in round 1. Presumably the MCC will honor the declaration of Cape Verde's eligibility so that the country will still be able to submit its proposal. So long as Cape Verde's compact is approved by the Board and it meets the performance standards encompassed in that compact, it should remain eligible. Once its compact ends, if it is still above the income ceiling, it should "graduate" from the MCC and no longer be eligible for MCC assistance.

Looking forward, the administration's original plans for the MCC suggested that in the third year (2006), the pool of candidate countries would expand significantly to include all countries with per capita incomes between $1,465 and $2,935. This proposal was problematic from the beginning, as these countries generally have access to market-based sources of development finance, and most already have graduated from other aid programs.[4] But with current budget constraints, it has become even more imprudent to consider further expansion of the country candidate list beyond those on the list for FY 2005. The administration's original proposal called for over $3 billion in funding in FY 2005 and $5 billion in 2006 to support the expanded country list. With the administration scaling back its FY 2005 request to $2.5 billion, Congressional discussions hovering around a figure closer to $1 billion, and so far only a tepid response from the administration, the higher budget figures now seem highly unlikely. *The candidate country list should not be expanded further in the future unless Congress approves significant additional funding close to the original $5 billion figure*.

Changes for the future: The MCC is exploring other changes for the future, including indicators on entrepreneurial activities, investments in people, trade barriers, and natural resource management. Many observers have been advocating for changes in these areas

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[3] The thirteen countries that meet the income requirement but are not eligible to receive US assistance are Burundi, Cambodia, Central African Republic, Cote d'Ivoire, Cuba, Guinea-Bissau, Liberia, Myanmar, Somalia, Sudan, Syrian Arab Republic, Uzbekistan, and Zimbabwe.

[4] For a discussion, see Steve Radelet (2003), pp. 25-28

for some time. These changes could be important, both because some important areas are missing (e.g., natural resources) and because some of the current indicators are weak (especially the trade, education spending, and health spending indicators). Nevertheless, it was prudent to not rush these changes through for round two, both because it would have made little sense to significantly change the rules so quickly after round one, and because high quality indicators for these other areas are not readily available. At the same time, the MCC must move quickly to initiate work on these indicators now so that they will be ready in time, lest they be stuck again searching for new indicators at the last minute. The weaknesses in the current set of indicators have been obvious since they were first announced nearly two years ago, but little progress has been made so far in improving them

In addition to changing these indicators, the MCC should consider other changes to the selection process. Four stand out. First, the MCC should change from using median values to using absolute hurdles. For example, instead of using the median immunization rate, the MCC should use a specific hurdle (such as 75%) and stick with it. Under the current system, the medians change, creating moving targets for recipient countries and in effect constantly changing the MCC's standard for good policy. Second, the MCC should add two new indicators in the "investing in people" category, since this area is under-represented (with only four indicators) relative to the "ruling justly" and "economic freedom" categories (each with six indicators). In particular, the MCC should add the girls-to-boys enrollment ratio and an additional health policy variable. This step is important both to send a strong signal to potential recipients and because of the very strong evidence linking better health and education to more rapid long-term growth. Third, the MCC should consider changing the hard hurdle on corruption. Fourth, it should investigate ways to change the bias against the poorest countries inherent in the current selection system. These issues have been discussed in depth elsewhere, so we do not repeat the arguments here.[5]

Use of Board Discretion

Although the selection process can be strengthened, it will never be perfect. Therefore it is appropriate that the Board use some discretion in determining the final list of eligible countries. It may makes sense to adjust the list to add countries that just miss, or drop countries that meet the quantitative targets, so long as the change is consistent with original intent of the MCA.

During the first round, the Board did not select 4 countries that passed the indicators test: Bhutan, Vietnam, Mauritania and Guyana. The first three of these presumably were not selected because they failed all three of the democracy indicators (civil liberties, political rights, and voice and accountability). All of the countries selected passed these three hurdles. Guyana's omission was less clear, but it may have been because it was one of only ten countries worldwide to be given a Tier III (lowest) ranking by the State

[5] See, for example, Radelet, Lucas, and Bhavnani, "A Comment on the Millennium Challenge Account Selection Process," http://www.cgdev.org/Research/?TopicID=36.

Department in its 2004 Trafficking in Persons Report. These possible explanations are reasonable, but unfortunately the Board did not publicly state its reasons.

At the same time, the Board declared eligible 3 countries that did not pass the indictors test: Bolivia, Mozambique and Georgia, and provided a brief rationale for these decisions.[6] Bolivia came as close as possible to qualifying by the numbers, missing out because it was at the median (rather than above) on the corruption indicator. Mozambique showed clear positive trends in the "investing in people" indicators that it missed, and scored relatively well on Transparency International's corruption index. Again, both of these changes were justifiable.

By contrast, the selection of Georgia was very troubling, because it ran directly counter to the core idea of the MCA that countries are chosen on the basis of ***demonstrated*** commitment to strong development policies, not on promises. The Board stated that it supported the decision based on progress of the new government during its first three months, including establishing two new bureaus, initiating procurement legislation, and unifying treasury accounts. But this is a weak rationale: many countries have created anti-corruption bureaus and started the legislative process on procurement, but most falter. To reward Georgia before it follows though on these initiatives and achieves any results is inconsistent with the treatment of other countries in the MCA process. The process and rationale suggest that the decision was driven by the administration's desire to support Georgia's political transition to a newly elected president. While this goal is certainly justifiable from a U.S. foreign policy perspective, it is not an appropriate use of MCA funds. The appropriate financial vehicle to support Georgia's transition is the State Department's Economic Support Fund, not the MCA.

Two main lessons emerge from the use of discretion during the first round:

- *First, the Board should make clear the reasons why it used discretion in each case*. One of the core principles at the heart of the MCA is a transparent and objective selection process. That objective is best met when the Board makes clear why they have used their discretion in each case. While many of the changes made in round one seem sensible, and the Board provided some rationale for some of its decisions, it did not do so in all cases, especially those that passed the tests but were not deemed eligible.
- *Second, there is a clear danger in politicizing the MCC selection process*. The selection of Georgia sets the unfortunate precedent of MCC funds being used for political purposes when other programs designed for that purpose are short on funding. Further politicization of the MCC selection process along these lines will weaken the program's ability to meet its objectives and to enjoy continued strong support.

[6] http://www.mcc.gov/countries/eligible/Report_Selection_FY04.pdf

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