A Comment on the Millennium Challenge Account Selection Process

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The Millennium Challenge Account (MCA) is a welcome initiative that could dramatically improve the effectiveness of U.S. foreign assistance. The MCA will distinguish itself by targeting a relatively small number of recipient countries based on their demonstrated commitment to sound development policies; providing them with sums of money large enough and flexibly enough to make a real difference; and holding them much more accountable for achieving results. The program's clear focus on economic growth and poverty reduction, its unique design, and its promised funding of \$5 billion per year, if realized, could together make this the most important change in U.S. foreign assistance policy in 40 years.

This note focuses on the critical issue of the county selection process, and follows the publication of the Millennium Challenge Corporation's "Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2004." The proposed selection process has several strengths and weaknesses which have been thoroughly discussed and debated during the last15 months. Overall it is a reasonable starting point for the MCC, although there are several simple steps that could be taken to improve the system. In what follows we highlight some key points and recommendations.

I. Many Recommendations, But No Change

The most striking aspect of the MCC's proposed selection process is that it is essentially unchanged (other than the sources for a few indicators and some additional qualitative assessments) from what the administration originally proposed in November 2002. In the 15 months since the original proposal, there has been significant public comment and written analysis of the selection process from a wide variety of sources (Radelet, 2003; Brainard et. al., 2003; Birdsall et. al, 2002; Kaufmann and Kraay, 2002; Pasicolan and Fitzgerald, 2002; Palley, 2003; Sperling and Hart, 2003; Interaction, 2003; Catholic Relief Services, 2003). These analyses have made recommendations on a wide range of topics, including the weight given to democracy, the weight given to private enterprise, the exclusion of gender-related indicators, the dangers of relying on the medians, concerns over control of corruption as a hard hurdle, changing to an aggregate weighting system rather than medians, giving more weight to African countries, using changes rather than levels for the indicators, and several other issues.

The striking fact is that the proposed system remains essentially unchanged in the wake of all this analysis. This raises the question of whether the administration considered any of the recommendations, whether it did any internal analysis on them, and if and how it will consider material submitted during the official comment period this month. Transparency and accountability are the spirit and foundation of the MCA, and would suggest that the MCC should make public any additional internal analysis it has done on the selection process.

II. Changes in Sources

When the selection process was initially announced in November 2003, all sixteen indicators were based on publicly available sources. In hearings for the Senate Foreign Relations Committee and House International Relations Committee in March 2003, administration witnesses emphasized the importance of publicly available sources that anyone could download from the internet and check for accuracy. However, several data sources now have been changed, and some of the indicators are now drawn from non-public sources.

- The indicators for *public expenditure on health* and *public expenditure on primary education* originally were to have been obtained from the "World Bank/national sources" but will now be culled exclusively from "national governments."
- The budget deficit data originally were from "IMF/National sources" and now will come from "national governments."
- Inflation data were to have been obtained from the IMF but will now be obtained from unspecified "multiple" sources.

It is not clear why the administration changed these sources, but presumably it is because data are missing for several countries. Since countries are penalized when data are missing (as it counts as a missed hurdle), it makes sense to try to fill in the missing data where possible. However, doing so raises some very important issues:

- Obtaining data from national governments creates perverse incentives for them to over-report their spending on health and education, and under-report budget deficits.
- There is the danger that the indicators will be defined differently in different countries, making them impossible to fairly compare across countries (this is especially the case for budget deficits, for which there are several alternative definitions).[1]
- These sources are not publicly available, and therefore cannot be checked and scrutinized in the same manner as the other indicators. The foundation of the selection process is that the indicators come from <u>neutral</u>, <u>public</u> sources, so that the accuracy of the data can be checked and verified, but these sources put that in doubt. Using data from non public sources will undermine the MCA's commitment to transparency.

If the administration uses these sources, it should make the data available to the public <u>before</u> it announces its list of qualifiers for 2004. It is imperative that these data be

[1] The most appropriate definition for the MCA is to measure the deficit after receipts of grants and concessional loans, since deficits financed by these donor flows do not represent a problem.

available for public scrutiny so they can be compared with other sources, ensure that appropriate and comparable definitions were used, and otherwise checked for accuracy.

Moreover, this should be seen as a short run solution. The MCC should work hard with the World Bank and IMF to ensure that member countries report budget data to these organizations on a more timely and accurate basis, so that in turn comparable data can be made available from these institutions as neutral and public sources.

III. Bias against the Poorest Countries

The current approach, by relying on the *levels* of the indicators, creates a built-in bias against the poorest countries of the world. It is much more difficult for the poorest countries of the world (with annual incomes below $300 per capita) to pass some of the hurdles than for the relatively richer countries (with per capita annual incomes above $1000). This is especially true for the "investing in people" indicators but is also true for the five governance indicators drawn from the World Bank Institute and the country credit rating. For these ten indicators, there is a clear positive relationship between the level of income and the indicator score, with poorer countries scoring lower than the relatively richer countries. Although causality can never be absolutely proven, there are good reasons to suspect that very low income creates a substantial barrier to scoring well on these indicators.

The immunization rate and primary school completion rate provide two good examples. Consider two countries, one with per capita income of $250 (Country A) and the other with per capita income of $1,250 (Country B). Each spends 2% of national income on health and education. Thus country A spends $5 per capita per year on health and education, while Country B spends $25 per capita per year on each. Obviously Country B is in a much stronger position to increase its primary school completion rate and immunization rate. Country A faces a huge disadvantage, simply because it is poor. It would have to spend 10% of its income on health and education – an implausibly high figure – just to be on the same footing as Country B.

There are three possible solutions to this problem:

1. One could estimate the relationship between income and the indicator, and judge a country based on its expected score for its income rather than against the median. While this solution has theoretical merits, the uncertainties in the estimation process render it an impractical solution.
2. Countries could be scored on the *changes* in the indicator, rather than the level. This solution has several merits and is the right medium-term goal. However, using changes requires slightly higher quality data (with a better time series and less measurement error), but this is an appropriate medium term goal for the MCA. But it only goes so far in addressing the income bias, as poor countries face obstacles in making large changes in the indicators in a given year.
3. The comparator group could be divided in half. The core group of 75 countries (increasing to 87 next year) could be divided into two similar sized groups (with a dividing line somewhere between $400 and $450 per capita), with medians calculated

for each group. In that way, the poorest countries would be competing only against other poor countries, not countries with income 5 or even 6 times greater than their own. The MCA has already partially embraced this strategy by planning for the countries with per capita incomes between $1,415 and $2,935 to compete separately in 2006. This principle should be extended to by dividing the low income group into two sub-groups in the first year, and should be combined with using changes in these indicators when the data sources are robust enough to support this change.

IV. Using the Medians

The use of the median as the hurdle raises three concerns:

- First, medians change from year to year. As result, countries will be aiming at moving targets, which is less than ideal both for recipient countries and for the MCC. Moreover, changing medians imply that countries can gain or lose eligibility over time based not on their own progress, but that of others.
- Second, using medians as benchmarks severely restricts the potential for the number of MCA countries to expand over time. As countries strive to improve their scores to what are now acceptable levels, the medians will rise, and the number of qualifiers will not.
- Third, several of the indicators have narrow, discrete scales (i.e., rated from 1 to 7 with only whole numbers) so that a large number of countries are bunched together on the median. This means that far fewer than half the countries score above the median. These narrow, discrete scales are less than ideal for MCA purposes. For example, the trade policy index is weak because of the large number of missing data (17 out of 75 countries) and its narrow scale (effectively from 2 to 5). As a result of this combination, only 20 countries of 75 receive scores above the median on this indicator, which is obviously contrary to the design of the indicators approach. The rule of not counting scores equal to the median as passing the hurdle unnecessarily eliminates some countries.

Because of these concerns, the administration should:

1. Quickly adopt absolute hurdles for as many indicators as possible, perhaps using the medians from the first year as a guide (e.g., an immunization rate of 72). This step could be taken immediately for the four "investing in people" indicators, inflation (already using an absolute standard of 20 percent), the budget deficit, and days to start a business. It will be more difficult to take this step for the other indicators, but the administration could work with the suppliers of the data to explore ways in which the other indicators can be adjusted to an absolute scale that could be compared over time.
2. Either look for alternatives or refine some of the indicators that use very narrow scales resulting in many countries bunched together near or at the median. The Heritage Foundation/Wall Street Journal trade policy index is the weakest indicator in this area, but the Freedom House civil liberties and political rights indices are also of concern. Once this step is taken, the administration can allow median scores to be a passing grade on each hurdle.
3. Adjust the criteria for passing a hurdle from *above* the median to *equal to or above*.

One further issue on the medians is the question of whether or not to include countries that are ineligible for U.S. foreign assistance in calculating the medians. The basic purpose of the medians is to establish a standard for passing an indicator, relative to the performance of all other developing countries. It makes sense to include the scores of *all* other comparator countries, including those that for whatever reason also happen to be ineligible for U.S. foreign assistance. To exclude those countries from calculating the medians would create odd results. For example, consider a situation in which no countries are ineligible for U.S. assistance. Then one country, presumably already poorly governed and near the bottom of the "ruling justly" list, does something to make its situation worse, such as egregiously violate human rights. Stopping U.S. assistance makes sense, but dropping its score from the MCA selection process does not. The reason is simple: dropping the country would change the median (presumably increasing it) which in turn would penalize another country from gaining MCA eligibility. It makes no sense to penalize one country because another country goes from bad governance to much worse. Thus countries that are ineligible for U.S. assistance should be included in the calculations of the median, but obviously excluded from receiving MCA funding.

V. The "Hard" Hurdle on Corruption

The proposal to eliminate all countries with corruption scores below the median regardless of their performance in other areas should be reexamined. Margins of error in estimating the indicators can be a significant problem because for a country with an observed score just below the median on any indicator, one cannot have a high degree of confidence that the actual level is below the median. The biggest concern with measurement errors is the hard hurdle for corruption: a country that scores below the median on corruption is eliminated from qualifying for the MCA, regardless of its scores on other indicators. This means that the eligibility of a given country can hinge on the accuracy of one criterion only – control of corruption. Although the high standard on corruption is crucial to ensure effective use of MCA funds, the make-or-break requirement may unnecessarily eliminate some countries. Dani Kaufmann and Aart Kraay, the designers of this index who know its strengths and weaknesses better than anyone, have written convincingly of the problems associated with fully eliminating from the MCA all countries with scores equal to or below the median (Kaufmann and Kraay, 2003).

There are three alternatives:

1. The administration could fully eliminate only those countries that score in the bottom quartile on corruption, rather than the bottom half. Countries in the second quartile would not be given credit for passing the hurdle, but would not be eliminated from the MCA either.
2. The administration could eliminate countries where the data (and the corresponding margins of error) indicate that there is a 75 percent or greater chance that the true score is below the median. Of those that remain, only those above the median would get credit for passing the hurdle; others would not be given credit but would not be eliminated from the MCA.

3. For countries that otherwise pass sufficient hurdles to qualify but are below the median on corruption, the MCC should initiate a deeper qualitative assessment of their control of corruption before deciding to eliminate them. This would involve consultations with the government and review of secondary sources and other relevant information, and a closer examination of the sources and margins of error in the WBI index. The MCC's report on the selection process hints that it might follow something like this procedure (e.g., by also examining Transparency International's corruption index), but the description is vague. If this is the intention, more clarity is required on what the process will entail.

V. Additional Indictors

There are a range of additional or alternative indicators that should be considered in order to strengthen the selection process:

- Most importantly, the "investing in people" indicators should be expanded to include the ratio of girls to boys in primary schools, plus one other health indicator.
- Budget data should be improved to refine the measure of the budget deficit (measured after receipt of grants and net concessional loans).
- Countries should be urged to make available data on tariff and non-tariff barriers to trade, with a breakdown for capital and intermediate goods. These data could replace the current trade indicator, which is among the weakest of the indicators, both because of its subjectivity and narrow range of scores.
- Data on "days to start a business" should be expanded to include information on other barriers to start new business, and its country coverage should be expanded substantially.

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