

Millennium Challenge Corporation

# Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in Fiscal Year 2008

September 2007



REDUCING POVERTY THROUGH GROWTH

## Summary

This report to Congress is provided in accordance with Section 608(b) of the Millennium Challenge Act of 2003, 22 U.S.C.A. §§7701, 7707(b) (the “Act”).

The Act authorizes the provision of Millennium Challenge Account (MCA) assistance to countries that enter into Compacts with the United States to support policies and programs that advance the prospects of such countries achieving lasting economic growth and poverty reduction. The Act requires the Millennium Challenge Corporation (MCC) to take a number of steps in determining the countries that, based on their demonstrated commitment to just and democratic governance, economic freedom and investing in their people and the opportunity to reduce poverty and generate economic growth in the country, will be eligible for MCA assistance during Fiscal Year 2008 (FY08). These steps include the submission of reports to the congressional committees specified in the Act and the publication of Notices in the *Federal Register* that identify:

1. The countries that are “candidate countries” for MCA assistance during FY08 based on their per-capita income levels and their eligibility to receive assistance under U.S. law, and countries that would be candidate countries but for specified legal prohibitions on assistance (Section 608(a) of the Act);
2. The criteria and methodology that the Board of Directors of MCC (the “Board”) will use to measure and evaluate the relative policy performance of the candidate countries consistent with the requirements of Section 607 of the Act in order to select “MCA eligible countries” from among the “candidate countries” (Section 608(b) of the Act); and
3. The list of countries determined by the Board to be “MCA eligible countries” for FY08, with justification for eligibility determination and selection for compact negotiation, including which of the MCA eligible countries the Board will seek to enter into MCA compacts (Section 608(d) of the Act).

This report sets out the criteria and methodology to be applied in determining eligibility for FY08 MCA assistance.

## Changes to the Criteria and Methodology for FY08

MCC reviews all of its indicators annually to ensure the best measures are being used and, from time to time, recommends changes or refinements if MCC identifies better indicators or improved sources of data. MCC takes into account public comments received on the previous year’s criteria and methodology and consult with a broad range of experts in the development community and within the U.S. Government. In assessing new indicators, MCC favors those that: (1) are developed by an independent third party; (2) utilize objective and high quality data that rely upon an analytically rigorous methodology; (3) are publicly available; (4) have broad country coverage; (5) are comparable across countries; (6) have a clear theoretical or empirical link to economic growth and poverty reduction; (7) are policy linked (i.e., measure factors that governments can influence within

a two to three year horizon); and (8) have broad consistency in results from year to year. There have been numerous noteworthy improvements to data quality and availability as a result of MCC's application of the indicators and the regular dialogue MCC has established with the indicator institutions. While improvements to the selection criteria are critical, MCC is also mindful of the need to provide countries with a fairly stable set of policy criteria to meet, if MCC is to create significant incentives for reform. This factor is also taken into account when MCC is considering indicator changes.

Considering these factors and the input on the indicators during the FY07 public comment period, MCC has conducted extensive research and consultations with experts and relevant stakeholders in the development community. That input has been taken into account in creating the criteria and methodology for the selection of compact eligible countries for FY08.

## 1. Natural Resource Management Indicators

MCC is incorporating two measures—a *Natural Resource Management index* and a *Land Rights and Access index*—into the FY08 selection criteria and MCC Scorecard. In FY07, MCC concluded a public search for indicators to address MCC's congressional mandate of measuring "a country's economic policies that promote sustainable management of natural resources." MCC's Board of Directors approved these indicators as supplemental information for the FY07 selection process and, for later consideration as part of the formal selection criteria in FY08. This gradual integration of the Natural Resource Management and Land Rights and Access indicators into the formal eligibility criteria was designed to provide adequate notice to compact, threshold and candidate countries of the new measures and their performance before the new indicators were formally adopted. Over the course of the last year, MCC brought the new indicators—and any relevant performance issues—to the attention of candidate, threshold and compact countries. MCC also conducted extensive consultation on the appropriate placement of the indicators into the respective policy categories contained on the MCC Scorecard. A brief summary of the indicators follows; a detailed rationale for the adoption of these indicators can be found in the FY07 Selection Criteria and Methodology Report.

### *Natural Resource Management Index*

The Natural Resource Management Index has four sub-component indicators and is jointly produced by the Center for International Earth Science Information Network (CIESIN) and the Yale Center for Environmental Law and Policy (YCELP).

- **Eco-Region Protection:** Produced by CIESIN, this component assesses whether countries are protecting at least 10 percent of all their biomes (e.g., deserts, tropical rainforests, grasslands, savannas and tundra). It is designed to capture the comprehensiveness of a government's commitment to habitat preservation and biodiversity protection. The World Wildlife Fund provides the underlying biome data,

and the United Nations Environment Program World Conservation Monitoring Center—in partnership with the IUCN World Commission on Protected Areas and the World Database on Protected Areas Consortium—provide the underlying data on protected areas.

- **Access to Improved Water:** Produced by the World Health Organization (WHO) and the United Nations Children’s Fund (UNICEF), this component measures the percentage of the population with access to at least 20 liters of water per person per day from an “improved” source (household connections, public standpipes, boreholes, protected dug wells, protected springs and rainwater collection) within one kilometer of the user’s dwelling.
- **Access to Improved Sanitation:** Produced by the WHO and UNICEF, this component measures the percentage of the population with access to facilities that hygienically separate human excreta from human, animal and insect contact. Such facilities include sewers or septic tanks, pour-flush latrines and simple pit or ventilated improved pit latrines, provided that they are not public.
- **Child Mortality (Ages 1-4):** Produced by the Population Division of the United Nations Department of Economic and Social Affairs, this indicator measures the probability of a child dying between the ages of 1 and 4. Since the underlying causes of child mortality among 1-4 year olds are predominantly environmental, this indicator is considered to be an excellent proxy for environmental conditions.

### *Land Rights and Access Index*

The Land Rights and Access Index includes three indicators:

- **Access to Land:** Produced by the International Fund for Agricultural Development (IFAD), this indicator assesses the extent to which the institutional, legal and market framework provides secure land tenure and equitable access to land in rural areas. It is made up of five subcomponents: (1) the extent to which the law guarantees secure tenure for land rights of the poor; (2) the extent to which the law guarantees secure land rights for women and other vulnerable groups; (3) the extent to which land is titled and registered; (4) the functioning of land markets; and (5) the extent to which government policies contribute to the sustainable management of common property resources.
- **Days to Register Property:** Produced by the International Finance Corporation (IFC), this component measures how long it takes to register property in the capital city. The IFC records the full amount of time necessary when a business purchases land and a building, and to transfer the property title from the seller to the buyer so that the buyer can use the title for expanding business, as collateral in taking new loans, or, if necessary, to sell to another business.

- **Cost of Registering Property:** Produced by the IFC, this component measures the cost to register property as a percentage of the value of the property in the capital city. The IFC records all of the costs that are incurred when a business purchases land and a building to transfer the property title from the seller to the buyer, so that the buyer can use it for expanding his business, as collateral in taking new loans, or, if necessary, to sell it to another business.

### *Placement of the Natural Resource Management Indicators*

Reflecting extensive public consultations about the placement of these indicators, MCC will place the *Natural Resource Management* index in the Investing in People category and the *Land Rights and Access* index in the Economic Freedom category. Investing in People means, among other things, investing in the assets required for a sustainable livelihood. The *Natural Resource Management* index measures whether governments are investing their resources in ways that will enable poor people, particularly poor women and children, to live healthy and productive lives. Land is also a crucial asset and a social safety net that poor people rely on to improve their well-being; however, the *Land Rights and Access* index also clearly captures a government's commitment to secure property rights and sound economic policy, which will strengthen the Economic Freedom category.

## 2. Combining The Time And Cost Of Starting A Business Into A Single Index

MCC will combine two existing International Finance Corporation (IFC) indicators—*Days to Start a Business* and *Costs to Start a Business*—with equal weight into one index called *Business Start-Up*. The creation of a single *Business Start-Up* index, in conjunction with the addition of the *Land Rights and Access* index to the Economic Freedom category, will strengthen the Economic Freedom category and enhance MCC's ability to better measure countries' overall economic policies.

### *Business Start-Up Index*

The *Business Start-Up* index is made up of two indicators produced by the IFC:

- **Days to Start a Business:** This component measures the number of calendar days it takes to comply with all procedures that are officially required for an entrepreneur to start up and formally operate an industrial or commercial business. These include obtaining all necessary licenses and permits and completing any required notifications, verifications or inscriptions for the company and employees with relevant authorities.
- **Cost of Starting a Business:** This component measures the cost of starting a business as a percentage of country's per capita income. The IFC records all procedures that are officially required for an entrepreneur to start up and formally operate an industrial or commercial business. These include obtaining all

necessary licenses and permits and completing any required notifications, verifications or inscriptions for the company and employees with relevant authorities.

## Potential Future Changes

In addition to the changes identified in this Report, MCC will explore potential changes to the indicators for future years. MCC will continue to explore potential measures of educational quality for inclusion in the Investing in People category in future fiscal years.

In FY07, MCC pursued an intensive research and consultation agenda to explore the possibility of adding a new education indicator to the Investing in People category. However, MCC was unable to identify an indicator that would significantly strengthen the selection criteria in FY08.

Over the last fifteen years, much attention has been focused on enrolling and keeping more children in school, but not necessarily on enhancing the quality of education. With the support of the World Bank, USAID, UNESCO and others, efforts are currently underway to develop cross-country measures of the quality of education and learning outcomes. However, these efforts are still in a nascent stage and there are currently no education quality indicators that are viable for MCC purposes at this time. MCC will continue to monitor and support these efforts, with an eye towards adopting a measure of education quality in a future fiscal year.

## Criteria and Methodology

The Board will select eligible countries based on the following, among other factors: (1) their overall performance in relation to their peers in three broad policy categories—Ruling Justly, Encouraging Economic Freedom and Investing in People; (2) the opportunity to reduce poverty and generate economic growth. Section 607 of the Act requires that the Board’s determination of eligibility be based “to the maximum extent possible, upon objective and quantifiable indicators of a country’s demonstrated commitment” to the criteria set out in the Act. For FY08, there will be two groups of candidate countries—low-income countries and lower middle-income countries. Low-income candidate countries refer to those countries that have a per capita income equal to or less than \$1,735 and are not ineligible to receive United States economic assistance under part I of the Foreign Assistance Act of 1961 by reason of the application of any provision of the Foreign Assistance Act or any other provision of law. Lower middle-income candidate countries are those that have a per capita income between \$1,736 and \$3,595 and are not ineligible to receive United States economic assistance.

The Board will make use of seventeen indicators to assess policy performance of individual countries (specific definitions of the indicators and their sources are set out in Annex A). These indicators are grouped for purposes of the FY08 assessment methodology under the three policy categories listed below.

| Ruling Justly            | Encouraging Economic Freedom | Investing in People                               |
|--------------------------|------------------------------|---|
| Civil Liberties          | Inflation                    | Public Expenditure on Health                      |
| Political Rights         | Fiscal Policy                | Public Expenditure on Primary Education           |
| Voice and Accountability | Business Start-Up            | Immunization Rates (DPT <sub>3</sub> and Measles) |
| Government Effectiveness | Trade Policy                 | Girls' Primary Education Completion               |
| Rule of Law              | Regulatory Quality           | Natural Resource Management                       |
| Control of Corruption    | Land Rights and Access       |   |

In making its determination of eligibility with respect to a particular candidate country, the Board will consider whether a country performs above the median in relation to its peers on at least half of the indicators in the Ruling Justly and Economic Freedom categories, above the median on at least three of the five indicators in the Investing in People category, and above the median on the *Control of Corruption* indicator. One exception to this methodology is that the median is not used for the Inflation indicator. Instead, to pass the *Inflation* indicator a country's inflation rate needs to be under a fixed ceiling of 15 percent. The Board will also take into consideration whether a country performs substantially below the median on any indicator (i.e. in the bottom 25th percentile) and has not taken appropriate measures to address this shortcoming. The indicator methodology will be the predominant basis for determining which countries will be eligible for MCA assistance. In addition, the Board may exercise discretion in evaluating performance on the indicators and determining a final list of eligible countries.

Where necessary, the Board may also take into account other quantitative and qualitative information ("supplemental information") to determine whether a country performed satisfactorily in relation to its peers in a given category. There are elements of the criteria set out in the Act for which there is either limited quantitative information (e.g., rights of people with disabilities) or no well-developed performance indicator. Until such data and/or indicators are developed, the Board may rely on additional data and qualitative information to assess policy performance. The Board may also consider whether any adjustments should be made for data gaps, lags, trends or other weaknesses in particular indicators. For example, the State Department Human Rights report contains qualitative information to make an assessment on a variety of criteria outlined by Congress, such as the rights of people with disabilities, the treatment of women and children, worker rights and human rights. Similarly, as additional information in the area of corruption, the Board may consider how a country scores on Transparency International's Corruption Perceptions Index and the Global Integrity Index, as well as on the defined indicator.

Compact eligible partners are accountable for maintaining and improving policy performance. MCC recognizes and expects that partner countries may not meet the formal eligibility criteria from time to time due to a number of common factors, such as changes in the peer-group median; graduation into a new income category (e.g. from low income to lower middle income); numerical declines that are within the margin of error; slight declines in policy performance; revisions or corrections of data; the introduction of new sub-data sources; or changes in the indicators used to measure performance. MCC may suspend or terminate eligibility for a substantial decline in performance which is characterized by a pattern of events, or a single egregious event, that signal a significant policy reversal inconsistent with MCC's selection criteria. When making a decision to suspend or terminate eligibility, MCC will also consider the extent to which country partners are taking action to reverse significant declines in performance.

As provided in the Act, following the determination of eligible countries, the Chief Executive Officer's report to Congress will set out the list of eligible countries, identify which of those countries the MCC will seek to enter into Compact negotiations, and include a justification for such eligibility determinations and selections for Compact negotiation.

## **Relationship to Legislative Criteria**

Within each policy category, the Act sets out a number of specific selection criteria. As indicated above, a set of objective and quantifiable policy indicators is being used to establish eligibility for MCA assistance and measure the relative performance by candidate countries against these criteria. The Board's approach to determining eligibility ensures that performance against each of these criteria is assessed by at least one of the seventeen objective indicators. Most are addressed by multiple indicators. The specific indicators used to measure each of the criteria set out in the Act are listed below.

| Section of the Millennium Challenge Act of 2003   | Legislative Criteria   | Indicators Used   |
|---|--|---|
| Section 607(b)(1): Just and democratic governance, including a demonstrated commitment to:          | (A) promote political pluralism, equality and the rule of law;                                     | <ul style="list-style-type: none"> <li>• Political Rights</li> <li>• Civil Liberties</li> <li>• Voice and Accountability</li> <li>• Rule of Law</li> </ul>  |
|   | (B) respect human and civil rights, including the rights of people with disabilities;              | <ul style="list-style-type: none"> <li>• Political Rights</li> <li>• Civil Liberties</li> </ul>   |
|   | (C) protect private property rights;   | <ul style="list-style-type: none"> <li>• Civil Liberties</li> <li>• Regulatory Quality</li> <li>• Rule of Law</li> <li>• Land Rights and Access</li> </ul>  |
|   | (D) encourage transparency and accountability of government; and                                   | <ul style="list-style-type: none"> <li>• Political Rights</li> <li>• Civil Liberties</li> <li>• Voice and Accountability</li> <li>• Control of Corruption</li> <li>• Government Effectiveness</li> </ul>          |
|   | (E) combat corruption;   | <ul style="list-style-type: none"> <li>• Civil Liberties</li> <li>• Rule of Law</li> <li>• Control of Corruption</li> </ul>   |
| Section 607(b)(2): Economic freedom, including a demonstrated commitment to economic policies that: | (A) encourage citizens and firms to participate in global trade and international capital markets; | <ul style="list-style-type: none"> <li>• Fiscal Policy</li> <li>• Inflation</li> <li>• Trade Policy</li> <li>• Business Start-Up</li> <li>• Regulatory Quality</li> </ul>   |
|   | (B) promote private sector growth and the sustainable management of natural resources;             | <ul style="list-style-type: none"> <li>• Inflation, Business Start-Up</li> <li>• Fiscal Policy</li> <li>• Land Rights and Access,</li> <li>• Natural Resource Management</li> <li>• Regulatory Quality</li> </ul> |
|   | (C) strengthen market forces in the economy; and   | <ul style="list-style-type: none"> <li>• Fiscal Policy</li> <li>• Inflation</li> <li>• Trade Policy</li> <li>• Business Start-Up</li> <li>• Regulatory Quality</li> </ul>   |
|   | (D) respect worker rights, including the right to form labor unions;                               | <ul style="list-style-type: none"> <li>• Civil Liberties</li> <li>• Voice and Accountability</li> </ul>   |

| Section of the Millennium Challenge Act of 2003  | Legislative Criteria   | Indicators Used   |
|--|--|---|
| Section 607(b)(3): Investments in the people of such country, particularly women and children, including programs that | (A) promote broad-based primary education and  | <ul style="list-style-type: none"> <li>• Girls' Primary Education Completion</li> </ul>   |
|  | (B) strengthen and build capacity to provide quality public health and reduce child mortality. | <ul style="list-style-type: none"> <li>• Public Expenditure on Primary Education</li> <li>• Immunization Rates</li> <li>• Public Expenditure on Health</li> <li>• Natural Resources Management</li> </ul> |

Where necessary the Board will also draw on supplemental data and qualitative information, including the State Department's Human Rights Report, Transparency International's Corruption Perceptions Index, and the Global Integrity Index.

# Annex A:

## Indicator Definitions

The following 17 indicators will be used to measure candidate countries' demonstrated commitment to the criteria found in Section 607(b) of the Act. The indicators are intended to assess the degree to which the political and economic conditions in a country serve to promote broad-based sustainable economic growth and reduction of poverty; and thus provide a sound environment for the use of MCA funds. The indicators are not goals in themselves; rather they measure policies that are necessary conditions for a country to achieve broad-based sustainable economic growth. The indicators were selected based on their relationship to economic growth and poverty reduction, the number of countries they cover, their transparency and availability and their relative soundness and objectivity. Where possible, the indicators are developed by independent sources.

### Ruling Justly

1. *Civil Liberties*: A panel of independent experts rates countries on: freedom of expression; association and organizational rights; rule of law and human rights; and personal autonomy and economic rights. *Source: Freedom House*
2. *Political Rights*: A panel of independent experts rates countries on: the prevalence of free and fair elections of officials with real power; the ability of citizens to form political parties that may compete fairly in elections; freedom from domination by the military, foreign powers, totalitarian parties, religious hierarchies and economic oligarchies; and the political rights of minority groups. *Source: Freedom House*
3. *Voice and Accountability*: An index of surveys that rates countries on: ability of institutions to protect civil liberties; the extent to which citizens of a country are able to participate in the selection of governments; and the independence of the media. *Source: World Bank Institute*
4. *Government Effectiveness*: An index of surveys that rates each country on: the quality of public service provision; civil services' competency and independence from political pressures; and the government's ability to plan and implement sound policies. *Source: World Bank Institute*
5. *Rule of Law*: An index of surveys that rates countries on: the extent to which the public has confidence in and abides by rules of society; incidence of violent and nonviolent crime; effectiveness and predictability of the judiciary; and the enforceability of contracts. *Source: World Bank Institute*
6. *Control of Corruption*: An index of surveys that rates countries on: the frequency of "additional payments to get things done;" the effects of corruption on the business environment; "grand corruption" in the political arena; and the tendency of elites to engage in "state capture." *Source: World Bank Institute*

## Encouraging Economic Freedom

1. *Inflation*: The most recent 12-month change in consumer prices as reported in the IMF's International Financial Statistics or in another public forum by the relevant national monetary authorities. *Source: The International Monetary Fund's World Economic Outlook (WEO) database*
2. *Fiscal Policy*: The overall budget deficit divided by GDP, averaged over a three-year period. The data for this measure is provided directly by the recipient government and cross-checked with other sources and made publicly available to try to ensure consistency across countries. *Source: National Governments and the International Monetary Fund's World Economic Outlook (WEO) database*
3. *Business Start-Up*: An index that rates countries on: the time and cost of complying with all procedures of- ficially required for an entrepreneur to start up and formally operate an industrial or commercial business. *Source: International Finance Corporation*
4. *Trade Policy*: A measure of a country's openness to international trade based on weighted average tariff rates and non-tariff barriers to trade. *Source: The Heritage Foundation's Index of Economic Freedom*
5. *Regulatory Quality*: An index of surveys that rates each country on: the burden of regulations on business; price controls; the government's role in the economy; foreign investment regulation; and many other areas. *Source: World Bank Institute*
6. *Land Rights and Access*: An index that rates countries on: the extent to which the institutional, legal, and market framework provide secure land tenure and equitable access to land in rural areas and the time and cost of property registration in urban and peri-urban areas. *Source: The International Fund for Agricultural Development (IFAD) and the International Finance Corporation*

## Investing in People

1. *Public Expenditure on Health*: Total expenditures by government at all levels on health divided by GDP. *Source: The World Health Organization (WHO)*
2. *Immunization Rates*: The average of DPT<sub>3</sub> and measles immunization rates for the most recent year avail- able. *Source: The World Health Organization (WHO)*
3. *Total Public Expenditure on Primary Education*: Total expenditures by government at all levels of primary education divided by GDP. *Source: The United Nations Educational, Scientific and Cultural Organization (UNESCO) and National Governments*
4. *Girls' Primary Completion Rate*: The number of female students completing primary education divided by the population in the relevant age cohort. *Source: World Bank and the United Nations Educational, Scien- tific and Cultural Organization (UNESCO)*

5. *Natural Resource Management*: An index made up of four indicators: eco-region protection, access to improved water, access to improved sanitation, and child mortality within the 1-4 age cohort. *Source: The Center for International Earth Science Information Network (CIESIN) and the Yale Center for Environmental Law and Policy (YCELP)*