

Millennium Challenge Corporation

**Report on the
Criteria and Methodology
for Determining the
Eligibility of
Candidate Countries for
Millennium Challenge
Account Assistance in
Fiscal Year 2010**

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MILLENNIUM
CHALLENGE CORPORATION
UNITED STATES OF AMERICA

Summary

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

The Act authorizes the provision of Millennium Challenge Account (MCA) assistance to countries that enter into a Millennium Challenge Compact 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 what countries will be eligible for MCA assistance for fiscal year 2010 (FY10) based on the countries’ demonstrated commitment to just and democratic governance, economic freedom, investing in their people, and the opportunity to reduce poverty and generate economic growth in the country. These steps include the submission of reports to the congressional committees specified in the Act and publication of notices in the *Federal Register* that identify:

- ★ The countries that are “candidate countries” for MCA assistance for FY10 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; 22 U.S.C. §7707(a));
- ★ The criteria and methodology that MCC’s Board of Directors (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 (22 U.S.C. 7706) in order to determine “MCA eligible countries” from among the “candidate countries” (section 608(b) of the Act); and
- ★ The list of countries determined by the Board to be “MCA eligible countries” for FY10, 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 FY10 MCA assistance.

Criteria and Methodology for FY10

MCC reviews all of its indicators and methodology annually and, from time to time, recommends changes or refinements if MCC identifies better methodologies, better indicators, or improved sources of data. MCC takes into account public comments received on the previous years’ criteria and methodology and consults with a broad range of experts in the development community and within the U.S. Government.

In response to a request in the Explanatory Statement accompanying the 2009 Department of State, Foreign Operations, and Related Programs Appropriations Act, MCC considered an indicator that takes into account the votes and positions of countries in international and multilateral institutions with respect to human rights;

however, MCC's current indicator framework already includes three indicators -- *Political Rights*, *Civil Liberties*, and *Voice and Accountability* -- that measure government commitment to human and democratic rights within their own borders. These indicators are better suited for measuring a government's commitment to human rights than its voting record, which can be influenced by political goals. Thus, such a measure is not a good fit for MCC's indicator-based system, as it would potentially politicize the country selection process.

In keeping with MCC's commitment to aid effectiveness through the regular evaluation of its own practice, the agency plans to review the selection criteria and methodology as a whole in 2010. This will include, as a matter of course, consultations with a broad group of stakeholders. As a first step, we invite broad participation in the 30-day public comment period that follows the publication of this report.

Changes to the Criteria and Methodology for FY10

Approach to Country Income Graduation

Every year, changes in candidate countries' income status substantially affect MCC's candidate country pool -- some countries "graduate" from one income category to another; low income countries (LIC) become reclassified as lower middle income countries (LMIC), and LMICs are reclassified as upper-middle income countries. Changes in economic growth rates, exchange rates, and relative inflation can contribute to country graduation, without necessarily representing a dramatic or immediate improvement in overall living standards of the country's population.

Because MCC evaluates the relative performance of LICs and LMICs in separate income groups, when a country graduates from LIC to LMIC, it typically does not meet the higher performance standards in its new group, even if it performed relatively well as an LIC, and, in absolute terms, maintained or improved performance over the previous year.

To address the challenges associated with graduating countries that have experienced no real change in performance, MCC is adopting an approach to income graduation in which a country that graduates from LIC to LMIC will have its indicator performance considered both relative to its LMIC peers as well as in comparison to the current fiscal year's LIC pool for a period of three years. This practice is consistent with the flexible, gradual graduation approaches of other donor institutions.

Eligibility for Consecutive Compacts

Several of MCC's early compacts are due to conclude within the next two years. MCC's experience to date suggests that compact development takes approximately 18 months. To maximize benefits of lessons learned in the first compact, the Board may determine that certain compact countries should be selected as eligible to develop a second compact before the completion of their first compact program.

For FY10, when determining a country's eligibility for a second compact, MCC will consider, among other factors, the country's policy performance using the selection criteria and methodology outlined in this report, the opportunity to reduce poverty and generate economic growth in the country, the funds available to MCC to carry out compact assistance, and the country's performance implementing its first compact. To assess implementation of a first compact, the MCC recommends that the Board consider the nature of the country partnership with MCC, the degree to which the country has demonstrated a commitment and capacity to achieve program results, and the degree to which the country has implemented the compact in accordance with MCC's core policies and standards.

Criteria and Methodology

The Board will determine country eligibility based on several factors including (i) their overall performance in three broad policy categories – *Ruling Justly*, *Encouraging Economic Freedom*, and *Investing in People*; (ii) the opportunity to reduce poverty and generate economic growth; and (iii) the funds available to MCC to carry out compact assistance. 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 FY10, there will be two groups of candidate countries – LICs and LMICs. LIC candidates refer to those countries that have a per capita income equal to or less than \$1,855 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. LMIC candidates are those countries that have a per capita income between \$1,856 and \$3,855 and are not ineligible to receive United States economic assistance.

The Board uses seventeen indicators to assess the policy performance of individual countries (specific definitions of the indicators and their sources are set out in the attached Annex A). These indicators are grouped for purposes of the FY10 assessment methodology under the three policy categories listed below.

Ruling Justly	Encouraging Economic Freedom	Investing in People
1. Civil Liberties	1. Inflation	1. Public Expenditure on Health
2. Political Rights	2. Fiscal Policy	2. Public Expenditure on Primary Education
3. Voice and Accountability	3. Business Start-Up	3. Immunization Rates
4. Government Effectiveness	4. Trade Policy	4. Girls' Primary Education Completion
5. Rule of Law	5. Regulatory Quality	5. Natural Resource Management
6. Control of Corruption	6. 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 income level peers (LIC or LMIC) on at least half of the indicators in the *Ruling Justly* and *Encouraging 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 may 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.

Each year a number of countries shift income groups, and some countries formerly classified as LICs suddenly face new, higher performance standards in the LMIC group. To address the challenges associated with sudden changes in criteria for these countries, MCC has adopted an approach to income graduation whereby the Board may consider the indicator performance of countries that graduated from the LIC to the LMIC category in FY10 both relative to their LMIC peers as well as in comparison to the current fiscal year's LIC pool for a period of three years.

Consistent with the Act, the indicators will be the predominant basis for determining which countries will be eligible for MCA assistance. However, the Board may exercise discretion when evaluating performance on the indicators and determining a final list of eligible countries. Where necessary, the Board also may 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 income category. There are elements of the criteria set out in the Act for which there is either limited quantitative information (*e.g.*, the 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. 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, workers rights, and human rights. The Board may also consider whether any adjustments should be made for data gaps, lags, trends, or other weaknesses in particular indicators. For example, as additional information in the area of corruption, the Board may consider how a country scores on supplemental sources like Transparency International's Corruption Perceptions Index and the Global Integrity Index, as well as on the defined indicator.

Countries nearing the end of compact implementation may be considered for eligibility for a second compact. In determining eligibility for consecutive compacts, MCC recommends that the Board consider, among other factors, the country's policy performance using the methodology and criteria described above, the opportunity to reduce poverty and generate economic growth in the country, the funds available to MCC to carry out compact assistance, and the country's track record of performance implementing its first compact.

Compact eligible country partners are expected to seek to maintain and improve policy performance. MCC recognizes that country partners may not meet the eligibility criteria from time to time due to a number of 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. None of these factors alone signifies a significant policy reversal nor warrants suspension or termination of eligibility and/or assistance. However, countries that demonstrate a significant policy reversal may be issued a warning, suspension, or termination of eligibility and/or assistance. According to MCC’s authorizing legislation, “[a]fter consultation with the Board, the Chief Executive Officer may suspend or terminate assistance in whole or in part for a country or entity ... if ... the country or entity has engaged in a pattern of actions inconsistent with the criteria used to determine the eligibility of the country or entity” Because of data lags, this pattern of actions need not be captured in the indicators for MCC to take action.

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 used to determine 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 appear in parentheses below next to the corresponding criterion set out in the Act.

Section 607(b)(1): Just and democratic governance, including a demonstrated commitment to —

- (A) promote political pluralism, equality and the rule of law (*Political Rights, Civil Liberties, Voice and Accountability, and Rule of Law*);
- (B) respect human and civil rights, including the rights of people with disabilities (*Political Rights, Civil Liberties, and Voice and Accountability*);
- (C) protect private property rights (*Civil Liberties, Regulatory Quality, Rule of Law, and Land Rights and Access*);
- (D) encourage transparency and accountability of government (*Political Rights, Civil Liberties, Voice and Accountability, Control of Corruption, Rule of Law, and Government Effectiveness*); and
- (E) combat corruption (*Political Rights, Civil Liberties, Rule of Law, and Control of Corruption*);

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 (*Fiscal Policy, Inflation, Trade Policy, Business Start-Up, and Regulatory Quality*);
- (B) promote private sector growth (*Inflation, Business Start-Up, Fiscal Policy, Land Rights and Access, and Regulatory Quality*);
- (C) strengthen market forces in the economy (*Fiscal Policy, Inflation, Trade Policy, Business Start-Up, Land Rights and Access, and Regulatory Quality*); and

- (D) respect worker rights, including the right to form labor unions (*Civil Liberties and Voice and Accountability*);

Section 607(b)(3): Investments in the people of such country, particularly women and children, including programs that —

- (E) promote broad-based primary education (*Girls' Primary Education Completion and Public Expenditure of Primary Education*);
- (F) strengthen and build capacity to provide quality public health and reduce child mortality (*Immunization Rates, Public Expenditure on Health, and Natural Resource Management*); and
- (G) promote the protection of biodiversity and the transparent and sustainable management and use of natural resources (*Natural Resource Management*).

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 linked to broad-based sustainable economic growth. The indicators were selected based on their (i) relationship to economic growth and poverty reduction, (ii) the number of countries they cover, (iii) transparency and availability, and (iv) 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/expert assessments that rates countries on the 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/expert assessments that rates countries on the quality of public service provision; civil servants' 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/expert assessments that rates countries on the extent to which the public has confidence in and abides by the rules of society; the incidence of violent and nonviolent crime; the effectiveness, independence, and predictability of the judiciary; and the enforceability of contracts. Source: *World Bank Institute*
6. *Control of Corruption*: An index of surveys/expert assessments 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 average annual change in consumer prices. Source: *The International Monetary Fund's World Economic Outlook Database*
2. *Fiscal Policy*: The overall budget deficit divided by GDP, averaged over a three-year period. The data for this measure relies primarily on IMF country reports with input from U.S. missions in host countries, or is provided directly by the recipient government where public IMF data is outdated or unavailable. All data is cross-checked with the IMF's World Economic Outlook database to try to ensure consistency across countries and made publicly available. Source: *International Monetary Fund Country Reports, National Governments, and the International Monetary Fund's World Economic Outlook Database*
3. *Business Start-Up*: An index that rates countries on the time and cost of complying with all procedures officially 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*
5. *Regulatory Quality*: An index of surveys/expert assessments that rates countries on the burden of regulations on business; price controls; the government's role in the economy; foreign investment regulation; among 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 and the International Finance Corporation*

Investing in People

1. *Public Expenditure on Health*: Total expenditures on health by government at all levels divided by GDP. Source: *The World Health Organization*
2. *Immunization Rates*: The average of DPT₃ and measles immunization rates for the most recent year available. Source: *The World Health Organization*
3. *Total Public Expenditure on Primary Education*: Total expenditures on primary education by government at all levels divided by GDP. Source: *The United Nations Educational, Scientific and Cultural Organization and National Governments*

4. *Girls' Primary Completion Rate*: The number of female students enrolled in the last grade of primary education minus repeaters divided by the population in the relevant age cohort (gross intake ratio in the last grade of primary). Source: *United Nations Educational, Scientific and Cultural Organization*
5. *Natural Resource Management*: An index made up of four indicators: eco-region protection, access to improved water, access to improved sanitation, and child (ages 1-4) mortality. Source: *The Center for International Earth Science Information Network and the Yale Center for Environmental Law and Policy*