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Applying the Compact Model of Economic Assistance in Fragile States

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"Policymakers are increasingly attuned to the security implications of state fragility. Whether we worry that the state in question is unable to prevent localized conflict from spilling over borders, inadvertently providing a safe haven for violent actors through lack of territorial control, or increasing the risk of epidemics as a result of inadequate medical response, most of the policy community's focus on fragile states begins with a security concern. However, if fragility is defined as the absence or breakdown of the social contract between a state and its citizens, then any effort to address fragility must also consider fragility's economic underpinnings.

In looking for ways to make economic assistance effective in fragile states, the question arises of whether a major innovation of U.S. economic assistance of the past decade—the economic compact model pioneered by the Millennium Challenge Corporation (MCC)—might usefully be applied. The answer is yes, but not in all fragile states, and only if we learn the full lessons of what MCC's experiment can teach us about the compact approach to economic development.

THE ALLURE OF SELECTIVE LESSONS LEARNED

Over the last decade, there has been growing bipartisan support for more effective application of U.S. economic assistance. Lessons learned in the 1980s and 1990s were piloted in some agencies in the 2000s, and adopted – at least rhetorically – across much of the U.S. government by 2015. When it comes to translating sound economic development practices into fragile contexts, our greatest stumbling block may well be a temptation to conflate favorite innovations in aid with the practical conditions required to stimulate economic outcomes.

The **Fragility Study Group** is an independent, non-partisan, effort of the Carnegie Endowment for International Peace, the Center for a New American Security, and the United States Institute of Peace. The chair report of the study group, *U.S. Leadership and the Challenge of State Fragility*, may be accessed here: http://www.usip.org/fragilityreport. This brief is part of a series authored by scholars from the three institutions that build on the chair report to discuss the implications of fragility on existing U.S. tools, strategic interests, and challenges. The complete list of policy briefs may be accessed here: http://www.usip.org/fragilitypolicybriefs.

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Each of the approaches outlined below is now accepted as a common tenet of "aid effectiveness," but MCC began a more aggressive, experimental implementation of them in 2004. Nearly all of them make assumptions about the political context in which programs operate in the United States and in the country in question.

- Selectivity recognizes that it is not possible to deploy every assistance tool in every country. In its most visible form, MCC relies on a public, data-driven policy scorecard to inform decisions about where it will invest. Selectivity assumes U.S. domestic politics can tolerate omitting high-profile states when they do not meet specific criteria.
- Country Ownership describes a situation in which the recipient country leads in defining the project and implementing it—thereby "owning" the project. It assumes both administrative capacity and political will on part of the partner state.
- Mutual Accountability describes an arrangement where the U.S. investment in a country is committed to and fully funded in advance, but staggered to follow key policy reforms. In practice, MCC uses this model to maximize the impact of infrastructure investment by incentivizing massive regulatory reform. To work, this approach assumes a U.S. willingness to cancel the investment if the policy reforms do not come through.
- Scale Operations in countries with infrastructure or other system-wide needs provide the required resources over multiple years. This assumes substantial multiyear funding unencumbered by earmarks and presidential initiatives.
- Local Partnership is considered meaningful when the primary responsibility for implementation is managed by local actors in a way that is consistent with local accountability structures, even if they are supported by U.S. technical experts. Maintaining local partnership assumes mutual trust between U.S. officials and the implementing body.
- Sustainability Planning, or designing programs so as to achieve the intended outcome as well as donor exit, is now a gold standard in development practice. For this to work, planners must be able to assume some degree of economic, political, and institutional stability.

These approaches are all logical in many low-income economies. In fragile contexts, however, many of the necessary preconditions do not apply. In their absence, simply asserting that an economic development project will be implemented "in partnership" or "with mutual commitment" changes nothing more than the way the work is described.

Perhaps most significantly, at MCC, these practices form an integrated approach. Mutual accountability works because there is indeed country ownership. Local partnership in implementation works because the investments are tailored to specific countries and operate over 5 years at the half billion dollar scale. Selecting just a few elements of MCC's approach and believing they can be replicated in isolation in a fragile context will result in mismatched expectations at best and failure at worst.

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RECOMMENDATIONS

If the United States wants to apply the compact model of economic assistance to fragile states, it must fully unpack how the model might translate. Applying the model requires four key practices, each dependent on specific tactics.

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1. **Be extremely selective and set shared expectations**

If economic development work in fragile countries is intended to address a broken state-citizen contract, then the economic programs must avoid mismatched expectations on both sides of that contract. Specifically, the expectations-setting phase of any fragile state investment mechanism should:

- Clarify why this country has "qualified" for an economic investment compact. This would require the U.S. to select pilot countries for a compact based on their likelihood of success, not the urgency of our desire to stabilize them. The selection process can combine public and classified information, but its goal should be to identify those countries in which we believe a sustained capital investment over multiple years has the greatest likelihood of bolstering economic resilience. Particularly in the early days of any such program, misperception that the investment is a one-off reward for some aspect of the relationship will be common. Consistency in explaining otherwise is one of the few ways to align U.S. and partner country expectations.
- Clarify the intended scale and scope of the investment. In the beginning, MCC struggled with countries assuming the Compact would be an upfront cash infusion for them to spend as they wished, and wanting to plan their next budget cycle around it. The population's similarly mismatched expectations led some local NGOs to initially assume that not seeing results in the first six months meant the government must be stealing the money.
- Clarify to Congress and international partners that this approach can only work in select fragile states and with focused investments. There is a tendency to "pilot" initiatives in multiple countries, but realistically, at any one time, there may be very few fragile states that can meaningfully manage an economic compact investment and where scarce resources can be applied to the required levels. Don't try them all at once.

2. **Design the investment with transparent partnership in mind.**

Avoiding a stalemate and keeping the investment on track requires both the U.S. and the recipient country to be transparent about intentions and measures of success. Although negotiating a new assistance package in Washington typically involves a series of closed-door meetings, MCC has demonstrated that transparency can go a long way towards ensuring that key stakeholders in both countries stay on the same page. To pursue transparency:

- Make decisions about the desired impact of the compact in advance. Will success be measured in purely economic terms? Do other metrics of reduced fragility count? If so, which ones? Before MCC defined the economic rate of return as a driving consideration in deciding whether or not to fund specific proposals, countries (and Congressional actors) were regularly disappointed by the projects MCC rejected. Once the investment criteria were in place, it was much easier to keep all stakeholders moving in the same direction. This is not to say an economic compact in a fragile state should revolve exclusively around the same criteria that MCC relies on, but that any such compact should define in advance the impact-oriented criteria for including a project in the investment.
- Use shared, transparent diagnostic tools to design or estimate the potential effects of an investment. People point to MCC's collaborative compact design process – which keeps countries in the lead on proposing specific projects – as a way of generating country ownership and domestic buy in. However, MCC and countries can collaborate because they rely on a set of previously agreed on tools to determine what sectors are appropriate for investment. While the tools might be different in a fragile setting – particularly when data scarcity hinders easy analysis – agreeing to them in advance helps to later push back against politically expedient, but economically unviable, "pet projects."
- Implement a consultation process to generate political buy-in from the social and political actors that matter in implementation – all of them, not just the convenient ones. Particularly in countries where control of a territory or area may shift between actors, consultations with all possible leaders ensures implementation can continue even if political or social control shifts. This approach helped MCC

navigate deep-rooted political transitions in a variety of places, perhaps most visibly in Central America after the election of Daniel Ortega in Nicaragua.

3. Create realistic implementation structures

Country ownership and local partner implementation are broadly recognized as positive for program sustainability, and as a means of expanding a country's complex project management capacity. Indeed, the fact that recipient country governments have "skin in the game" because they carry the burden of implementation is a celebrated aspect of MCC's model, and one that some have suggested is a means to increase fragile states' control of their own future. This may be, but this "ownership" model also places a heavy burden on countries, and in fragile contexts, there may not be sufficient domestic technical capacity to pursue certain investments. Creating a realistic implementation model requires attention to methods of building capacity, while simultaneously protecting the compact from interagency wrangling back in Washington. To do this:

- Align the implementation unit with the most legitimate domestic institutions. For MCC, the implementation unit is primarily accountable to the leadership of the elected government. In a fragile state context, it may be worth considering whether there are non-traditional government actors – or non-government actors – that are better placed to house a unit designed explicitly to expand the complex project management capacity of national staff. If looking at non-government actors, also ask how this unit would be accountable – to the government, to the population, and/or to donors.
- Recognize the tradeoff between speed and capacity building. If there is extremely limited domestic experience with specific technical requirements (public procurement, bookkeeping, construction contract management, environmental assessment, etc.), there are creative means of expanding the implementation unit's skills. For example, tasking international staff to coach the management—instead of tasking staff to take over management – is much more time consuming, and requires a high tolerance for near misses. But it builds sustainable capacity in a way that speed cannot.
- Manage interagency in-fighting by giving one agency clear leadership of the investment. A Board structure can work for the initial go or no-go investment decision, but falls apart on a day to day basis unless one actor is elevated to make mundane, but critical, decisions. For example, determining which of two competing economic models should be used to estimate the likely impact of a change in implementation is not a principals' level decision. However, until it is explicit which agency has the right to make this type of decision on its own, day-to-day management of the investment will be bogged down in bureaucratic positioning.

4. Define the occasion for exit

Mutual accountability works only when both sides are willing to walk away if the other side fails to hold up its end of the bargain. At MCC this manifests in two ways: in the agency's willingness to suspend countries for a pattern of governance decline, and in its willingness to hold off on an investment if the regulatory reform is not in place or if test measures fall short. While these practices are not as widely celebrated as the data driven selection system or the country-led implementation units, they are fundamental to the success of the compact model. Practically speaking, this is probably the most complicated element of an economic development "compact" to translate to a fragile context because the occasion for investment in fragility likely has security implications for the United States. However, thinking in advance about the circumstances in which the U.S. would curtail or halt an investment provides necessary discipline for deciding where to start. There are three mandatory components:

- Define red flags instead of redlines. No one can predict the exact circumstances that would cause the United States to walk away from an economic compact with a fragile state. However, taking steps to identify the security and political stability issues that would change the terms of the partnership early, and defining a list of "red flags" can set the stage for regular, consistent interrogation of whether the situation has changed enough to warrant a change in U.S. engagement. MCC uses this approach to determine when a country's governance has declined to the point of disqualification. Any single red flag is typically acceptable, but a pattern of them suggests the terms of the investment have changed.

- Think early about the things for which the U.S. is willing to accept public blame. Certain types of investment wreak havoc and leave civilian economic casualties if they are left incomplete as a result of a compact breach and a U.S. decision to back away. Some of these are obvious: if you tear up half of the only international grade runway in a landlocked country, you have to put it back down or bear the blame for isolating the country from humanitarian and military assistance. Other investments have similar effects on livelihoods, and therefore the state-citizen contract: farmers are worse off if the fertilizer they borrowed to buy is not delivered. Thinking in advance about the tradeoffs between halting an investment and the consequences of that halt does not make the outcome less painful, but it makes the terms of the decision clearer.
- Do not start down investment paths that cannot be abandoned. If one of the goals of applying an economic compact model to fragile states is to create incentives for mutual risk-taking and progress, then do not label as "compacts" investment relationships with countries that the U.S. cannot break due to explicit security ties. A failure to react when the mutual accountability dynamic is broken not only undermines impact in the country in question, but creates moral hazards for every other country with a similar compact investment.

CONCLUSION

In the course of seeking fresh policy approaches to fragile states, the United States should incorporate economic assistance tailored to strengthen the state-citizen contract. To that end, the compact investment model piloted by MCC is worth examining closely. However, a haphazard or piecemeal application of the MCC-piloted approaches could further undermine U.S. efforts to promote sustainable, stabilizing economic growth. Instead, we must take the necessary step of fully unpacking how development lessons might practically translate in fragile settings. Only then can efforts to address state fragility take full advantage of the lessons learned from applying the MCC model over the last twelve years.

NOTES

1. This ranges from the George W. Bush Administration's creation of MCC and PEPFAR, to Obama's Presidential Directive on Development Effectiveness and the Quadrennial Diplomacy and Development Review, to several recent pieces of legislation addressing food security and foreign aid transparency.
2. The MCC is an independent US foreign assistance agency that relies on a public, data-driven selection process to determine the low income (and lower middle income) countries in which it will invest. Large scale investments are known as "Compacts" and range from $65 million to $700 million over a five year period. Compact proposals are identified by the country in question through their team of economists and experts, with technical support from MCC's own technical staff. To be approved by MCC's Board of Directors, investments must demonstrate a reasonable economic rate of return (i.e.: for every dollar invested, most investments are expected to produce $1.10 or more in poverty reduction outcomes). Once approved, countries manage implementation of the compact investment directly through their own project management unit, which is accountable to the local government. Compacts often incorporate both large scale infrastructure investment (i.e.: power grid or highway infrastructure) and policy reform (re-regulation/concessions in the power or transport sector). For more information, see www.mcc.gov.
3. See examples of customs reform in Benin alongside a port rehabilitation, and power sector reform in Ghana preceding an investment in the power sector, and education reform in the Republic of Georgia accompanying a Science and Technology education investment.
4. For example, the Growth Diagnostic and Beneficiary Analysis https://www.mcc.gov/resources/doc/guidelines-for-economic-and-beneficiary-analysis, or the Social and Gender Assessment https://assets.mcc.gov/guidance/2012-001-0972-01-pub-compact-development-guidance-chapter-3.pdf. For more examples see: https://www.mcc.gov/resources/compact-development-guidance
5. For example, a country with extremely limited opportunities for higher education or employment in structural engineering may have a difficult time finding local staff that can manage construction contractors for large scale infrastructure investments.

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