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Making the Millennium Challenge Corporation Compact Work for Sri Lanka

By Ganeshan Wignaraja

In April 2019, the Board of Directors of the Millennium Challenge Corporation (MCC) approved a compact program for Sri Lanka. This is a large five-year grant that was provided to Sri Lanka on the basis that it meets the MCC's eligibility criteria of good governance, economic freedom, and investment in its citizens. It will be implemented by a team appointed by the Sri Lankan government, under the guidance of MCC. As the process has taken longer than expected, it is hoped that the MCC Board when they meet on 18 September 2019 will grant additional time for the MCC Sri Lanka Compact (MCC Compact) to be approved by Sri Lanka's Cabinet. President Maithripala Sirisena has suggested that a decision would be taken after the upcoming Presidential elections in Sri Lanka in December 2019.

Ganeshan Wignaraja, executive Director of the Lakshman Kadirgamar Institute of International Relations and Strategic Studies, explains that "At least half of Sri Lanka's borrowing in 2018 was from private capital markets, and nearly a third came from China."

Proponents argue that it can reduce bottlenecks in transport and commercial land administration. Meanwhile, critics of the MCC Compact raise a host of legal, environmental, and external political interference issues. As Sri Lanka prepared to make a decision on whether to proceed with the MCC Compact, a simple cost-benefit analysis of the MCC-Sri Lanka Compact from a national economic perspective is imperative.

Expected Benefits

One important potential benefit is that the money is an outright grant and does not have to be repaid to the MCC. It is a substantial grant of $480 million over five years, equivalent to $22.43 for every Sri Lankan. If this were a loan that had to be paid back with interest, it would be a different story.

Another potential benefit is that the MCC Compact could help Sri Lanka re-balance its sources of development finance and external influence. The good news is that Sri Lanka was classified as an upper-middle-income country by the World Bank in 2019. The bad news that the country is heavily reliant on foreign development financing from capital markets and development partners because of a problem of twin economic deficits and a low tax base. At least half of Sri Lanka's borrowing in 2018 was from private capital markets, and nearly a third came from China. Multilateral development banks and Japan are also notable financiers. A high concentration of debt among a handful of financing sources is inherently risky for any developing country, making it vulnerable to external shocks and external policy manipulation. Diversifying the sources of development finance would facilitate better national macroeconomic management, and the MCC Compact could help this process. The MCC Compact would also help rebalance the country's geopolitical interests away from the perceived dependence on China and the debt-trap diplomacy narrative, to Sri Lanka's historical foreign policy of non-alignment.

An additional potential benefit is MCC's contribution to improving infrastructure development. Sri Lanka ranks 65th out of 144 countries on the 2018 World Economic Forum Infrastructure Quality Index. On urban infrastructure such as road quality, Sri Lanka is well below upper-middle-income Malaysia and even below low-income Pakistan. Decades of under-investment means that Sri Lanka needs to invest at least $30 billion over a decade or so to tackle infrastructure gaps and attain the standards of upper-middle-income countries. The larger part of the MCC Compact — the $350 million transport project — focuses on modernizing bus transport and improving traffic management systems, which would contribute toward crucial improvements in public transport and provide tangible benefits to the poor. The transport project has an estimated rate of return of some 19%, according to MCC and is expected to increase the relative efficiency and capacity of urban and provincial transport infrastructure in the Western, Central, and other provinces.

Some Quibbles

These expected benefits notwithstanding, some quibbles with the MCC Compact should be noted. One is that the land project seems ahead of its time in terms of the country's reform agenda. A small land project — envisaged to cost $67 million — seeks to improve the land administration policy in Sri Lanka. Specifically, it seeks to map and survey state lands, strengthen government capacity and provide help with the digitization of deeds. The land market is a mess with multiple distortions and information gaps which inhibit business investment and hinder Sri Lankans. However, land ownership is a politically sensitive topic, and is better included in a future economic reform program along with the other difficult issues like public sector reform. Instead, the MCC Compact should have prioritized the pressing issue of improving agricultural productivity in the North and North Central provinces of Sri Lanka. Modernization of ancient irrigation tanks in North Central Sri Lanka, and introducing new technology and management practices into small-holder farms in the Northern Province are important policy priorities to foster agricultural transformation. Reviving small fishing industry through the spread of sustainable fishing practices is also important.

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Another issue is that the administrative overhead seems high with some $50 million (10% of the total grant) allocated toward program administration and oversight. While this might be standard MCC operating procedure, it seems wasteful. A rough rule of thumb from World Bank projects in Asia and the Pacific is that an overhead figure of 5-7% should be sufficient for administrative overheads in aid programs of this magnitude. A lower overhead means that more resources could be made available for development projects in Sri Lanka.

Finally, the MCC Compact is not well understood in Sri Lanka—sometime leading to the spread of disinformation and inaccurate news. This may reflect inadequate transparency and engagement with stakeholders (such as civil society, think tanks, businesses, and the media) by MCC during the design phase. Many foreign aid programs suffer from this affliction.

A Last Word

Time is of the essence for Sri Lanka to make a decision on whether to proceed with the MCC Compact. Sri Lanka's attainment of upper-middle-income status means grant funding will be limited in the future. An initial cursory look at the available documents suggests that the MCC Compact could provide net benefits for Sri Lanka's economic development. It is free money, diversifies the sources of development finance, and helps improve transport for the poor. If the issues regarding project priorities, overhead, and consultations could be reflected during implementation, it may be an even better MCC Compact for Sri Lanka.

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