MILLENNIUM CHALLENGE CORPORATION
REDUCING POVERTY THROUGH GROWTH

Fact Sheet

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Economic Rates of Return on the Web

MCC Investment Decisions

MCC takes into consideration a number of factors when making its decisions to approve program proposals. We place a premium on supporting initiatives that have broad based support in the partner country and that were developed through a consultative process. We also examine whether the program proposal is consistent with MCC policies and guidelines on gender, the environment, and procurement procedures, among others. Given our focus on measurable results that will reduce poverty, we analyze each program to determine its sustainability and its likely economic impact, as reflected in its economic rate of return (ERR). We expect programs will generate adequate benefits to justify the specific investments. MCC also conducts beneficiary analysis to ensure that investments will deliver tangible benefits to the poor.

> *"...cost-benefit analysis is important in terms of accountability to donors and partners."*
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> ***- Centre for International Cooperation and Security, Department of Peace Studies, Bradford University***

The Essence of the Economic Rate of Return (ERR)

At its core, an ERR is a comparison of the costs and benefits of a public investment. In MCC's analysis, the costs of a project reflect the necessary financial expenses, including those covered by other parties. The benefits include the increased income of a country's population or value added by its firms due specifically to the proposed project. Estimating the ERR of a proposed project before the investment is made offers MCC a forecast of the project's likely economic impact. More details on how the ERR is calculated are provided below...

Publicly Sharing ERRs

One of MCC's guiding principles is that foreign assistance should reinforce good governance practices, including enhanced transparency in government decision-making. As one of its initiatives aimed at increased transparency, MCC is making the ERR spreadsheets that were used in its funding decisions publicly available on its website. The spreadsheets are being released in Microsoft Excel format so that users can interact with the formulas, supporting data, and underlying assumptions used in the calculations . In addition, many of the files include interactive components that allow users to change key assumptions and see how those changes affect the project's ERR.

The spreadsheets reflect the technical rigor of the original economic calculations. In an effort to make the spreadsheets more broadly accessible, we have included a project description and a user's guide in each file.

The spreadsheets reflect the best information available to MCC at the time of the investment decision, and thus indicate the organization's estimate of the project's economic returns. MCC understands that underlying conditions and model parameters may change over time, and project design may be revised during implementation. When significant changes occur, MCC may revise these models. Updated information will be posted as it becomes available.

Calculating ERRs

Every ERR calculation considers two scenarios:

- The expected outcome with the project investment, including the increases in income or value added generated by the project, as well as its full costs; and
- The expected outcome without the project investment, including ongoing trends (i.e., a growing economy would continue growing even without the project).

ERR analysis compares the difference in incomes or value added between the two scenarios. The ERR, then, is expressed in percentage terms, and represents the interest rate at which the discounted net benefits equal the discounted costs. Projects that are likely to generate larger increases in household incomes per dollar invested will have higher ERRs.

The ERR may include income or value added that may be generated through environmental and social improvements, but MCC does not attempt to quantify and incorporate the broader social value of these improvements.

MCC models incorporate the best information available at the time regarding core parameters, but MCC also conducts sensitivity analysis to account for the uncertainty of these parameters. Thus, ERRs represent MCC's best estimate of what we expect will happen as a result of the project, while the sensitivity analysis represents the potential range of outcomes.

How ERRs Affect Proposals and Compacts

Countries eligible to receive compact funding from MCC prepare a compact proposal which identifies the main constraints to economic growth and proposes several programs to address those constraints. These countries have the primary responsibility for analyzing the economic impact of their proposed programs, and are expected to estimate this impact with an ERR. MCC's due diligence process includes reviewing and validating ERR estimates produced by our country partners and, if necessary, working with a country to identify and assess possible alternatives, modifications or complements to the proposed projects.

In cases where major changes in project designs or underlying conditions occur after a compact is signed, re-calculating an ERR can show whether restructuring is necessary and whether a project is still likely to yield sufficient returns. MCC has done so in a number of countries. This updated information will also be posted as it becomes available.

[1] In some cases, the ERRs were calculated in part using proprietary software (such as the HDM-IV software); in these cases, the Microsoft Excel spreadsheets present the outputs of this software.