The Millennium Challenge Account: Moving Toward Smarter Aid

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EXECUTIVE SUMMARY

The Millennium Challenge Account (MCA) proposed by President George W. Bush in March 2002 is an important step toward smarter US assistance to low-income countries. While it cannot yet be said to represent a revolution in development assistance, it is a welcome experiment and merits substantial funding by the Congress.

The original concept remains valid. A level of funding—$5 billion per year, large enough to be transformational—is one key element of the concept. Other key elements are rewarding good performance, country ownership, measurable results, and operational efficiency.

Sadly, the MCA program is limping, largely as a result of self-inflicted injuries. The most visible signs of trouble are the mid-June announcement of the resignation of Paul Applegarth, the first CEO of the Millennium Challenge Corporation (MCC), and the cuts imposed by the Congress in the FY 2006 budget mark-up process during the same month. The health of the program in the short run will depend on finding a second CEO who can mobilize strong bipartisan support in the Congress.

Funding is a critical issue because the FY 2006 appropriations level is headed toward a level below $2 billion compared with the President's request for $3 billion. The original proposal envisioned ramping up quickly to a steady commitment level of $5 billion per year beginning in FY 2006. The funds requested in both FY 2004 and FY 2004 were also cut by the Congress, by a total of $1.3 billion.

The goal of a $5 billion-per-year program is now getting in the way of building a successful program. An operating level of $2-3 billion annually over the next several years can still have a significant impact. At this level, however, opening the program to the lower middle-income countries, which become eligible for MCA funding in October, would be premature. The health of the program in the medium term will depend on the skill of the MCC in implementing the four Compacts already concluded and finalizing another dozen high-quality Compacts during the coming year.

Criticism of the MCC for getting off to a slow start is missing the point. Pressure to conclude a certain number of Compacts or commit a certain level of funding by some arbitrary date is counterproductive. In particular it undercuts the value of the consultative process that is unique to the MCA.

More seriously, the MCA program appears to be drifting toward "more of the same". This trend represents a grave risk and results from MCC policies as well as legislative constraints. Allowing the MCC to have multiple Compacts with an eligible

country could contribute significantly to the program's efficiency. Similarly, lifting the 5-year limit on Compacts and opening the door to having Compacts with regional governments or private sector entities would strengthen the program.

Creativity and flexibility are the keys to the ultimate success of the MCA program. The first four Compacts come across as different flavors of vanilla. They hint at a reluctance to engage in fast-disbursing sector support or other more flexible arrangements. To thrive, the program will have to experiment and act opportunistically. One way to do this could be to reimburse governments for home-grown programs of exceptional quality. Another way could be to establish a grant facility that would be drawn down for pre-agreed types of activities directly linked to economic growth and poverty reduction.

The decision to create the MCC still looks sensible. The delay in appointing the two House-nominated members of the Board of Directors, however, is another self-inflicted wound. The self-imposed ceiling of 200 for the staff of the MCC was questionable for a program operating at the rate of $5 billion per year but may be adequate at the more likely near-term rate of $2-3 billion per year.

The selection system for identifying countries eligible for MCA funding on the basis of objective indicators is innovative and methodologically sound. It is also a work in progress. Adjustments to reduce time lags in the indicators would enhance the effectiveness of the system in identifying the current best-performing countries. Finding a way to recognize improvements in country performance would reinforce the incentives inherent in the system. Explaining clearly why the MCC sometimes deviates from the indicators in selecting eligible countries would help to reassure skeptics that the MCA is fulfilling its promise of objectivity.

The Compacts recently signed with Madagascar, Honduras, Cape Verde, and Nicaragua may not be inspiring but they are solid. The MCC has demonstrated exceptional speed in progressing from country proposals to formal Compacts. The goal of becoming one of the largest donors in Compact countries has only been reached in the case of Cape Verde, but beginning modestly was a prudent way to start in the other countries. The degree of country ownership in these Compacts is impressive and the degree of coordination with other donors appears broadly satisfactory. The sector focus is reasonable but the MCC will probably have to move beyond infrastructure and rural development in future Compacts to deliver added value.

The reliance on newly-created Program Management Units to implement Compacts is a source of concern. It is contrary to best practice in the business of development assistance. The number of implementation decisions that require prior approval by the MCC is another possible weakness. The approach to measuring results could backfire by signaling failure when targets are missed despite broader success. On a positive note, the MCC deserves applause for focusing on estimated costs and benefits at an early stage in the design process.

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> Today, I call for a new compact for global development, defined by new accountability for both rich and poor nations alike….The United States will lead by example. We will increase our development assistance by $5 billion over … the next three budget cycles…The new money … is above and beyond existing aid requests in the current budget I submitted to Congress.
>
> George W. Bush,
> March 14, 2002

I. The Promise and Progress to Date

President Bush unveiled the Millennium Challenge Account (MCA) initiative on March 14, 2002, fourteen months after his inauguration and six months after the terrorist attacks on September 11, 2001.[1]

The MCA proposal was big. President Bush's commitment to fund the MCA at the rate of $5 billion per year within three fiscal years represented a 50 percent increase in official development assistance, because he promised not to cut other aid programs to accommodate the MCA.

The MCA proposal was a bold departure from past aid mechanisms. It would focus entirely on poor countries that were implementing sound economic development and poverty reduction strategies, selected on the basis of objective indicators.

This study is an interim report on the MCA's progress in delivering on the President's promise as of mid-2005. Its main features are described in Part I. The first four Compacts—with Madagascar, Honduras, Cape Verde, and Nicaragua—are examined in Part II. Part III presents our findings and suggestions for improvement.

The Bush Administration labored for almost eleven months after the MCA initiative was announced to prepare a formal legislative proposal to Congress. While this seems like a slow pace, extensive consultations among Executive Branch departments, agencies, and offices were required to resolve basic issues such as establishing a government corporation—the Millennium Challenge Corporation (MCC)—to implement the initiative.

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[1] The principal analytical work in defining a proper role for the MCA and in describing the technical strengths and weaknesses of the MCC has been done by Steve Radelet at the Center for Global Development and Lael Brainerd at the Brookings Institution. Their major publications are cited in the list of references (Annex F) and have been drawn on in preparing this study.

Congress took another eleven months to pass the Millennium Challenge Act. One factor that contributed to this long gestation was the limited consultations carried out by the Administration with the Congress before submitting its bill.

Table 1 provides a timeline of the major events in the evolution of the MCC program through the signing of the first four Compacts.

This section of the study focuses on four main features of the MCA program: overall size, the choice of an executing agency, the country selection process, and a set of basic limitations.

A. Program size

The Administration initially proposed to ramp up funding for the MCA over a period of three years. The ramp-up was extended by a year in the President's budget request for FY 2004 as the costs of the war on terrorism put pressure on the budget and many programs were cut or extended. The same pattern was repeated in FY 2005 and is likely to be repeated in FY 2006, with Congress providing substantially less funding for the MCA than requested by the Administration (see Table 2.)

Table 1
Timeline of Major MCC-related Actions

Action	Date
Announcement of the MCA by President Bush	March 14, 2002
MCA Legislation Sent to Congress	February 5, 2003
MCA Legislation Signed by President Bush	January 23, 2004
First MCC Board Meeting	February 2, 2004
FY 2004 Eligible Countries Announced	May 6, 2004
MCC CEO Applegarth confirmed by Senate	May 9, 2004
MCC Staff reaches 20	May, 2004
FY 2005 Eligible Countries Announced	November 8, 2004
MCC Staff reaches 105	April, 2005
Signing of Madagascar Compact	April 18, 2005
Signing of Honduras Compact	June 13, 2005
Resignation of CEO Applegarth announced	June 15, 2005
Signing of Cape Verde Compact	July 4, 2005
Signing of Nicaragua Compact	July 14, 2005

Table 2
MCA Funding Requested and Provided
(Billion dollars)

	FY 2004	FY 2005	FY 2006	FY 2007
Original Proposal	1.3	3.3	5.0	5.0
Authorized by Congress	1.0	2.3	5.0	5.0
Budget Request	1.3	2.5	3.0	5.0*
Appropriations	1.0	1.5	1.75**	TBD***

* OMB projection
** House Appropriations Committee mark-up: Senate mark-up was $1.8 billion
*** To be determined

As of mid-2005, against cumulative appropriations of $2.5 billion, four Compacts had been signed that committed a total of $610 million of aid over the next 4-5 years. The amount of MCA funds disbursed up to this point was insignificant, and consisted almost entirely of overhead costs.

B. Executing agency

It is easy to promise "a better mousetrap". It is harder to design one that actually works better. A first step in translating the promise of the MCA initiative into reality was the choice of an executing agency. Three options were considered: giving USAID the responsibility for administering the MCA, creating a new office within the State Department to administer it, or creating a new single-purpose government corporation to run the program. The President decided to create a new entity, the Millennium Development Corporation (MCC).

The Administration proposal of a three-person Board of Directors (the Secretary of State, Secretary of the Treasury, and Director of the Office of Management and Budget) was roundly criticized for omitting the Administrator of USAID and including the OMB Director. Congress decided instead to enlarge the Board and include some non-government directors. Five directors are ex officio: Secretary of State (chairperson), Secretary of the Treasury, USAID Administrator, US Trade Representative, and CEO of the MCC. The four non-government directors, one each recommended by the majority and minority leaders of the Senate and House, are nominated by the President, and confirmed by the Senate. As of end-June 2005, only the two Senate-selected non-government directors had taken office.

The MCA was to stay small—a powerful way of differentiating "new aid" from the "old aid" administered by USAID. Early plans envisioned an MCC staff of no more than 100, but it became evident that a larger staff would be needed. Thus, the ceiling adopted when the MCC became operational in February 2004 was 200.

C. Country selection

The selection of countries to receive MCA grants was critical to the goal of rewarding good performance. A considerable amount of time was devoted to this aspect of the program during 2002 when the Bush Administration was making the basic decisions required before authorizing legislation could be submitted to the Congress.

An early step was deciding on an annual per capita income ceiling that would be the objective basis for a list of "candidate" countries. When the draft MCA bill was submitted, it envisioned the selection of "eligible" countries on the basis of sixteen indicators, all produced by independent sources, measuring performance in the areas of ruling justly, investing in people, and economic freedom. These indicators were broadly welcomed and the Millennium Challenge Act supported their use. The application of the indicators yielded 16 eligible countries in FY 2004, and one more was added in FY 2005. The selection process and the indicators used are analyzed in detail in Annex B.

The Millennium Challenge Act also opened the door to MCA grants to lower middle-income countries (as defined by the World Bank), a group of 29 countries with per capita incomes from $1,466 to $3,035 in 2003 that includes Algeria, Peru, Russia, South Africa, and Thailand. The Act, however, limits funding to these countries to 25 percent of the amount[s] appropriated in FY 2006 [and subsequent years]. An important issue for the MCC is how far to open the door in FY 2006 given the likelihood that the actual appropriations level will be far below the level envisioned when the Act was passed.

One other group of countries was singled out in the Millennium Challenge Act: the so-called threshold countries. These are countries that demonstrate a significant commitment to just rule, investing in people, and economic freedom but fall short of meeting the formal standard. In selecting countries for the threshold program in FY 2004, the MCC Board favored those that had to improve on only one or two indicators to qualify "cleanly" as eligible countries. The MCC is not authorized to negotiate Compacts with the threshold countries but is allowed to finance activities that will help them improve their performance in areas where they fall short. It has invited 12 countries so far to negotiate threshold plans (see Annex A) and has decided to let USAID take the lead ("in partnership with MCC") in implementing the threshold program. The first Threshold Country Plan—$12.9 million for Burkina Faso—was signed in July 2005 and will focus on improving performance against the indicator for girls' primary education completion.

D. Basic limitations

The MCA program is a bilateral program launched at a time when other donors were moving in the direction of multilateral approaches, including the pooling of funds for specific problems (such as malaria) or specific countries. The general trend is a reaction to an abundance of evidence that project proliferation by dozens of aid agencies—each with different procurement, monitoring and evaluation procedures—can

easily overwhelm the administrative capacity of governments in many poor countries. Thus a new bilateral effort needs to justify itself by yielding benefits that exceed the costs of the additional management burden on the partner countries.

President Bush's initial proposal said nothing about how the MCA program would be implemented. The Administration's draft bill specified a bilateral agreement between the MCC and the government of the partner country and the MCA bill locked in this approach. The rationale for precluding the MCC from entering into Compacts directly with sub-national government authorities, NGOs, or private firms is not clear.

The Administration's draft MCA bill did not specify a time limit for Compacts, but Congress limited the life of any one Compact to a maximum of five years, and prohibited the MCC from having more than one Compact with a country at any one time. The rationales for these two requirements are not evident from past experience.

II. The MCC in Operation: The First Four Compacts

By the end of June 2005, the MCC Board had approved Compacts with four countries: Madagascar, Honduras, Cape Verde, and Nicaragua.[2] This section describes the content of these four Compacts, examines eight aspects, and provides an overall assessment.

An important caveat is that most aid programs are based on broad strategy documents that outline the general approach, the reasons for its selection, the expected outcomes, and the risk factors that might prevent these outcomes from being achieved. In contrast, the Compacts are lawyerly documents, full of legal language about the responsibilities of both parties. The MCC's ability to move from country proposals directly to contractual agreements can be regarded as one of the advantages of the MCA approach. It shortens significantly the time between the conception of a program and its implementation. As a result, however, the broad framework normally available for assessment purposes is not contained in or clearly identified in the Compacts.

A. The Content of the Compacts

Madagascar

The MCC's first Compact, for $110 million, was signed in April 2005. It includes three components, expected to be synergistic, with each reinforcing the ultimate goal of increased investment, productivity, and incomes in rural areas of Madagascar. They are:

Land Registration ($38 million). The Compact states that the lack of firm land ownership rights has been an important barrier to investment in rural areas, where 80 percent of Madagascar's population lives. Distrust of the government's formal land registration system is widespread, so rural landowners depend heavily on informal local tenure practices. This limits tenure security and prevents land from being used as collateral to finance improvements.

Financial Reform ($36 million). Improvements in the financial sector will help it to contribute more to Madagascar's economic growth, by: improving the efficiency of the financial system; expanding financial access by increasing real and perceived creditworthiness; and introducing greater competition into the financial sector. This reform is to be accomplished in part by new laws that will permit a multi-tiered financial system and reduce the time required for checks to clear through the banking system. Some $21 million will be used to modernize the inter-bank payments system. Small-

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[2] The MCC had also notified Congress of its intention to negotiate a Compact with Georgia. Board consideration is expected during July.

denomination treasury bills will be issued, allowing small savers access to competitive interest rates on their savings. Micro-finance institutions will also be strengthened and loan delinquency reduced.

Agribusiness Investment Promotion ($17 million). This component will promote investment in five rural zones. The primary vehicle for this activity will be the establishment of non-governmental agricultural business centers (ABCs). The MCC Compact will pay the operating costs of these entities, estimated to be about $3 million per year. A National Coordinating Center in the capital will provide information to the ABCs, and coordinate their activities.

Honduras

The Honduras Compact, for $215 million over five years, combines infrastructure investment with rural development. The four components of this program are:

Highway Construction ($96 million). A portion of the principal artery connecting large parts of Honduras (as well as El Salvador and Nicaragua) with Central America's principal Atlantic port will be improved. This project complements loans from other donors (IBRD, IDB, CABEI) that are funding other portions of this artery. The collection of tolls on this artery is envisioned to assure adequate funding for road maintenance. This portion of the Compact should also benefit the rural producers in northwest Nicaragua who are the focus of Nicaragua's Compact.

Rural Roads ($42.9 million). Secondary and farm-to-market roads will be constructed with a view to increasing rural incomes by reducing the gap between farm-gate prices and prices in urban markets.

Rural Business Development ($51 million). Technical assistance will be provided to encourage farmers to shift to higher-value crops and to improve access to credit. Grants will fund agricultural "public goods" projects.

Highway Weight Control ($4.7 million). This component will finance investments to ensure that overweight vehicles do not degrade the principal arteries.

Cape Verde

The Cape Verde Compact is for $110 million over five years. Although it is for only half the amount originally proposed by Cape Verde, and is the smallest amount approved so far, it represents a large investment for a country of less than a half-million people.

Agricultural Support and Watershed Management ($10.8 million). Much of the activity under this component broadly parallels activities in the other three Compacts. It also includes support for improvement in water management, including the establishment

of user fees for water use, and a small amount of credit for the development of drip irrigation.

Port and Road Infrastructure ($78.8 million). The bulk of the funding for this component ($53.7 million) is for improvements in Cape Verde's main port at Praia. It will substantially improve the efficiency of the port, making it a site for transshipment and warehousing for West African countries.

Private Sector Development ($7.2 million). This component will stimulate investment in productive business enterprises, and help to increase the effectiveness of the financial sector.

Nicaragua

The Nicaragua Compact, for $175 million over five years, is primarily an integrated rural development program focused on two provinces in Northwest Nicaragua, Leon and Chinandega. It includes three components:

Property Regularization ($26.5 million). Land title insecurity was identified by Nicaraguans as a major obstacle to investment in their country. This component will finance cadastral mapping, land titling, demarcation of protected areas, linkage of municipal and national cadastral databases, and the resolution of land title disputes. The component extends to the province of Leon an ongoing World Bank project in the province of Chinandega.

Rural Business Development ($33.7 million). A rural business development center, similar to those created in Madagascar and Honduras, will be created to help farmers identify market opportunities, provide technical assistance to farmers for production and marketing, and fund grants for improved water use and watershed management.

Transportation Infrastructure ($92.8 million). A 58-kilometer section of the main national highway will be upgraded and secondary roads in the two target provinces will be constructed. The national highway project complements the upgrading of the remainder of this highway between Managua and the Honduran border financed by the World Bank and other multilateral banks. The secondary road project is expected to reduce transportation costs between the agricultural areas supported by the project and markets inside and outside of Nicaragua.

B. The MCC Approach to Compacts

These four Compacts are the only raw material currently available for judging how well the MCC is living up to its promise. Eight aspects are analyzed: program preparation, the investment approach, the funding level, country ownership and public participation, coordination with other donors, the economic sectors chosen, administrative requirements, and the relationship to USAID activity.

1. Program Preparation. All four of the Compacts approved so far depart from the conventional to program preparation. Instead of the usual donor-driven approach, the first step toward MCA funding is the submission of a proposal by an eligible country. The MCC then dispatches a team to the country to discuss its proposal and begin refining it into a contractual agreement. Comparing the initial proposals with the Compacts, three generalizations emerge, all of which appear consistent with the MCC's mandate to promote economic growth and poverty reduction:

- The amount of funding has been reduced. On average, signed Compacts have been about two-thirds of the original proposal.

- The Compacts significantly narrowed the range of activities being undertaken, producing a more focused and coherent program.

- The Compacts were more focused on sustainability and income generation.

Reflecting this unconventional approach, the MCC has shown that it can move quickly (6 months) to sign a Compact compared with the 18-24 months it typically takes to go from proposal to contract under most multilateral and bilateral programs. This requires skipping many of the traditional steps (e.g., assessments of economic impact, administrative capacity, environmental impact, impact on women or vulnerable groups, and cultural impact), which entails both upside benefits and downside risks. One large upside benefit is rapid implementation. Projects are more likely to be implemented effectively when their designers and promoters are still present to implement them.

One downside risk is that more things are likely to go wrong. At the same time, the body of existing studies prepared as background for prospective operations by donors is already quite large, and many studies lag behind rapidly changing facts on the ground. Country "buy-in" may do more to mitigate the downside risks, especially if senior government officials are deeply committed and have engaged in thorough consultations with affected parties.

2. The Investment Approach. While the MCC has been innovative in Compact preparation, it has been conventional in its decisions about what to finance and how to finance it. At least in the first four Compacts, the MCC has fully embraced a project approach rather than a budget or sector support approach. Under the former, discrete activities deemed to be of high priority are funded. Donors have long preferred this approach because it results in a concrete product with which the donor is linked. The difficulty with this approach is "fungibility". Countries need roads and other investments, and would finance them with their own resources if foreign aid were not available. Donor funding of these investments therefore frees up domestic resources for other purposes. If these other purposes are important, all is well. However, if the other purposes are non-developmental or anti-developmental, then the donor has indirectly funded them.

There are many ways around this difficulty, including direct support of the government's overall budget or a particular part of the budget. Alternatively, aid can be disbursed against actual results already achieved by the government, or to private sector entities, bypassing the government entirely. The MCC has so far shown no interest in experimenting with these other approaches.

3. Funding Level. One of the early claims of the MCC was that it would be among the largest donors in any participating country, and thus able to command the attention of both the government and non-governmental actors. Table 3 shows how the MCC stands up against this standard. The World Bank is typically the largest or second-largest source of donor financing to most well-performing developing countries, so the first comparison in Table 3 is with the World Bank. Given that a typical World Bank project disburses in five years, the size of its active portfolio can be used as a proxy for comparison with the MCC's typical five-year Compact. As shown by Table 3, Cape Verde is the only country where MCA funding appears to exceed World Bank funding. In the three other countries, it is less than half the size of World Bank activity.

Table 3 also looks at the MCC's initial Compacts in relation to all official development assistance (ODA) for the past five years (four years in the case of Madagascar). Again, only Cape Verde stands out as a country where the MCC adds more than 10 percent to total donor funding.

Table 3
Compact Amounts and Total ODA
How Big is the MCC?

Country	Compact Amount ($ million)	World Bank Active Portfolio	Compact as % of World Bank Portfolio	Total ODA, 1999-2003 ($ million)	Compact as Share of 5-Year ODA
Cape Verde	110	53	208%	544	20%
Honduras	215	452	48%	2,771	8%
Madagascar*	110	1000	11%	1,608	7%
Nicaragua	175	400	44%	3,516	5%

*As the Madagascar compact is only for four years, a comparison is made with total ODA for the four-year period 2000-2003

These numbers show that the MCC has become an important new player in quantitative terms only in Cape Verde—a country with less than 500,000 people. The MCC's claim to having a better approach will therefore depend mainly in qualitative factors in the other countries. The MCC's use of grants rather than loans is one significant qualitative factor that distinguishes it from most programs of the multilateral development banks, although these banks are increasing steadily the share of financing they provide to low-income countries in the form of grants.

Table 4 highlights another aspect of the MCC's approach: its emphasis on smaller countries. It shows that *per capita* MCC funding is inversely correlated with country population. Proportionately, the Cape Verde program is far larger than any of the others, while the Compact with Madagascar—the only country with a population of more than 10 million people—is by far the smallest in per capita terms. Since most of the world's poorest people live in large countries, the MCC's approach so far has been better calibrated to help poor *countries* than to help poor *people.*

Table 4
Country Population and Compact Amounts
A Bigger Player in Smaller Countries?

Country	Compact Amount ($ million)	Population (million)	Compact Amount: per capita per year
Madagascar	110	16.4	1
Honduras	215	6.8	6
Nicaragua	175	5.3	7
Cape Verde	110	0.5	47

4. Country Ownership and Public Participation. All four Compacts document extensive public participation in the discussions leading up to the Compact. This is the most difficult of the dimensions of the MCC approach to analyze. All four of the countries had previously completed Poverty Reduction Strategy Papers (PRSPs). The preparation of PRSPs typically involves consultations with NGOs and other elements of civil society, although they frequently suffer from a lack of prioritization and end up as "wish lists". It is impossible to pinpoint the extent to which governments in the countries concerned actually took comments from other actors into account.

5. Coordination with other Donors. The four Compacts all reflect a significant degree of interaction with other donors. Three of them are directly complementary to World Bank projects. In all four cases, there appears to have been coordination with USAID in the design and implementation process. In this area, the MCC appears to be delivering on its promises.

6. Economic Sectors Chosen. President Bush offered several examples of possible activities—including the fight against HIV/AIDS, computer instruction for young professionals, providing textbooks and training, and use of science and technology to increase harvests—when he proposed the MCA in March 2002. Except for agricultural technology, where the emphasis in the Compacts is mainly on dissemination of existing knowledge, none of them have funded health, education, or technology. MCC officials deny steering cooperating country partners away from these sectors, and claim that the activities selected reflect country priorities and not MCC preferences. They also

suggest that other donor programs provide substantial funding for the social sectors, while shortchanging activities that directly promote economic growth.

Table 5 provides an overview of the sector breakdown of funding under these Compacts in both dollars and percentage shares. Six characteristics of the sector focus of the first four Compacts are worth highlighting.

- Targeting rural poverty. Three of the four Compacts are aimed primarily at the agriculture sector in rural areas, and the fourth (Cape Verde) includes significant funding for rural areas. As a large percentage of the poor population is found in rural areas in all four countries, this gives the MCA program a strong pro-poor orientation.

- Investing in physical infrastructure. Transportation infrastructure accounts for over half of MCC funding in every country but Madagascar.

- Strengthening farm-to-market linkages. Rural business development, through project-established facilitators, accounts for between 10 percent and 20 percent of the funding committed in each of the four Compacts.

- Reinforcing property rights. Two of the four Compacts make major investments in land registration.

- Expanding rural credit. All four Compacts acknowledge the need for increased credit to agriculture and rural enterprises. Except for Madagascar, this constraint is addressed mainly through policies rather than funding. Even in the case of Madagascar, most of the funding is for improvements in financial infrastructure, not for credit. This conforms with best practice.

- Keeping costs low. Overhead, monitoring and evaluation costs represent between 9 percent and 17 percent of total costs, a range that appears to be far below the comparable percentages for USAID and other bilateral donor agencies.

7. Administrative requirements. The procedural advantages of the MCC over current USAID programs are discussed in Annex C. Particular benefits are likely to flow from the absence of a "buy America" requirement, and the MCC's intention to reduce costs and promote institutional development by procuring far more technical assistance in the partner country.

All four Compacts appear to rely on the creation of organizations dedicated to the MCA as the primary implementation vehicles. Donors have long used such Program Management Units, or PMUs, to speed implementation. Nevertheless, PMUs typically become elite organizations that attract the best professionals from line ministries and undercut the capacity of government institutions while a project is being implemented. The OECD recently identified the use of PMUs as an approach to be avoided except in

Table 5
The MCC's First Four Compacts
Allocation by Type of Activity
($ Million)

Country	Infrastructure	Land Tenure and Property Rights	Rural Business Development	Watershed Management	Credit, Financial Sector Development	Administration, M&E	Total
Cape Verde	79	-	11	7	-	13	110
Honduras	147	-	35	-	14	19	215
Madagascar	-	38	18	-	36	18	110
Nicaragua	94	27	34	-	-	22	176
Total	**320**	**64**	**98**	**7**	**50**	**72**	**611**

The MCC's First Four Compacts
Allocation by Type of Activity
(Percent)

Country	Infrastructure	Land Tenure and Property Rights	Rural Business Development	Watershed Management	Credit, Financial Sector Development	Administration, M&E	Total
Cape Verde	72%	-	10%	6%	-	12%	100%
Honduras	68%	-	16%	-	6%	9%	100%
Madagascar	-	34%	16%	-	33%	17%	100%
Nicaragua	53%	15%	19%	-	-	13%	100%
Total	**52%**	**11%**	**16%**	**1%**	**8%**	**12%**	**100%**

unusual circumstances (OECD/DAC, 2005). Thus, the MCC appears to have chosen an approach that is likely to speed implementation of its Compacts, but at some cost to longer-term sustainability and institution building.

The typical Compact specifies numerous implementing decisions where prior MCC approval is required, such as changes in the leadership of governing organizations, without specifying whether it must come from MCC headquarters in Washington or from the MCC representative in the country. These provisions are potential sources of misunderstanding and delay.

All four Compacts contain extensive quantitative measures that can be used to monitor progress and to eventually evaluate the success of the Compacts. The MCC appears to have gone much further than other donor agencies in providing quantitative progress and outcome indicators. This has been incorporated into the MCC's general approach, whereby the expected outcomes that serve to justify the Compact in benefit-cost terms are used as progress indicators. This integration of expected outcomes with proposed interventions at an early stage of discussion may be an important innovation in donor practice. It is common in donor practice for projects to be designed before economists are called in to justify them in benefit-cost terms. For the MCC, benefit-cost analysis appears to be driving project design. In principle, the MCC approach to achieving results is more promising.

The MCC approach includes three levels of quantitative measurement: which might be characterized as results, outputs, and outcomes. Drawing on the Nicaraguan Compact to illustrate the approach, one results indicator for the property regularization activity is the number of parcels with regular titles: 1,000 in year one, 8,754 in year two, etc. At the next level (outputs), targets are set for the value of land titled under the program, year by year. And at the outcome, level, targets are set for income gains as a result of the property titles. For this category, Year 5—the final year of the Compact—is the only year for which a target is set. This is reasonable, but it highlights the fact that most aid projects generate results only gradually, and that the real impact of any project cannot be evaluated in outcome terms until after the money has been spent. Furthermore, in most good projects, benefits will continue to accrue for years after the last disbursement of project funds has been made.

8. The MCC and USAID in the Compact Countries. For the four countries with Compacts, the annual flow of MCC resources to the country is, on average, about 10 percent larger than the FY 2005 flows from USAID. Thus, it represents slightly more than a doubling of U.S. bilateral aid. The countries do differ significantly. USAID does not operate in Cape Verde, and the annual flows from the MCC to Madagascar are likely to be significantly higher than USAID flows, while USAID will still be quantitatively larger in Honduras and Nicaragua. Looking only at funding for economic growth-promoting activities, the picture changes dramatically. For Madagascar, MCC funding represents a forty-fold increase in total U.S. aid funding for this area, while for Honduras and Nicaragua it is an increase of 410 percent and 238 percent, respectively.

C. Preliminary Assessment of Four Compacts

It is far too early to judge the quality of the Compacts negotiated so far. Nevertheless, our preliminary assessment is that they are too similar to conventional aid activities to be considered a bold new approach. They are similar both in scale and structure. Except possibly in the case of Cape Verde, they are too modest to be transformational. The one area where the MCC approach has clearly been superior is the speed with which Compacts have been concluded (at least for the first four countries). The level of buy-in by the leaders of the Compact countries may also be superior. The magnitude of these advantages, however, will only be measurable in another 3-5 years.

III. Interim Assessment of the MCA Program

We begin by examining four features of the program generally (the "macro" dimension). We then examine six features of the first four Compacts (the "micro" dimension.

A. Four Features of the Program Generally

Our assessment of the MCA program focuses on four features. One of them is in serious difficulty: the promised size of the program. The announcement in mid-June of the resignation of CEO Paul Applegarth has revealed problems with respect to a second feature: the choice of an executing agency for the program. A third feature of the program—country selection—has been a strong point, but the impending cut in the FY 2006 budget request creates some issues here. Finally, several of the basic limitations imposed on the MCA program appear inconsistent with the flexibility that will be required to make the program a success.

1. <u>Program Size</u>

The $5 billion price tag President Bush put on the MCA program was impressive. It was big enough to make a difference and yet was still feasible in a tough budget environment. The validity of the number was borne out by the relative ease with which the Congress embraced it when the MCA bill was passed at the beginning of 2004. However, an early sign of trouble was the cut in the appropriations in FY 2004 for the MCA to $1.0 billion from the President's request for $1.3 billion. The signs of trouble have escalated since then. The President's ambitious ramp-up schedule has been stretched out, the Congress cut his FY 2005 request more deeply, and his FY 2006 request seems headed for an even bigger cut. Instead of getting an additional $5 billion of funding in FY 2006, the MCC appears likely to end up with less than $2 billion.[3]

A simple explanation for why the MCA program is on a trajectory well below the $5 billion level is Iraq. The high costs of stabilization and reconstruction in Iraq are putting pressure on every category of the budget, especially Budget Function 150 that groups together foreign aid and other foreign operations. The costs of the war on terrorism and homeland security are compounding this pressure.

In the competition for scarce Budget Function 150 funds, however, the MCA program is losing out to one other new program—the President's Emergency Fund for AIDS Relief (PEPFAR)—and has also been affected by increased funding for longstanding programs including development assistance administered by USAID, food

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[3] In the markup process for the FY 2006 appropriations bill, the House mark for the MCC announced on June 16 was $1.75 billion. The Senate mark announced on June 29 was $1.8 billion.

aid, humanitarian relief and reconstruction financing for Afghanistan and Iraq. The contrast with PEPFAR is interesting and is addressed in Annex D.

For a variety of reasons, the MCA program has not yet developed a strong domestic—or foreign—constituency. One reason was the decision by the architects in the White House to minimize consultations with the Congress and the NGO community in the early stages of designing the program. A second reason is that relations between the MCC and the Congress in the year since it became operational in May 2004 have been poor or worse. The White House hang-up over the appointment of the House-nominated members of the MCC Board looks like another missed opportunity. A fourth reason is that when the President's FY 2006 budget request was sent to the Congress, three years after he proposed the MCA and almost a year after the MCC became operational, not a single Compact with a partner country had been signed. A $3 billion request for a program that has no traction is a fat target for cuts.

Could the MCC have moved faster to sign Compacts and commit larger amounts of money? There is no easy answer to this question. It almost certainly could have moved faster by compromising on some of the basic principles such as country ownership. Or it could have decided at an early stage to commit some pump-priming funds rather than holding off committing anything until Compacts were signed. Or it could have decided to provide fast-disbursing sector or structural adjustment grants instead of slow-disbursing project grants.

A fundamental problem is that most of the eligible countries at this stage are small countries with limited absorptive capacities. Adopting generous assumptions about the number of Compacts that will be concluded with the presently eligible countries by the end of FY 2006, the average size of each Compact, amendments to increase the size of the earliest Compacts, and the size of the threshold program, the funding requirement for the FY 2004-2006 period could reach $5.0 billion against the $5.5 billion that would have been available if the Congress had provided the full amount the MCC requested for FY 2006. For various technical reasons, the problem of too much money gets worse beyond FY 2006. It is hard to identify a need for more than $3 billion a year in FY 2007 and FY 2008.

Is an MCA program operating at the $2-3 billion level worthwhile? We believe it is. Like most start-ups in either the private sector or the public sector, the risk of failure is substantial, but the potential rewards are also large. As President Bush said in Monterrey, the MCA vision is not about "arbitrary inputs from the rich" but about "tangible outcomes for the poor". The $5 billion figure was arbitrary. If the MCC, at a running rate of $2-3 billion per year, can deliver tangible results for the poor that compare favorably with other bilateral and multilateral programs, then it will clearly be deserving of continued funding, and even funding at a level above $5 billion per year.

In short, we believe there is still a good chance for the MCA program to live up to its transformational potential to promote economic growth and reduce poverty.

2. Organizational approach

Four aspects are worth examining: the choice of a government corporation, the Board of Directors, the management, and the staff (in Washington and in the field).

Choice of a corporation. President Bush chose to establish the MCC to run the MCA program instead of embedding it in the State Department or USAID. The Congress supported the President's choice despite strong appeals to put it in USAID from the NGO community, which has long sought to give this agency more clout in determining how funds for various U.S. foreign aid programs are allocated among countries and sectors.

The MCC's performance to date tends to support five arguments that were advanced for establishing a new organization:

- A corporation separate from the State Department and USAID will be less political, and therefore better positioned to manage a program based on objective criteria.

- A corporation will be more cost efficient by having more freedom to hire, fire, procure and enter into contracts than a Federal agency has.

- A corporation will not be bound by the provisions of the Foreign Assistance Act that have hobbled USAID for years.

- A corporation will staff up with people who were inclined to be more innovative and less burdened by old habits of aid-giving.

- A corporation will present a fresh face of America and therefore be better positioned to cut through some of the negative attitudes toward US assistance that have developed in recent years.

Board of Directors. The substitution of the USAID Administrator for the Director of OMB and the addition of the US Trade Representative and four public members is an improvement over the membership proposed in the original MCA bill submitted by the Bush Administration. The Senate-linked non-government directors, Kenneth Hackett (President of Catholic Relief Services) and Christine Todd Whitman (former Administrator of the Environmental Protection Agency and former governor of New Jersey) are solid choices. It is regrettable that the two House-linked non-government directors have not yet been nominated. With two more equally distinguished members, the MCC Board would achieve a high standard of governance.

MCC management. The MCA program suffered a serious blow when its first CEO, Paul Applegarth, announced his resignation on June 15, 2005. His resignation begs the question of whether a nominee with stronger credentials, someone like Randall Tobias who was picked around the same time to be the U.S. Global AIDS Coordinator, could have helped the MCC get launched more quickly and smoothly.

It is an understatement to say that the future of the MCA program will depend critically on the choice of a successor to Applegarth. We believe that either a senior member of Congress or a CEO from the private sector with the kind of reputation that Ambassador Tobias brought to his job will be necessary to restore the optimism that existed when the MCC came into being a year ago. A candidate who appeals to both sides of the aisle would also improve the odds of success for the MCA program.

MCC staff. In testimony introducing the Administration's original MCA bill, Under Secretary of State Alan Larson said that the MCC "will draw its staff from the best and brightest in the public, private and non-profit sectors. We envision a relatively small staff, which would serve for time-limited terms." The size of the MCC staff was one of the most hotly debated issues in the process of passing the Millennium Challenge Act. Numbers as low as 50 were advanced but at the point of passage the target size was 200. The studies by Brainard et al. (2003) and Radelet (2003) have pointed out that, relative to other aid-giving organizations operating at the same funding level through similar project-based activities, a staff of 200 is extremely low.

We believe that a staff of 200 is adequate for a program operating at a commitment pace of $2-3 billion per year, although the current staffing pattern appears somewhat top-heavy. We are more concerned about indications that the MCC will limit the number of Americans in the field to one or two in each Compact country. We believe that a stronger field presence will be required to respond in a timely fashion to the implementation issues that will inevitably arise and thereby threaten the measurable results that have been promised.

3. Country Selection

Rewarding poor countries that are pursuing sensible approaches to economic growth remains one of the most popular features of the MCA program. As noted in Appendix B, however, this kind of performance-based programming is not totally new.

President Bush's original idea of assessing performance by focusing on ruling justly, investing in people, and economic freedom as the measures of performance was enshrined by the Congress in the Millennium Challenge Act. The MCC has only departed from these three measures by starting to search for an additional indicator to measure natural resources management.[4]

The MCC system for selecting eligible countries is innovative and basically sound. (See Annex B.) The diverse set of indicators being used seems to be effective in preventing seriously unsuitable countries from being selected. The 17 countries deemed eligible for FY 2004 and FY 2005 funding are all reasonable choices. Our concerns about the selection process are related to the countries that have been left out. A case can be made that the formal standard is too demanding for the poorest countries and therefore

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[4] The Brookings Institution held a conference on this topic on June 24, 2005.

a modest loosening of the standard could give the MCA program more credibility and more impact.

Up to this point, the MCC Board has not explained the basis for deviating from its formal performance standard by making a few countries eligible that have not met this standard and excluding more countries that have met the standard. (See Annex B.) Providing such explanations in the future would do much to show that the MCA is fulfilling its promise of selecting countries on the basis of performance rather than foreign policy objectives.

More importantly, with the program's funding level unlikely to exceed $3 billion in the near term, allocating 25 percent of any new appropriations for Compacts with lower middle-income countries—as permitted under the Millennium Challenge Act—would adversely affect the MCC's ability to provide transformational assistance in the poorest countries. A small number of opportunistic operations in the lower middle-income countries, however, could help in building support for a bigger program in future years.

With regard to the threshold program, the countries selected so far seem reasonable. Our concern at this stage is the division of labor between the MCC and USAID in designing and implementing Threshold Country Plans. Better results might be achieved—in terms of tangible progress in helping countries move from threshold to eligible status—by having the MCC take full responsibility for the threshold program as it becomes fully staffed.

The MCC's selection system is best seen as a work in progress. Efforts to make the indicators more contemporaneous are clearly desirable and the addition of a natural resource management indicator is a sensible step. In the final analysis, however, the mission of the MCC is to use taxpayer money to promote economic growth and poverty reduction. Success here will depend much more on the content of individual Compacts than on the performance ranking of countries when they sign their Compacts.

4. Basic Limitations

We are not especially bothered by the bilateral character of the MCA program. However, the statutory prohibition against using multilateral agencies or trust funds that pool donor resources takes the underlying concern a step too far. In some of the smallest countries, for example, using multilateral agencies or trust funds could be highly cost-efficient.

No one has advocated giving the MCC the flexibility to make loans as well as grants, and no one has seriously questioned the untied nature of MCA funding. We agree that untied grants offer the best chances for getting better results in a more efficient manner. The per capita income ceiling for candidate countries is also sound.

We believe that a group of three inter-related limitations—derived both from the Millennium Challenge Act and from MCC policies—are among the most serious weaknesses of the MCA program:

- The Act limits the term of Compacts to five years. This kind of arbitrariness in the aid business brings no advantages and usually reduces effectiveness and raises costs. It makes sense at least to amend the legislation to make clear that Compacts can be extended beyond five years when necessary to achieve the desired results.

- The Act prohibits the MCC from entering into multiple Compacts in any individual country. We have examined this limitation from numerous perspectives and have been unable to find any hint of a compelling rationale for it. It is harmful because it forces the MCC and its partner countries into a stop-and-go cycle. It creates pressure to add program components prematurely and delays worthwhile new components until the current Compact expires.

- The Act requires the MCC to enter into a Compact with the national government of each eligible country that seeks MCA funding. Here is another opportunity closed off arbitrarily. Especially in large countries, programs focusing on a specific province or district may be exceptionally attractive. Forcing the MCC to operate through the national government in these cases is likely to add significant costs without tangible benefits. In some countries, Compacts with an NGO or a private firm may be worthwhile complements to Compacts with the national governments. These will necessarily be more narrowly focused and involve smaller amounts of funding, but the benefits may be an order of magnitude larger.

We believe the success of the MCA program in the long run will depend critically on its flexibility, its willingness to experiment and take risks, and its ability to act opportunistically. Experimentation is especially desirable because of the rapidly changing political and social environment in the target countries, not to mention changes in technology and other external factors. One prime area for experimentation is fast-disbursing non-project assistance. Two examples encountered in the course of our work illustrate the kind of experimentation we have in mind:

- The MCA program is designed to reward good performance in broad “macro” areas such as economic freedom. It could also reward good performance in “micro” areas such as the construction of schools under an entirely homegrown, self-financed, corruption-free program. This could be done extremely simply by reimbursing the government for what it has already invested in this activity. Monitoring and evaluation costs would be eliminated. The risk of failure would be zero. The measurable results could be documented on the day the grant is disbursed.

- One of the disadvantages of fast-disbursing sector grants is that they come with conditions that are inconsistent with country ownership or they are interrupted

when reform deadlines are missed. A fast-disbursing alternative would be to establish a grant facility that could be drawn down by the government for pre-agreed types of activities such as vaccine for children, rural road construction, or expansion of the electrical grid to underserved rural areas.

B. Six Features of Compacts

We have assessed six main features of the first four Compacts. The MCC's performance to date in three areas has been good: program preparation, country ownership and the participation of civil society, and coordination with other donors. Its record in three other areas is mixed: the funding level, sector focus, and a set of administrative requirements.

1. Program Preparation

The MCC has demonstrated an ability to move from concept to Compact in only six months, considerably faster than it takes most bilateral and multilateral aid programs. Naturally when the MCC moves this quickly much of the credit goes to the partner country for making the MCA program a high priority and assigning responsibility to people and institutions capable of making the necessary policy decisions in a timely fashion. We view operational speed as one of the strengths of the MCC. Exceptional efforts by the MCC, by the Administration, and by the Congress will be required to resist the kinds of "barnacles" (unnecessary restrictions) that have made other U.S. aid programs slow and diminished their effectiveness.

2. Funding Level

One of the objectives of the MCC has been to become one of the largest donors in each country where it is active. Among the first four Compact countries, Cape Verde is the only one where this objective has been achieved. We doubt that this objective is critical to the success of the MCA program, but expectations have been created that are not being met. We are also concerned by the apparent disconnect between the number of poor people in partner countries and the scale of their Compacts. It makes sense to have larger programs in countries with more poor people.

3. Country Ownership and the Participation of Civil Society

While not mentioned explicitly by President Bush in his original proposal, country ownership has become one of the hallmarks of the MCA program. Like performance-based programming, country ownership is not a new idea. For several years, aid from the IMF and World Bank to low-income countries has been provided in the framework of Poverty Reduction Strategies. The participation of civil society in developing these strategies, uneven at first, has become an important part of the process.

A solid assessment of country ownership in the first four Compacts would require visits to the countries involved, which were beyond the scope of this exercise. Assessing

ownership is also difficult in these cases because all four Compact countries had Poverty Reduction and Growth Strategies in place that were the product of broad consultations with other donors and civil society consistent with IMF and World Bank guidelines. There is considerable anecdotal evidence that the MCC has been able to achieve a higher degree of country ownership than other donor programs. Furthermore, new benchmarks appear to have been set in incorporating the views of people in target regions and sectors, and the personal involvement of top leaders in the first four countries has been impressive. In this respect, the MCC's approach seems to have the potential of becoming a positive force of some significance for economic growth and poverty reduction. While there is certainly room for improvement in this area, we consider it to be one of the outstanding features of the program and urge the MCC to continue exploring new ways of enhancing country ownership.

4. Coordination with Other Donors

There is a fair amount of anecdotal evidence that the first four Compacts embody an above-average degree of country ownership and that the choice of projects to be carried out reflects above-average participation by civil society, including people directly affected. Nevertheless, a greater effort by the MCC to draw on the (sometimes distinctly unhappy) experience of other donors could help it avoid problems down the road and enhance its ultimate impact.

5. Sector Focus

We see advantages in the relatively narrow sector focus of the first four Compacts, especially because growth-promoting programs in poor areas appear to be relatively under funded by other donors. At the same time, the circumstances differ so much from country to country that we expected to see more sector variation. We consider any effort to push the MCC in the direction of projects in the health and education sectors to be inappropriate, as these choices should be made by the country and not the MCC. But we agree with the argument advanced by some NGOs that avoiding these sectors is inconsistent with the mission of the MCC. Still, the MCC's emphasis on sustainability after completion of the project clearly limits its role in many activities in these areas. Our biggest concern about sector focus is the apparent reluctance of the MCC to provide fast-disbursing sector grants to countries whose overall performance in allocating resources in a pro-growth and pro-poor manner has been convincingly demonstrated.

6. Administrative Requirements

MCA support is not intended to be perpetual. Thus an important element of every country program is sustainability. As discussed above and in Annex C, the MCC has a mandate to be a lean organization and to pursue low-cost approaches to delivering aid. Its relative freedom from statuatoryl restrictions is an asset, and its emphasis on contracting for services in-country both lowers costs and promotes institutional development and sustainability. On the other hand, the MCC's reliance on Program

Management Units in the first four Compacts appears inconsistent with institution-building and sustainability.

Getting tangible results has been the dream of every foreign aid program for the past 50 years. Taxpayers add up the amount of foreign aid that has been provided to developing countries during this period, they look at the extent of poverty that remains in these countries, and they conclude that much of the aid must have been wasted. This prevalent view, however, is mistaken in two respects. First, a great deal of progress has been made. Life expectancy, literacy, and standards of living have improved dramatically during this period in the developing world as a whole and for most of its citizens, and foreign aid has played a role in this progress. Second, no one really knows how to jump-start an under performing country like Bolivia or Liberia or Egypt and transform it into an economic "tiger" like Thailand. Rapid and sustainable economic growth is a complex phenomenon. Many parts of a country's economic, political, and social systems have to be transformed and aligned to achieve this objective.

Without the prospect of achieving tangible results surpassing those of other aid programs, it is unlikely that the MCA program would have elicited the degree of support in the Congress it has enjoyed so far. Like all aid programs, however, the odds are heavily stacked against the MCC being able to achieve the advertised results, especially as standards have steadily risen for what constitutes development success. If the performance targets for the MCC's country programs are met, it will almost never be possible to prove that this result was due in large part to the MCA grants. If the targets are not met, even though it is unrelated to any shortcoming in the MCA grant, the blame will still fall on the MCC.

The MCC's approach to achieving measurable results has one positive feature and one potentially negative feature. On the positive side, we applaud the MCC for adopting an unconventional approach to measuring results by focusing on cost and benefit estimates at an early stage in project design. The large number of targets and benchmarks in the monitoring and evaluation plans are an important tool for tracking progress and for identifying mistaken assumptions or approaches. The potential negative occurs when quantitative targets, rather than basic changes in poverty levels and economic growth for which they are proxies, become an end in themselves or a vehicle for micromanagement.

Finally, in the area of fiscal accountability, we are concerned about the large number of implementation decisions requiring MCC approval spelled out in the first four Compacts. They seem to reflect a tendency toward micro-management and could be a source of serious misunderstandings and delays.

Overall Assessment

President Bush's concept of creating a new bilateral aid instrument to reward countries that are performing well remains valid despite the birth pangs experienced over the past three years. The MCC program is a valuable addition to America's foreign aid toolkit.

The program is seriously wounded and limping visibly. The resignation of Paul Applegarth, the MCC's first CEO, simply underscored the difficulty of obtaining Congressional support to operate the program at the proposed level of $5 billion per year beginning in FY 2006. The health of the program in the short run will depend on finding a second CEO who can develop strong bipartisan support in the Congress for the program.

The more serious problem is a sense that the MCA program is drifting toward "more of the same," more of the kinds of activities that have failed in the past to deliver results that impress American taxpayers and their representatives in the Congress. Creativity is the key to avoiding this fate. Removing a number of arbitrary limitations we have identified in the authorizing legislation and the MCC's policies would help to foster this essential creativity.

The goal of a $5 billion-per-year program is now getting in the way of building a successful program. We believe that an operating level of $2-3 billion over the next 3-5 years would help to restore the credibility required to achieve success. A program at this level cannot accommodate the lower middle-income countries as a group. It can, however, accommodate experimental programs with a small number of them.

Annex A

Candidate, Eligible and Threshold Countries, FY 2004-2005

Candidate Countries	MCC Compact-Eligible Countries			Threshold Program Countries	
	2004	2005		2004	2005
Afghanistan					
Albania				yes	
Angola					
Armenia	yes	yes			
Azerbaijan					
Bangladesh					
Benin	yes	yes			
Bhutan	*	*			
Bolivia	yes #	yes			
Bosnia and Herzegovina					
Burkina Faso		*			yes
Cameroon					
Cape Verde	yes				
Chad					
China		*			
Comoros					
Congo, DR					
Congo, Rep.					
Djibouti		*			
East Timor				yes	yes
Egypt		*			
Eritrea					
Ethiopia					
Gambia					
Georgia	yes #	yes			
Ghana	yes	yes			
Guinea					
Guinea-Bissau					
Guyana	*	*			yes
Haiti					
Honduras	yes	yes			
India					
Indonesia					
Kenya				yes	yes
Kiribati	*				
Kyrgyz Rep.					

Candidate Countries	MCC Compact-Eligible Countries			Threshold Program Countries	
	2004	2005		2004	2005
Lao PDR					
Lesotho	yes	yes			
Madagascar	yes	yes			
Malawi					yes
Mali	yes	yes			
Mauritania	*				
Moldova					
Mongolia	yes	yes			
Morocco		yes #			
Mozambique	yes #	yes			
Nepal					
Nicaragua	yes	yes			
Niger					
Nigeria					
Pakistan					
Papua New Guinea					
Paraguay					yes
Phillippines		*			yes
Rwanda					
Sao Tome and Principe				yes	yes
Senegal	yes	yes			
Sierra Leone					
Solomon Isl.					
Sri Lanka	yes	yes			
Swaziland		*			
Tajikistan					
Tanzania				yes	yes
Togo					
Tonga	*				
Turkmenistan					
Uganda				yes	yes
Ukraine					
Vanuatu	yes	yes			
Vietnam	*	*			
Yemen Rep.				yes	yes
Zambia					yes

* Met the objective criteria for MCA eligibility but not selected by the MCC as an eligible country.
# Did not meet the objective criteria for MCA eligibility but still selected as an eligible country.
Note: The countries shown do not include 12-14 countires that were not candidates because of legal prohibitions.

Source: General Accountability Office

Annex B

Country Selection by the MCC

As shown in Annex A, the MCC had a universe of 72 candidate countries to select from during its first two years of operation. This excluded about a dozen poor countries ineligible because of legal prohibitions. The MCC declared 17 of the candidate countries eligible to apply for MCC support. Another 13 countries were identified as "threshold" countries, close to meeting MCA criteria, and potentially eligible if they improved their performance.

The idea that a country's policies and institutions are important determinants of its economic growth is not new. USAID experimented in the 1980s with using quantitative measures of country performance to shift funding to better-performing countries. The effort was abandoned in Latin America when it confronted the reality that Congressional earmarks for countries and sectors, and short-term foreign policy considerations, were insurmountable obstacles. The Development Fund for Africa (DFA) was created in 1987 to boost funding to countries meeting objective performance criteria. The DFA was also operationally freed from many USAID restrictions that limit effectiveness, including procurement from U.S. sources. The World Bank moved gradually toward reallocating its lending operations in favor of better-performing countries in the 1980s, and moved more strongly in this direction in the 1990s.

The publication in 1998 of a World Bank study of aid effectiveness, *Assessing Aid: What Works, What Doesn't, and Why,* provided a strong conceptual and empirical underpinning for making performance-based aid part of conventional wisdom in the field of development assistance. The empirical work for this study concluded that foreign aid was effective in raising incomes and reducing poverty in good-performing countries, but had no effect on either in countries with bad policies. For the latter group of countries, the study concluded, only limited assistance aimed at strengthening institutions, improving policies and reducing corruption would be worthwhile.

One recent study (Radelet and Roodman 2004) reinforces this claim by distinguishing between amounts of foreign aid that can be expected to promote growth and aid given for other purposes (e.g., disaster relief, political benefits, HIV/AIDS). Another recent study (Dollar and Levin, 2004) confirms that most donors have accepted the World Bank conclusions, and have been moving steadily in the direction of concentrating resources in better-performing countries. However, other recent research (e.g., Rajan and Subramanian, 2005) raises doubts about the World Bank's hypothesis. This discussion clearly highlights the fact that promotion of development in poor countries is not an exact science. Continued experimentation with different approaches is essential.

If the view that country policies determine the effectiveness of aid is accepted, this is still less than half the battle. Two bigger challenges remain: choosing a good way

to measure country policy performance; and creating an aid vehicle that actually enhances a country's growth prospects. The first challenge is discussed in this Annex. The second is discussed in Section II of the main paper.

A good country performance indicator would meet three criteria:

- *Reliability*: It consistently separates good-performing countries from poor performers.
- *Contemporaneousness*. It provides a very recent estimate of country performance, ideally lagging the present by no more than a few months.
- *Stability*. It produces consistent results over time measured in years.

No single indicator can adequately capture the multiple dimensions of country performance. The challenge is to combine a set of indicators, each meeting the three criteria listed above, into an overall country score that accurately represents the economic, political, legal, social, and other dimensions of country performance.

Economists can argue about indicators, but policymakers have to choose. The Bush Administration proposed a set of sixteen indicators in the original MCA bill. These were organized into three groups: ruling justly, investing in people, and economic freedom. The sixteen indicators were selected from literally hundreds developed in recent years. Judging country performance has been a growth industry. Indicators have been designed and published by NGOs (the Environmental Defense Fund, the Heritage Foundation, the Nature Conservancy,), international organizations (IMF, World Bank, UNICEF), and private-sector groups (the Economist Intelligence Unit, Institutional Investor, rating agencies).

Only one of the sources mentioned above has produced indicators that come close to meeting the three standards cited earlier for individual indicators, and combines them in a broadly representative way. This is the World Bank's Country Performance and Institutional Assessment (CPIA) system. It is based on staff assessments of country conditions that are virtually contemporaneous. Still, the CPIA suffers from two weaknesses. First, the ratings are subjective, not based on objective indicators. Second, the ratings are available only to World Bank staff –although there are plans to make them public in the future.

The Millennium Challenge Act directs the MCC Board to select countries for MCA funding on the basis of "objective and quantitative indicators" that measure country performance in five areas related to just rule, four areas related to economic freedom, and two areas related to investing in people. Consistent with this requirement, the MCC Board decided to adopt the sixteen indicators in the original Bush Administration proposal with only modest variations. It then had to decide how to combine the sixteen indicators into a composite country score. Would some indicators be given greater weight than others? Would country selections be based on absolute scores or on the relative ranking of countries?

The MCC took the innovative approach of requiring countries to rank above the median on at least half of the indicators in each of the three categories to be eligible for MCA grants, and to be above the median on the corruption indicator.

MCC officials have argued that the use of the median as a country performance measurement will stimulate competition countries for MCA funding among candidate countries, leading to a gradual rise in the absolute level represented by the median. Observing the movement of the median over the coming years will be an important test of the MCA concept. For the single indicator where it seems easiest for a country to show improved performance – the number of days to establish a business – there is already evidence (World Bank, 2005, p. 18) that the MCA program has spurred a race to eliminate hurdles to business establishment. This finding bodes well for the MCA concept.

The weakest area in the MCC's rating system is contemporaneousness. Some of the institutions on which the MCC relies exaggerate the extent to which their scores represent current conditions (see Table B-1.) The two Freedom House indicators for political rights and civil liberties used in the FY 2005 selection process, represented as referring to 2004 by Freedom House and by the MCC, reflect information only through November 2003. The Heritage Foundation indicator for trade policy, also identified as referring to 2004, reflects judgments based on 2001-03 data. The five indicators from the World Bank Institute reflect conditions in 2001-02. In sum, half of the MCC indicators measure country performance with a lag of 1-4 years.

The problem of using indicators that are not contemporaneous is illustrated by the case of Bolivia, a country identified as above the median on all six governance indicators. In November 2004, when it was declared by the MCC to be an eligible country, Bolivia was in the midst of a severe political crisis manifested in roadblocks and other forms of civil disobedience in various parts of the country. The country's political crisis has continued to deepen in subsequent months.

For many poor countries, judging the performance of the current government, rather than that of some previous administration, matters a great deal. The firm commitments of one government are often swept aside by its successor. Thus, the current indicator system runs the risk of risking credibility by enabling the MCC to enter into Compact negotiations with countries that are actually poor performers.

The MCC has explained that its decisions on country eligibility are not driven automatically by the indicators. Indeed, the FY 2004 country selections excluded six countries (Bhutan, Guyana, Kiribati, Mauritania, Tonga and Vietnam) that met the objective criteria, and included three countries (Bolivia, Georgia and Mozambique) that failed to meet them. In FY 2005, the gap in the selection process between countries that met the objective criteria and those selected widened, with ten countries (Bhutan,

Table B-1
MCC Indicators, Sources and Meaurement Dates For 2005 Country Selections

Category	Item	Source	Measurement Date for November 2004
Ruling Justly	Political Rights	Freedom House	Jan-Nov 2003
	Civil Liberties	Freedom House	Jan-Nov 2003
	Voice and Vote	World Bank Institute	2001-2002
	Gov't Effectiveness	World Bank Institute	2001-2002
	Rule of Law	World Bank Institute	2001-2002
	Control of Corruption	World Bank Institute	2001-2002
Investing In People	Girls Primary Completion	World Bank/UNESCO	Variable, 2000 to 2003
	Primary Education Expenditure	National Governments	Variable, 1998 to 2004
	Health Expenditures	National Governments	Variable, 1998 to 2003
	Immunization rate	WHO	2002-2003?
Economic Freedom	Country Credit Rating	Institutional Investor	Current
	Inflation	Multiple	Current
	Fiscal Policy	IMF and National Govt	to last fiscal year
	Trade Policy	Heritage Foundation	2001-2003
	Regulatory Quality	World Bank Institute	2001-2002
	Days to start a business	World Bank	Early 2003

Note: the FY 2005 country selections were announced in November 2004.

Burkina Faso, China, Djibouti, Egypt, Guyana, Nepal, the Philippines, Swaziland, and Vietnam) excluded even though they met the objective criteria, and one country (Morocco) included that failed to meet them.

The MCC has explained that its decisions to include or exclude countries are made in part on the basis of more current assessments of country performance. Given the MCC's commitment to transparency, however, this explanation is hardly satisfactory. The credibility of the selection process would be enhanced substantially if the MCC provided specific explanations for each country excluded that met the MCC's formal performance standard and for each country included that did not meet this standard.

A more controversial weakness in the selection system is that it does not take into account the direction and pace of change in candidate countries. The incentive effect of the MCC program could be strengthened by favoring countries showing improved performance over countries whose performance is static or even falling.

The issue of a progress indicator raises two broader questions about the selection process: the treatment of "threshold countries" and the treatment of other candidate

countries that do not meet the formal standard for eligibility but have registered significant progress toward just rule, investment in people, and economic freedom.

A preliminary assessment of the threshold program was beyond the scope of this study. The selection of threshold countries seems reasonable and the first Threshold Country Plan with Burkina Faso seems well targeted. The MCC has decided to give USAID a major role in the implementation of the threshold program. This is reasonable while the MCC is still in start-up mode. However, to fully capture the value of the experience gained and the lessons learned in the threshold program, the MCC may have to take full responsibility for it.

The treatment of other candidate countries that have shown substantial improvement from below-the-median positions is a more complex issue. Given the mandate to reward good performance, it is anomalous for the MCC to essentially ignore these countries. For example, Indonesia has made huge strides in the area of just rule since 1999. It may still take another decade of improvement for Indonesia to rise above the median for the corruption indicator and five years to meet the formal standard in other areas. Thus, the selection process is closing off an opportunity to reward exceptional performance in a strategically important low-income country.

A final issue related to selection is the treatment of the 29 lower middle-income countries that will become eligible for MCA funding in FY 2006, including such large countries as Algeria, Peru, Russia, Thailand, and South Africa. Given the level of appropriations likely in the next 2-3 years, it is hard to justify allocating such a large share of MCA resources to this group of countries. However, a few exceptionally innovative or catalytic Compacts with lower middle-income countries could help to build a case for moving up to the original funding level of $5 billion per year.

Annex C

Procedural Restrictions: USAID and MCC

Comparing the procedural requirements for USAID and the MCC is difficult. The table below is only suggestive and broadly applicable to USAID-managed programs. Nevertheless, MCC appears to be a more promising vehicle for transferring resources flexibly in response to the key needs of recipient countries.

The legislation governing the MCC is relatively clear, but one key rule relating to federal procurement requirements is in dispute, as shown below. The legislation governing programs managed or implemented by USAID is extremely complex. The most important programs managed in part or in whole by USAID include Development Assistance, Child Survival and Health, Economic Support Funds, Assistance for Eastern Europe and the Baltic, Assistance for the Independent States of the Former Soviet Union, each with a different set of restrictions. The basic legislative framework for USAID, the Foreign Assistance Act of 1961, is in obvious need of a fundamental re-writing. Over the decades, new programs have simply been added on, creating a structure impossible to understand in broad strategy terms, and which USAID managers cannot easily negotiate without running afoul of one requirement or another.

Characteristic	USAID Legislation	MCC Legislation	Advantage
Requirement for use of U.S.-provided goods or services in procurement	Usually required, except for Africa and products obtained in the host country, though exceptions are made on a case-by-case basis	Not required	MCC
Exemption from specific limits in the Foreign Assistance Act (FAA) ("Notwithstanding Authority")	Limited authority, for special programs.	Broad authority to ignore provisions of the FAA	MCC
Earmarking of Fund Allocation	Congress provides separate allocations for various purposes (e.g., education, population, child survival), as well as country allocations for some funding categories.	Funding limited only by per-capita income of partner countries	MCC
Use of U.S. federal procurement procedures	Covered by all such procedures	Perhaps excluded. Issue under discussion with Inspector General. Were the MCC to follow such requirements, its procedures would be even less flexible than those of USAID.	If Inspector General prevails, USAID
Country prohibitions	Assistance prohibited to Burma, Burundi, Cambodia, Central African Republic Cote d'Ivoire, Cuba, Guinea-Bissau, Liberia, Somalia, Sudan, Syria, Uzbekistan and Zimbabwe	Same restrictions	Same
Congressional notification of proposed commitments	Notification of Congressional Committees at least 14 days prior to commitments	Same restriction	Same
Abortions and Sterilizations	Prohibition of using funds for these purposes	Same restrictions	Same

Annex D

The PEPFAR Initiative

President Bush launched a second bold international initiative nine months after the MCA. The "President's Plan for Emergency AIDS Relief" (PEPFAR) committed the US Government to spend $15 billion over five years to support the global campaign to arrest the HIV/AIDS pandemic. It is interesting to compare the commitments, the budget requests, the Congressional reactions, and the disbursement record for the two programs.

The MCA commitment was open-ended: $5 billion a year indefinitely. The PEPFAR commitment was limited to five years at the rate of $3 billion per year. The President's first funding requests for these two programs were contained in the FY 2004 budget: $1.3 billion was requested for the MCA and Congress appropriated $1.0 billion; $2.0 billion was requested for PEPFAR and Congress appropriated $2.4 billion. In the next two fiscal years, the President again requested more for PEPFAR than the MCA. For FY 2005, $2.5 billion was requested and $1.5 billion appropriated for the MCA. For PEPFAR, $2.8 billion was requested and $2.8 billion appropriated. For FY 2006, the Administration requested $3.0 billion for the MCA and $3.2 billion for PEPFAR. It appears likely that the appropriations by the Congress for the MCA later this year will be substantially below the requested amount, and that the appropriations for PEPFAR will be the full amount requested or close to it.

As of July 2005, less than $700 million of MCA program funds had been committed and less than $50 million had been disbursed, mostly for start-up and overhead expenses. By the end of FY 2004, PEPFAR had committed $2 billion and disbursed more than $700 million.

Compared to the MCA program, PEPFAR began with three large advantages. It was highly focused on one disease and 15 countries. It was funding prevention, treatment and care programs that were already largely in place. The Office of the Global AIDS Coordinator, created to direct the PEPFAR program, was lodged in the State Department where it enjoyed the benefit of a well-established administrative infrastructure.

In terms of tangible results, from February through September 2004, PEPFAR contributed to antiretroviral therapy for 155,000 infected individuals, supported services (including short course antiretroviral preventative therapy) for 1.2 million women to help prevent mother-to-child transmission (thereby averting an estimated 23,766 newborn infections), and trained 312,000 health workers in the 15 focus countries. As of July 2005, the MCC was just beginning to implement its first Compacts, with the initial results not due to be measured for another year or two.

The task of the MCC is inherently tougher than PEPFAR's, but the potential payoffs are also larger. Where it succeeds, countries will have the capacity to deal with HIV/AIDS and other challenges without recourse to foreign assistance from the USA or other donor countries.

Annex E

Persons Interviewed

Rodney Bent, House Committee on Appropriations
Kristin Brady, Academy for Educational Development
Lael Brainard, Brookings Institution
Patrick Cronin, Center for Strategic and International Studies
Howard Dickinson, Office of Management and Budget
John Hurley, U.S. Treasury Department
Larry Nowels, Congressional Research Service
Asma Lateef, Bread for the World
Steven Radelet, Center for Global Development
John Simon, National Security Council

A senior executive at Emerging Markets Partnership
A senior executive at the Academy for Educational Development
The manager of an African investment fund

Half a dozen employees of the Millenium Challenge Corporation at different levels in the organization

Annex F

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