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BROOKINGS

QUALITY. INDEPENDENCE. IMPACT.

Strengthen the Millennium Challenge Corporation: Better Results are Possible

The Millennium Challenge Corporation (MCC) is one of the outstanding innovations of the eight-year presidency of George W. Bush. No other aid agency–foreign or domestic–can match its purposeful mandate, its operational flexibility and its potential muscle.

Above: MCC's CEO, Ambassador John Danilovich (second from right) joins farmers who received land rights as part of an MCC compact program in Madagascar. Photo courtesy of the MCC.

In the first year after it became operational in May 2004, however, the MCC made a number of mistakes from which it has not fully recovered. It also had the bad luck of facing an increasingly tight budget environment as its performance improved.

The MCC may not survive as an independent agency. Critics have advocated closing it down, while many supporters of foreign assistance reform would maintain the MCC program but consolidate it with the Agency for International Development and the President's Emergency Plan for Aids Relief under a single individual with broad development responsibilities.

In our assessment, one of the singular achievements of this innovation is the "MCC effect": steps taken by a number of countries to improve their performance against the MCC's objective indicators in order to become eligible for an MCC compact.

We conclude that the MCC is moving steadily to fulfill its potential of being the world's leading "venture capitalist" focused on promoting economic growth in low-income countries. The Obama administration can realize this potential by affirming the MCC's bold mandate, strengthening its leadership, and boosting its annual appropriations to at least $3 billion beginning in FY 2010.

A Rough Start

The Millennium Challenge Corporation started off in the wrong direction in 2004. New leadership a year later put the MCC back on track. Unfortunately, however, the MCC has not been able to recover quickly enough from its early mistakes to compete successfully for funding in the face of increasingly severe government-wide budget constraints. After more than four years of operation, it has not yet achieved "proof of concept." As a result, its future as an independent agency is in jeopardy.

The Concept

In March 2002, six months after the 9/11 terrorist attacks, President George W. Bush announced a commitment to increase U.S. aid to low-income countries by $5 billion per year, representing a jump of 50 percent from the baseline level of official development assistance (ODA).

More remarkable than the size of the commitment was the nature of the commitment. It would not be more of the same. It would be better. It would reward good performance by focusing exclusively on poor countries implementing sound economic development and poverty reduction strategies, as reflected in objective indicators. It would achieve measurable results.

President Bush's initial concept did not specify the organizational form of the new program. Instead of putting it under the State Department or Agency for International Development (USAID), President Bush opted for creating a special-purpose government corporation—the Millennium Challenge Corporation—to run the program.

Conception turned out to be the easy part. It took almost a year for the administration to send legislation proposing the MCC to Congress, and it took another year for the Congress to send authorizing legislation to the president.

The Record

Perhaps the biggest mistake in the MCC's first year of operations was a failure to develop a good working relationship with the U.S. Congress. Some staffing choices gave the impression that the MCC had no interest in the experience and expertise that existed in USAID, the multilateral development banks and NGOs working in low-income countries. In retrospect, a third problem may have been starting compact negotiations with more than a dozen countries instead of building its portfolio of compact countries more slowly and carefully.

Paul Applegarth resigned as CEO in June 2005 and John Danilovich took over the following October. At that point, compacts had been signed with five countries. Funding problems were already visible. Against the original proposal seeking a combined $4.6 billion for the first two start-up years (reaching the target $5 billion in FY 2006), the budget request added up to only $3.8 billion, Congress authorized only $3.6 billion, and appropriations only reached $2.5 billion.

For the next three years, FY 2006 – FY 2008, the administration's budget request for the MCC was straight-lined at $3 billion. Appropriations peaked in FY 2006 at $1.77 billion, and then slipped to $1.75 billion in FY 2007 and $1.482 billion in FY 2008 (after an across-the-board rescission). Thirteen more compacts were signed, bringing the total number of compact countries to 18. In addition, threshold agreements totaling $361 million were being implemented in 14 countries. At the end of FY 2008, cumulative MCC appropriations were $7.5 billion, and cumulative compact commitments were $6.3 billion.

As the Bush administration winds down and the Obama administration gears up, the MCC is in an awkward situation. It has recovered from its start-up problems and now has significant support in Congress and the development community. The evidence of an "MCC effect" is particularly notable. The compact countries are fans of the program, and other potentially eligible countries appear eager to conclude compacts.

However, the "measurable results" promised to an impatient Congress have not yet materialized. Since the first compact will not reach the end of its original four year lifespan until July 2009, it is too early to expect such results. Still, enough questions about the effectiveness of the MCC have been raised to strengthen the position of skeptics in the Congress.

A moment of truth is approaching. Assuming FY 2009 funding remains capped by continuing resolutions at a level no higher than $1.5 billion, the MCC will not be able to conclude more than three compacts averaging $400 million each during this fiscal year. While a strong case can be made for an independent aid agency operating at the rate of $5 billion per year, a rate of $1-$1.5 billion per year for a stand-alone agency is not so easy to justify. Meanwhile, an important coalition of foreign aid advocates sees the change of administration as an opportunity to consolidate a wide range of development and humanitarian assistance programs, including the MCC, into a single agency or cabinet-level department.

Findings and Recommendations

Our assessment of the MCC at the end of FY 2008 focuses on six operational issues and ends with a recommendation to the Obama administration. (The full assessment is in our working paper "The Millennium Challenge Corporation: An Opportunity for the Next President.")

1. Objective indicators. From the outset, objective indicators of country performance have been at the core of the MCC approach to development assistance. The concept is simple: the MCC will provide funding to countries that excel against performance indicators in three areas: ruling justly, investing in people and providing economic freedom. Selecting countries is not so simple.

The MCC's 17 indicators of country performance are state of the art. But they are not embedded in concrete. The MCC has been pushing hard for improvements. A number of the independent providers of these indicators have tightened their procedures and methodology, and others have shortened the time between data collection and dissemination. The publication of updated country "scorecards" on the MCC Web site each year provides an unprecedented level of visibility linking country performance to donor assistance. In general, the MCC's indicators have met broad approval in the donor community.

The "MCC effect" has been the most important benefit of these indicators. The MCC's indicators provide a comprehensive, objective and highly visible system for comparing a country with its peer group and showing where its performance falls short. One academic study found that eligible countries improved their indicators significantly more after the MCC was established than in the pre-MCC period, and that eligible countries improved their indicators significantly faster than developing countries not eligible for compacts.

The MCC's objective indicator approach has been very successful. Still, it is important to recognize certain inherent limitations. Four are worth singling out:

- The majority of the measures used to measure performance are available only with a time lag.

- The indicators reveal relative performance, not absolute performance. Good performers on the basis of the indicators still face daunting challenges.

- Even a top performing country is likely to see its ranking slip on one of the indicators at some point during compact implementation. This can create a credibility problem for the program even when the underlying trend is positive.

- Measuring corruption is especially problematic. The corruption indicator is probably state of the art, but corruption has many elements, and there is no agreement on which weights to assign to each one.

Recommendation: **Retain and continue to refine the objective indicators.**

2. Country selection. Initially, the MCC was limited to funding low-income countries. Since FY 2006, the MCC has been able to commit up to 25 percent of its resources to lower-middle-income countries. For FY 2008, these were countries with annual per capita incomes between $1,736 and $3,595. Together, the two groups included 95 countries.

The MCC board reviews country scorecards once a year and decides which countries to add to the eligibility list. Selection is not automatic based on the indicators. The board considers a wide range of political, economic and social factors.

The MCC's overall track record in selecting countries is good but not brilliant. At the end of FY 2008, there were 18 countries with signed compacts, five threshold countries that had been declared eligible for compacts, and three additional countries declared eligible that were not in the threshold program. The few selections that have been criticized are cases where political factors might have tipped the balance in favor of the country.

Most of the selected countries have small populations, perhaps because it is easier to be transformational in a small country. Even large countries, however, have poor regions and a case can easily be made that the MCC might have a greater impact by focusing on one poor region in a large country like India or Indonesia than on one entire microstate like Vanuatu.

Recommendation: As long as the MCC's funding level remains below $2 billion per year, stick with the current approach to selection but avoid new cases where political factors appear to be overriding performance indicators. At higher funding levels, give greater weight to improvements in absolute performance so that the indicators will not be a constraint to adding countries and enlarging the MCC's impact.

3. Compact design. Compact design can be broken down into four elements: preparation, size, content and choice of partner. One of the hallmarks of the MCC approach to development assistance is an exceptional degree of participation by the host country government and civil society. In a relatively short time, the MCC approach to country ownership has set a high standard to which other donor agencies should aspire.

Compact size is seriously constrained by the statutory five-year limit on the length of a compact and by the prohibition against concurrent compacts. The limit leads to unrealistic expectations: anyone who believes a five-year program can be transformational does not understand development. The inability to have concurrent compacts has led the MCC to bundle together activities that would better be pursued separately. Within these constraints, compact size so far is defensible.

Regarding content, one early criticism of the MCC centered on its bias toward infrastructure projects. Agriculture and infrastructure were the clear priorities at the outset, based on partner-country priorities. These two sectors still account for more than half of all MCC funding, but attention to other sectors has grown. For example, funding for education was absent from the first 10 compacts, but was present in five of the next eight.

This evolution may reflect congressional pressure to be active in the social sectors despite evidence that more investment to expand productive capacity and lower costs could have a greater poverty reduction payoff.

The MCC has also shied away from non-project funding (budget support), which has the advantages of being fast-disbursing, having very low overhead costs and avoiding performance failure by rewarding countries for results recently achieved. Similarly, the MCC has yet to use its considerable ability to leverage funding from private investors, especially for infrastructure projects.

On partnership, all of the compacts to date have been with national governments even though the MCC has the authority to enter into compacts with regional/municipal authorities and private sector parties such as NGOs. With this narrow focus, the MCC is probably missing some opportunities to have a bigger impact.

Our major concern is that the design of the 18 compacts concluded so far reflects very little innovation. They can be characterized as collections of the kinds of development interventions that USAID, the World Bank and other donors have been undertaking for decades. Perhaps in the attempt to overcome its early start-up problems and minimize congressional criticism, the MCC has been too risk averse.

Recommendation: **Immediately remove the prohibition against concurrent compacts that is a disincentive to improving performance. Allow the MCC to extend compacts beyond five years when unanticipated complications arise. Provide encouragement from the White House and Congress to be more innovative in compact design.**

4. Compact implementation. No MCC compacts have been completed, so assessment of their impact is premature. One problem is the lag from the date of compact signing to the date of its entry into force, which has lengthened from about three months for the first three compacts to 10 months for the 10th and 11th compacts. This reflects the MCC's tactical decision to delay entry into force until the legal framework is in place and the implementing organization is up and running. The normal process of tendering for infrastructure projects accounts for some of the slowness, and bad luck has also created recent problems in the form of unanticipated increases in fuel and commodity costs.

The choice of an appropriate local implementing agency is both difficult and critical to success. The objectives of country ownership and capacity building/institutional development argue for selecting an existing government ministry or agency. Realities on the ground have led the MCC typically to establish a special-purpose organization ("accountable entity" in the MCC's jargon). In effect, the MCC has promoted strict accountability at the expense of building partner-country capacity.

The MCC's approach to monitoring and evaluation is a source of pride, but it could become the program's Achilles' heel. The MCC's recent decision to make public the "economic rate of return" analysis for each new compact puts it at the head of the donor community. Other donor agencies have been unwilling to take this step, except in a more opaque form. A potentially critical problem with the MCC's approach is latent in the micro performance benchmarks established for each compact. It seems likely that the results will be mixed at the end of most of the compacts. Given the high expectations created for the MCC's impact, the failure to show superior results could undermine congressional support for the MCC going forward.

Finally, the MCC has largely lived up to its billing as a lean organization. It is now fully staffed at its ceiling of 300 positions. The MCC's field offices, established after compact signing, are typically limited to two positions.

Recommendation: **Continue to refine implementation techniques to the point of becoming a pace-setter and develop performance benchmarks that are less likely to generate disappointment.**

5. Threshold Programs. The MCC has committed some $360 million to 16 “threshold” countries. Nearly all of these programs are managed by USAID. Two different visions seem to coexist. One vision is to prepare countries for a compact within a year or two. A second vision is to address a particular “target of opportunity” that will help a country qualify for a compact eventually. It is too soon to say how effective these programs have been under either approach.

However, the individual projects funded under the threshold programs have been indistinguishable from the typical USAID project involving a contract with an American firm to field a team of expatriate advisors focusing on a particular sector. A fundamental problem with the threshold programs is that they give the impression of trying to boost performance scores by short-term actions rather than rewarding the kind of self-generated progress that is more likely to be sustainable.

Recommendation: **As long as MCC funding remains below $2 billion per year, shift funding of threshold programs to USAID funding. This will help to ensure that the activities being funded are of high value, and encourage USAID to take a more strategic approach to its operations in low-income countries.**

6. Governance. The MCC legislation created a board of directors with five *ex officio* members and four private sector members. Having private sectors members on the board is one of the great strengths of the MCC, enhancing its objectivity and credibility, helping to ensure bipartisan support, and providing strategic links to the broader development community. By comparison to the boards of other government corporations, the MCC board is small in size and more biased toward public-sector members. Having the secretary of state chair the board weakens the image of the MCC as an agency focused on long-term development.

Recommendation: **Amend the MCC legislation to add four more private sector members to the MCC board, allow the board to elect one of its private sector members as chairman.**

The Existential Issue

Although the MCC has not yet lived up to its promise, it still has the potential of offering the biggest bang for the buck among all U.S. development assistance programs. Six features are not only worth keeping but strengthening further: rewarding good performance; using objective indicators to guide the selection of countries; focusing on low-income countries; achieving a high degree of country ownership; avoiding earmarks and time limits on spending authority; and keeping staff small.

However, the current operating level of less than $2 billion per year is far below the original concept. Retaining a separate agency for such a small program within a much larger bilateral assistance program is questionable. With funding moving toward the pace of $5 billion per year, and with added authority to have concurrent compacts, the MCC can be more innovative and more transformational.

The MCC has the potential of being the world's leading "venture capitalist" focused on promoting economic growth in low-income countries. As a core component of a foreign policy that relies more on partnership with other countries, the Obama administration can realize this potential by affirming the MCC's bold mandate, strengthening its leadership, and boosting its annual appropriations to at least $3 billion beginning in FY 2010.

Authors

Lex Rieffel is a nonresident senior fellow in Brookings's Global Economy and Development program. He is a former U.S. Treasury official and teaches a graduate course at George Washington University.

James W. Fox, formerly chief economist for Latin America at USAID, is an economic consultant.

Compact, Threshold and Other Eligible Countries, FY 2008

Country	Agreement Signed	Amount ($ Million)	Type	Comments
Compact Countries				
Madagascar	4/18/2005	$110	LIC	Year 3
Honduras	6/13/2005	$215	LIC	Year 3
Cape Verde	7/4/2005	$110	LMIC	Year 2
Nicaragua	7/14/2005	$175	LIC	Year 1
Georgia	9/12/2005	$295	LIC	Year 2
Benin	2/22/2006	$307	LIC	Year 1
Armenia	3/27/2006	$236	LMIC	Year 1
Vanuatu	3/29/2006	$66	LIC	Year 2
Ghana	8/1/2006	$547	LIC	Year 1
Mali	11/13/2006	$461	LIC	Year 1
El Salvador	11/29/2006	$461	LMIC	Year 2
Lesotho	7/23/2007	$363	LIC	Year 1
Mozambique	7/31/2007	$507	LIC	Year 1
Morocco	8/3/2007	$691	LMIC	Year 1
Mongolia	10/22/2007	$285	LIC	Year 1
Tanzania	2/17/2008	$698	LIC	Threshold, Compact year 1
Burkina Faso	7/15/2008	$481	LIC	Threshold, Compact not yet in force
Namibia	7/28/2008	$305	LMIC	Compact not yet in force

Countries with Threshold Programs				
Malawi	9/23/2005	$21	LIC	Compact Eligible, Threshold Signed
Albania	4/3/2006	$14	LMIC	
Paraguay	5/8/2006	$35	LIC	
Zambia	5/22/2006	$23	LIC	
Philippines	7/26/2006	$21	LIC	Compact Eligible, Threshold Signed
Jordan	10/17/2006	$25	LMIC	Compact Eligible, Threshold Signed
Indonesia	11/17/2006	$55	LIC	
Ukraine	12/4/2006	$45	LMIC	Compact Eligible, Threshold Signed
Moldova	12/15/2006	$25	LIC	Compact proposed, Threshold Signed
Kenya	3/23/2007	$13	LIC	
Uganda	3/29/2007	$10	LIC	
Guyana	8/23/2007	$7	LIC	
Yemen	9/12/2007	$21	LIC	
Sao Tome and Principe	11/9/2007	$9	LIC	
Peru	6/9/2008	$36	LMIC	

Other Eligible Countries				
Bolivia			LIC	Compact Proposal Received
Kyrgyz Republic			LIC	Threshold Eligible
Mauritania			LIC	Threshold Eligible
Niger			LIC	Threshold Eligible
Rwanda			LIC	Threshold Eligible
Senegal			LIC	Compact Proposal Received
Timor-Leste			LIC	Compact Eligible, Threshold Eligible

Countries with Threshold Programs

Country	Agreement Signed	Amount ($ Million)	Purpose
Burkina Faso	7/22/2005	12.9	Increase Girls' primary education
Malawi	9/23/2005	20.9	Deter and reduce corruption
Albania	4/3/2006	13.9	Improve tax administration, procurement to reduce corruption
Tanzania	5/3/2006	11.2	Use NGO monitoring, rule of law, procurement reform, new Financial Intelligence Unit to reduce corruption
Paraguay	5/8/2006	34.6	Use rule of law, transparency and less business informality to lower corruption
Zambia	5/22/2006	22.7	Use controls, better public service delivery, and border management to reduce corruption
Philippines	7/26/2006	20.7	Strengthen revenue administration and role of Ombudsman to fight corruption
Jordan	10/17/2006	25.0	Promote democratic participation, government transparency and better customs administration
Indonesia	11/17/2006	55.0	Improve health and reduce corruption
Ukraine	12/4/2006	45.0	Fight corruption in higher education, judiciary and in customs
Moldova	12/15/2006	24.7	Use an anti-corruption agency to fight corruption in judiciary, health, tax, police and customs
Kenya	3/23/2007	12.7	Fight corruption in procurement and health delivery
Uganda	3/29/2007	10.4	Use procurement reform, better financial management, civil society, and regular reports to fight corruption
Guyana	8/23/2007	6.7	Improve fiscal policies and promote a business-friendly environment
Sao Tome and Principe	11/9/2007	8.7	Improve fiscal collections from taxes and customs and streamline business regulation
Peru	6/9/2008	35.6	Increase immunizations, reduce corruption
Total		**360.7**	

MCC Eligibility Indicators

Indicator	Category	Source
Civil Liberties	Ruling Justly	Freedom House
Political Rights	Ruling Justly	Freedom House
Voice and Accountability	Ruling Justly	World Bank Institute
Government Effectiveness	Ruling Justly	World Bank Institute
Rule of Law	Ruling Justly	World Bank Institute
Control of Corruption	Ruling Justly	World Bank Institute
Immunization Rates	Investing in People	World Health Organization
Public Expenditure on Health	Investing in People	World Health Organization
Girls' Primary Education Completion Rate	Investing in People	UNESCO
Public Expenditure on Primary Education	Investing in People	UNESCO and national sources
Business Start Up	Economic Freedom	IFC
Inflation	Economic Freedom	IMF WEO
Trade Policy	Economic Freedom	Heritage Foundation
Regulatory Quality	Economic Freedom	World Bank Institute
Fiscal Policy	Economic Freedom	national sources, cross-checked with IMF WEO
Natural Resource Management	Investing in People	CIESIN/Yale
Land Rights and Access	Economic Freedom	IFAD / IFC