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Moving Toward Smarter Aid

Lex Rieffel and James Fox

The Millennium Challenge Corporation (MCC) is seriously wounded. Unveiled by President Bush in March 2002 as a promising new bilateral aid instrument for tackling global poverty, the most prominent sign of the MCC's distress was the mid-summer resignation of Paul Applegarth, its first CEO. More disturbing are the cuts imposed by the Congressional committees marking up next year's budget.

The MCC's original concept was to award $5 billion annually to low-income countries based on objective criteria measuring their performance in ruling justly, investing in people, and promoting economic freedom. Appropriations for the MCC in its third year of funding, however, appear to be stuck below $2 billion. Criticism of the MCC for getting off to a slow start misses the point. Creating a new agency takes time and the original concept remains valid. To enable the MCC to live up to its potential, its newly-nominated CEO will have to sell the MCC vision to a skeptical Congress and gain the flexibility required to avoid drifting toward "more of the same."

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President Bush surprised both critics and supporters of his foreign policies in March 2002—fourteen months after his inauguration and six months after the terrorist attacks on September 11, 2001—when he unveiled his proposal to establish the Millennium Challenge Account (MCA).

The size of Bush's funding commitment was remarkable; the President proposed funding the MCA at the rate of $5 billion per year within three fiscal years, which represented a 50 percent increase in official development assistance. The MCA vision also offered a bold departure from past aid mechanisms. It promised to focus entirely on poor countries that were implementing sound economic development and poverty reduction strategies, selected on the basis of objective indicators.

Extensive consultations among Executive Branch departments and agencies were required to resolve basic implementation issues, and the Bush Administration labored for almost eleven months after the initiative was announced to prepare a formal proposal to Congress. Congress then took another eleven months to pass the Millennium Challenge Act.

In May 2004, the first CEO of the MCC, Paul Applegarth, was sworn in. Another eleven months went by before the first grant agreement was signed: $110 million for Madagascar. By July 2005, the MCA had announced additional grants for Honduras, Cape Verde, and Nicaragua, bringing total commitments to $610 million. During this process, the MCA's program size, executing agency, and country selection process have taken shape:

Program Size. The FY 2004 budget submission contained the President's first request for MCA funding, and it was cut along with many other programs. FY 2005 saw the same pattern repeated, and FY 2006 promises more of the same. (Table 1 compares the amounts requested and appropriated from FY 2004–FY 2007.)

Executing Agency. The choice of an executing agency represented a first step in translating the promise of the MCA initiative into reality. Rather than giving USAID the responsibility for administering the MCA or establishing a new office within the State Department to administer it, the President created a new single-purpose government entity to

Table 1
MCA Funding Requested and Provided
(billions of U.S. 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

run the program—the Millennium Development Corporation (MCC).

The MCC Board of Directors includes nine members, five of whom are ex officio: the Secretary of State (chairperson), the Secretary of the Treasury, the USAID Administrator, the US Trade Representative, and the CEO of the MCC. 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. By the end of July 2005, only the two Senate-selected non-government directors had taken office.

The Administration designed the MCC to have a small staff—a powerful way of differentiating "new aid" from the "old aid" administered by USAID. Although early plans envisioned an MCC staff of no more than 100, it soon became evident that a larger staff would be needed; indeed, the FY 2004 budget request proposed a ceiling of 200 staff.

Country Selection. The selection of recipient countries is critical to the goal of rewarding good performance. Early on, the MCC adopted the World Bank's annual per capita income ceiling of $1,466 to establish a list of low-income "candidate" countries. The MCC Board then selected "eligible" countries on the basis of sixteen indicators, all produced by independent sources, that measured performance in the areas of ruling justly, investing in people, and encouraging economic freedom. Sixteen countries were selected in FY 2004, and one more was added in FY 2005.

The Millennium Challenge Act also opened the door to MCC grants to lower middle-income countries, a group of 29 countries with per capita incomes from $1,466 to $3,035 that includes Algeria, Peru, Russia, South Africa, and Thailand. The Act limited funding to these countries, however, to 25 percent of the amounts appropriated in FY 2006 and subsequent years.

The Millennium Challenge Act singled out one other group of countries: the so-called "threshold countries." Threshold countries demonstrate a significant commitment to just rule, investments in people, and economic freedom but fall short of meeting the formal standard. The MCC has invited 12 countries so far to negotiate threshold plans and has given USAID 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 girls' primary education completion.

EVALUATING THE FIRST FOUR COMPACTS

MCC grant funding is governed by "Compacts" between the MCC and the governments of eligible countries. The MCA legislation limits the term of Compacts to five years but otherwise places few constraints on what activities are supported by MCC grants.

Within a few weeks of Paul Applegarth's appointment as CEO in May 2004, MCC staff teams had visited all 16 of the countries selected by the Board to be eligible for grants from funds appropriated in FY 2004; these staff visits explained the objectives of the program and the steps countries would have to take to conclude a Compact. The first country proposal was

"It is too early to arrive at more than a superficial view of the quality of the initial Compacts. However, it is safe to say that the current MCC Compacts are too similar to conventional aid activities to be classified as the bold new approach that was originally advertised."

MCC Compacts Signed

MADAGASCAR
Signed: April 2005
Commitment: $110 million over four years
Objectives: increase land titling and land security; increase competition in the financial sector; improve agricultural technologies and market capacity in rural areas
Main components:
- Land registration ($38 million)
- Financial sector reform ($36 million)
- Agribusiness investment promotion ($17 million)

HONDURAS
Signed: June 2005
Commitment: $215 million over five years
Objectives: Increase the productivity and business skills of farmers who operate small- and medium-sized farms; reduce transportation costs between targeted production centers and national, regional, and global markets
Main components:
- Highway construction ($96 million)
- Rural road construction ($43 million)
- Rural business development ($51 million)
- Highway weight control ($5 million)

received in August 2004, and by July 2005, Compacts had been signed with Madagascar, Honduras, Cape Verde, and Nicaragua. (Please see sidebars for Compact details.)

It is too early to arrive at more than a superficial view of the quality of the initial Compacts. However, it is safe to say that the current MCC Compacts are too similar to conventional aid activities to be classified as the bold new approach that was originally advertised. Furthermore—except possibly in the case of Cape Verde—the Compacts remain too modest to be transformational.

Program Preparation. Instead of the usual donor-driven approach, the first step toward MCA funding is the submission of a home-grown proposal by an eligible country. By skipping traditional steps such as needs assessments and impact assessments, the MCC has been able to move from proposal to Compact in only six months—compared with the 18-24 month cycle it typically takes to move from proposal to contract under most multilateral and bilateral programs. Much of the credit for speed goes to the participating countries for giving a high priority to the negotiation of their Compacts and for assigning responsibility to people capable of making the necessary policy decisions in a timely fashion.

Exceptional efforts by the MCC, the Administration, and Congress will be required in the years ahead to resist the kinds of "barnacles" (unnecessary restrictions) that have diminished the effectiveness of other U.S. aid programs.

Investment Approach. 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 such projects because they yield a concrete product with which the donor is linked.

However, the weakness of this approach is that money is "fungible"; therefore donor funding of high-priority projects frees up domestic resources for less important purposes. Providing fast-disbursing grants to countries whose overall performance in allocating resources in a pro-growth and pro-poor manner has been convincingly demonstrated would be a smart move.

Funding Level. One of the MCC's early claims—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—has not been borne out. In fact, MCC funding in three of the first four Compacts ranges from only 11 to 48 percent of what the World Bank is providing, and only 5-8 percent of official development assistance to these countries from all donors in the 1999-2003 period. Only in one country—Cape Verde, with a population of fewer than 500,000 people—is the MCC adding a substantial amount (20 percent) to recent aid flows.

Indeed, the MCC is giving more *per capita* to smaller countries than larger countries, creating an apparent disconnect between the number of poor people in participating countries and the scale of their Compacts. Having larger programs in countries with more poor people would be more in keeping with the spirit of the original proposal.

Country Ownership and Public Participation. While not mentioned explicitly by President Bush in his original proposal, country ownership has become one of the hallmarks of the MCA program. It is an old idea, usually honored in the breach by donors. Assessing ownership is difficult at this stage, however, because all four Compact countries already had Poverty Reduction and Growth Strategies in place that were the product of broad consultations with other donors and civil society stakeholders consistent with IMF and World Bank guidelines.

There is considerable anecdotal evidence that the MCC has achieved a higher degree of country ownership than other donor programs. The personal involvement of the top leaders of the first four countries has been impressive, and new benchmarks appear to have been set in incorporating the views of people in target regions and sectors. In this respect, the MCC's approach has the potential to become a significant positive force for economic growth and poverty reduction. While there is room for improvement in this area, it is one of the outstanding features of the program.

Coordination with Other Donors. All four Compacts reflect significant interaction with other donors. Three Compacts directly complement World Bank projects, and in all four cases, the MCC appears to have coordinated reasonably well with USAID in the design and implementation process. 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.

Sector Focus. President Bush offered several examples of possible activities—the fight against HIV/AIDS, the provision of textbooks and training, computer instruction for young professionals—in proposing the MCA in March 2002. Except for agricultural technology, where the emphasis has been mainly on the dissemination of existing knowledge, none of the first four Compacts have funded health, education, or technology projects. Instead, the overwhelming focus has been on the agricultural sector in rural areas and transportation infrastructure. Indeed, three of the four Compacts are aimed primarily at the agriculture sector in rural areas, and rural business development accounts for between 10 percent and 20 percent of the funding committed in each Compact. Two of the four Compacts make major investments in land registration. All four Compacts acknowledge the need for increased credit to agriculture and rural enterprises. Meanwhile, transportation infrastructure accounts for more than half of MCC funding in every country but Madagascar.

This relatively narrow sector focus in the first four Compacts may be appropriate, in part because growth-promoting programs in poor rural areas appear to be relatively under-funded by other donors. At the same time, the circumstances differ so much from country to country that more sector variation will probably be necessary to achieve the impacts desired by the MCC.

Administrative Requirements. Many aid programs in the past have fallen short of their objectives because of excessive or inappropriate administrative requirements. One advantage of the MCC is that it began essentially with a clean

MCC Compacts Signed

CAPE VERDE
Signed: July 2005
Commitment: $110 million over five years
Objectives: Increase agricultural production in the intervention zones; increase integration of the internal market and reduce transportation costs; develop the private sector
Main components:
- Agricultural support and watershed management ($11 million)
- Port and road infrastructure ($79 million)
- Private sector development ($7 million)

NICARAGUA
Signed: July 2005
Commitment: $175 million over five years
Objectives: Increase investment by strengthening property rights in Leon Department; reduce transportation costs between Leon and Chinandega Departments and domestic, regional, and global markets; increase the value-added of farms and businesses in Leon and Chinandega Departments
Main components:
- Property regularization ($26 million)
- Rural business development ($34 million)
- Transportation infrastructure ($93 million)

> *"Providing fast-disbursing grants to countries whose overall performance in allocating resources in a pro-growth and pro-poor manner has been convincingly demonstrated would be a smart move."*

slate. For example, the absence of a "buy America" requirement in its legislation, and its intention to rely primarily on local procurement in its participating countries, can contribute significantly to the MCC's effectiveness.

At the same time, the MCC may be getting off on the wrong foot by relying on the creation of "policy management units" dedicated to Compact implementation. Units of this kind typically become elite organizations that tend to undermine capacity-building efforts in mainstream government institutions. Separately, the numerous implementing decisions requiring prior MCC approval show a tendency toward micro-management. These could become sources of misunderstanding and delay.

ASSESSING THE MCC SO FAR

Eighteen months after its first Board meeting, any assessment of the health of the MCC needs to address four key issues: Is the goal of committing $5 billion per year still a reasonable one? Was the choice of creating a new government corporation a sound one? Is the process of selecting eligible countries working well? Does the MCC have the operational flexibility required to achieve the intended results?

Program Size

The MCC is on a trajectory to commit $2–3 billion a year, well below the $5 billion level proposed by President Bush in 2002. (A simple explanation for this shortfall 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.)

But is an MCA program operating at the $2-3 billion level worthwhile? Like most start-ups in either the private sector or the public sector, the risk of failure is substantial, but the potential rewards are 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." If the MCC can deliver results that compare favorably with other bilateral and multilateral programs at its prospective running rate of $2–3 billion per year, then funding it at a level of $5 billion per year, or even more, would be an even better investment.

Organizational Approach

The MCC's performance to date tends to support several arguments that were advanced for establishing an entirely new organization, rather than putting the State Department or USAID in charge of the Millennium Challenge Account:

- The MCC has been less political, and therefore better positioned to allocate funding based on objective criteria.

- The MCC has been more cost efficient by having more freedom to hire, fire, procure and enter into contracts than Federal agencies normally have.

- The MCC is not bound by the provisions of the Foreign Assistance Act that have hobbled USAID for years.

- MCC staff seems inclined to be more innovative and less burdened by old habits of aid-giving.

- The MCC presents a fresh face for America and therefore can be more effective in cutting through some of the negative attitudes toward U.S. assistance that have emerged in recent years.

It is an understatement to say that the future of the MCA program will depend critically on the performance of the MCC's second CEO. Ambassador John Danilovich was nominated in August to fill this position. To restore the optimism that existed when the MCC came into being in early 2004, he will have to develop a better rapport with members of Congress on both sides of the aisle, manage MCC staff more skillfully, and bring to fruition more innovative Compacts with eligible countries.

Country Selection

The MCC country-selection system is innovative and remains basically sound. The 17 countries deemed eligible for FY 2004 and FY 2005 funding all represent reasonable choices. However, the formal standard may be too demanding for the poorest countries. Therefore a modest loosening of the standard might give the MCA program more credibility and more impact.

More importantly, with the program's funding level unlikely to exceed $3 billion in the near term, allocating 25 percent of any new appropriations to the lower middle-income countries—as permitted under the Millennium Challenge Act beginning in FY 2006—would adversely affect the MCC's ability to provide transformational assistance in the poorest countries.

With regard to the threshold program, the countries selected so far are decent choices. Currently, USAID has the lead in implementing the threshold program. Better results might be achieved by having the MCC take sole responsibility for the threshold program as it becomes fully staffed.

The MCC's selection system remains a work in progress. In the final analysis, however, the success of the MCC will depend much more on the content of individual Compacts than on the performance ranking of countries when they sign their Compacts.

Basic Limitations

Three inter-related limitations threaten to impact adversely on the effectiveness of the MCC:

- The Act limits the term of Compacts to five years. Amending the legislation to make clear that Compacts can be extended beyond five years when necessary to achieve the desired results could help the MCC avoid turning successful programs into failures.

- The Act prohibits the MCC from entering into multiple Compacts in any individual country. This prohibition creates pressure to add program components prematurely and delay worthwhile new components until existing Compacts expire.

- The Act requires the MCC to enter into a Compact with the national government of each eligible country that seeks MCA funding. 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

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countries, Compacts with an NGO or a private firm may be worthwhile complements to Compacts with the national governments.

MOVING FORWARD

The success of the MCC in the long run is likely to 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. There is still a good chance for the MCC to live up to its potential as a more effective aid instrument for promoting economic growth and reducing poverty. The MCC is in its infancy. Like many children, it suffers from the inexperience of its parents and their tendency to ignore the experience of the grandparents. The biggest threat to the MCC's future success may be impatience; it needs room to grow.

"There is still a good chance for the MCC to live up to its potential as a more effective aid instrument for promoting economic growth and reducing poverty."

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