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From Pushing Reforms to Pulling Reforms: The Role of Challenge Programs in Foreign Aid Policy

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Abstract

Most donors deliver aid in very similar ways across recipient countries even though recipients vary widely in the quality of their governance, commitment to strong development policies, degree of political stability, and level of institutional capacity. Aid effectiveness could be improved if donor systems were designed to take into account key differences in recipient countries. Proponents of country selectivity argue that donors should provide more aid to countries with better policies and stronger institutions because they are likely to achieve better results. But country selectivity could be used to influence more than the amount of aid. It could also influence the way aid is delivered, including the extent to which recipient countries set priorities and design activities, the mix of project versus program aid, the breadth of aid-financed activities, the length of donor commitments, and the distribution of aid to governments, NGOs, and other groups.

Donors could employ a differentiated strategy for aid delivery based on a country's quality of governance and commitment to development. This approach would create incentives that would challenge recipients to strengthen institutions and policies. The pull or reward for demonstrating stronger governance would be greater national policy ownership, more flexible and attractive aid modalities, and larger, more predictable and longer term resource commitments. This approach differs significantly from traditional aid programs in which donors "push" countries to reform by negotiating aid disbursements in return for specific policy changes (sometimes known as "buying" reforms).

This chapter considers what role pull instruments or challenge programs (such as the World Bank's Poverty Reduction Support Credits or the United States' Millennium Challenge Account) could play within the overall framework of foreign aid, asking how they could be designed to function as effective and efficient incentive instruments and how they could best complement other aid modalities. It looks first at how challenge programs differ from more conventional aid approaches, taking the Millennium Challenge Account as an example, and shows how challenge programs fall conceptually within the pull rather than push incentives type. It then develops an argument for differentiated aid strategies across countries based on key characteristics of recipient countries.

From Pushing Reforms to Pulling Reforms:
The Role of Challenge Programs in Foreign Aid Policy

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Most donors deliver aid in very similar ways across recipient countries even though recipients vary widely in the quality of their governance, commitment to strong development policies, degree of political stability, and level of institutional capacity. This approach makes little sense. Aid effectiveness could be improved if donor systems were designed to take into account key differences in recipient countries.

Proponents of country selectivity argue that donors should provide more aid to countries with better policies and stronger institutions because they are likely to achieve better results.[1] But country selectivity could be used to influence more than the amount of aid. It could also influence the way aid is delivered, including the extent to which recipient countries set priorities and design activities, the mix of project versus program aid, the breadth of aid-financed activities, the length of donor commitments, and the distribution of aid to governments, NGOs, and other groups. Donors could employ a differentiated strategy for aid delivery based on a country's quality of governance and commitment to development, as follows:

- *Strong-governance countries* would have significant say in establishing aid priorities and designing assistance programs, receive much of their aid as program funding, and benefit from larger and longer term financial commitments.

- *Weak-governance countries* would have limited say in setting priorities and designing aid activities, receive more aid as project finance rather than program funding, have a larger share of aid channeled through nongovernmental organizations (NGOs), and receive smaller and shorter term aid commitments.

- *Average-governance countries* would receive aid based on a mixed set of delivery strategies along the various dimensions noted for the other two categories.

Donors should make the distinctions between these strategies very clear, and transparently assign recipient countries to receive aid through one of these channels. This approach would create incentives that would challenge recipients to strengthen institutions and policies. The pull or reward for demonstrating stronger governance would be greater national policy ownership, more flexible and attractive aid modalities, and larger, more predictable and longer term resource commitments. This approach differs significantly from traditional aid programs in which donors "push" countries to reform by negotiating aid disbursements in return for specific policy changes (sometimes known as "buying" reforms).

Some donors are beginning to differentiate their aid strategies along these lines. The UK Department for International Development provides financing to support sector-wide approaches in some countries, but not others.[2] The World Bank provides Poverty Reduction Support Credits to a small number of countries to finance their poverty reduction strategy and the associated social, institutional, and policy reforms.[3] Most recently, the United States has introduced the Millennium Challenge Account (MCA), a new program intended to provide funding in innovative ways to a very select group of low-income developing countries that (according to a defined set of criteria discussed later in this chapter) demonstrate good governance and introduce sound development policies (www.mca.gov/about_overview.html).

This chapter considers what role such pull instruments or challenge programs could play within the overall framework of foreign aid, asking how they could be designed to function as effective and efficient incentive instruments and how they could best complement other aid modalities. It looks first at how challenge programs differ from more conventional aid approaches, taking the Millennium Challenge Account as an example, and shows how challenge programs fall conceptually within the pull rather than push incentives type. It then develops an argument for differentiated aid strategies across countries based on key characteristics of recipient countries.

AN OVERVIEW OF THE MILLENNIUM CHALLENGE ACCOUNT

The Millennium Challenge Account is designed to provide substantial financing to a select group of low-income countries that are "ruling justly, investing in their people, and establishing economic freedom." The program could herald the biggest change in US foreign assistance policy since the Kennedy administration, both because of its size (proposed to eventually grow to $5 billion per year) and because of the way aid will be delivered (Radelet, 2003). Operations formally commenced in February 2004 with the creation of the new Millennium Challenge Corporation (MCC) to run the program. The idea is to select countries based on their demonstrated commitment to sound policies and good governance, give them more say in designing programs, provide them with larger sums of money, and hold them accountable for achieving results. Each of these four program dimensions is examined in turn and compared with conventional aid practices.

Country selectivity

The assessment and ranking of countries is based on 16 quantitative indicators drawn from publicly available databases (table 1). To qualify, a country must score above the median for low-income countries on half the indicators in each of the three categories—ruling justly, investing in people, establishing economic freedom—and it must score above the median on corruption.[4] Thus, a country that does poorly on, say, trade policy or budget balances can still qualify on other indicators.

The process is not entirely mechanical. The administration has limited flexibility to adjust the list of qualifying countries to take account of gaps, lags, and weaknesses in the imperfect data. In May 2004 the MCC chose16 qualifying countries for the first year: Armenia, Benin, Bolivia, Cape Verde, Georgia, Ghana, Honduras, Lesotho, Madagascar, Mali, Mongolia, Mozambique, Nicaragua, Senegal, Sri Lanka, and Vanuatu (MCC 2004b). In November it added one country – Morocco – for 2005. The number of qualifiers is expected to reach 20–25 countries by 2006.

Table 1. Eligibility criteria for the Millennium Challenge Account

Indicator	Source
Ruling justly	
1. Control of corruption	World Bank Institute
2. Rule of law	World Bank Institute
3. Voice and accountability	World Bank Institute
4. Government effectiveness	World Bank Institute
5. Civil liberties	Freedom House
6. Political rights	Freedom House
Investing in people	
7. Immunization rate (DPT and measles)	World Health Organization/World Bank
8. Primary education completion rate	World Bank/United Nations Educational, Scientific, and Cultural Organization
9. Public primary education spending/GDP	National sources
10. Public expenditure on health/GDP	National sources
Ensuring economic freedom	
11. Country credit rating	Institutional Investor
12. Inflation	International Monetary Fund
13. Regulatory quality	World Bank Institute
14. Budget deficit/GDP	National sources
15. Trade policy	Heritage Foundation
16. Days to start a business	World Bank

Note: To qualify, countries must be above the median for countries in their income group on half the indicators in each of the three categories and above the median on corruption.

Source: MCC 2004d.

Many details of the selection process have been extensively debated, including the 16 indicators and their sources, the use of the median cutoff, the focus on the level of the indicators rather than changes, and the insistence on achieving a corruption score above the median (Radelet 2003; Brainard and others 2003). There are important concerns about the quality of the data, and whether the process is biased against the poorest countries, which would have difficulty scoring well on some of the indicators simply because of their poverty. Some observers see these indicators as an attempt by the U.S. government to push the "Washington Consensus." However, since the Millennium Challenge Account includes indicators on immunization rates, school completion rates, and political rights, and excludes indicators on tax reform, privatization, and foreign direct investment, that criticism is off base.[5] Without repeating the details of these important debates, three key points about the selection process are worth emphasizing.

First, by using a public, transparent methodology, the Millennium Challenge Account is aimed at depoliticizing the process of selecting countries. Political considerations will undoubtedly creep into eligibility and allocation decisions, but the public selection process will limit the extent to which this happens. In turn, this process should strengthen the focus of the program on growth and poverty reduction and on issues that recipient governments see as their highest priorities.

Second, only a small number of countries will qualify each year. This is by design, to make the program more effective by concentrating resources where the US believes they can achieve strong results. Nevertheless, most low-income countries will not qualify. Thus, while the Millennium Challenge Account has the potential to be a strong program for the countries that qualify, it does little for dozens of other countries that will not qualify and so leaves large gaps in what is necessary for a more complete foreign assistance strategy.

Third, qualification is based on policy and institutional changes that a country has already made, not on promises of future reforms. This makes the Millennium Challenge Account quite different from traditional conditionality-based aid in which donors disburse funds contingent on the recipient implementing specific policy changes and promising more in the future. In effect, the Millennium Challenge Account is more a reward for sound policy choices than a downpayment on future reforms. Once a country qualifies and begins to receive funding, additional tranches are contingent on achieving specified results—such as distributing a targeted number of bednets or building a certain number of miles of roads. Basing continued funding on results is very different from using funds as an incentive to “buy” future policy reforms.

The Millennium Challenge Account is not the only aid program that uses a quantitative process for selecting countries. The World Bank, the Asian Development Bank, and the African Development Bank have all adopted performance-based allocation systems for distributing concessional loans among eligible borrowers. In the World Bank a country’s allocation depends primarily on its Country Policy and Institutional Assessment (CPIA) score, through which Bank staff rank countries on 20 different policy and institutional criteria (World Bank 2003a and 2003b; see also chapter 7 by Paul Collier in this volume). The Asian and African Development Banks use similar systems (ADB 2001; AfDB 2004).

However, the Millennium Challenge Account differs from these other systems in several ways. First, its indicators determine eligibility, whereas performance-based allocation systems are used to determine funding allocations across many countries, almost all of them eligible for some funding. Second, the Millennium Challenge Account uses publicly available data for its indicators, while the other systems use confidential data based on the opinions of agency staff. Third, Millennium Challenge Account countries will not only receive more money, they will receive it in very different ways.

Country ownership and budget support

Unlike most aid programs, in which donors take the lead role in shaping projects and proposals, the Millennium Challenge Account is intended to give recipient countries a much greater say in setting priorities and designing programs and to provide funds more flexibly. Guidelines issued by the MCC call for recipient countries to design their own programs and submit proposals for how they intend to use the funds (MCC 2004a). If proposals are approved the MCC and the recipient will enter into a three-year agreement that specifies how the funds will be used and what targets the recipient will try to achieve. Countries can apply for new funding when the agreement expires so long as they maintain their eligibility and achieve the specified targets.

In giving recipient countries more say in defining priorities and designing programs, the Millennium Challenge Account resembles two other new and innovative aid delivery institutions: the Global Alliance for Vaccines and Immunizations and the Global Fund to Fight AIDS, Tuberculosis, and Malaria.[6] Governments work closely with NGOs and the private sector to design programs that meet local needs and conditions and in which recipients have a large stake in ensuring success.

Millennium Challenge Account countries are likely to have substantial latitude in deciding which activities to fund (say, for rural roads, water systems, or worker training). They will be expected to work with NGOs, private companies, faith-based organizations, and other groups to specify how proposed activities fit in with their poverty reduction strategies, the targets they expect to achieve, and the role of other donors in related activities. Some funding may be provided as budget support or to co-fund sector-wide approaches. The country ownership aspect of the Millennium Challenge Account is inseparable from the country selectivity approach: the U.S. is willing to grant extensive flexibility only to countries with good governance and not to countries with weak governance, high levels of corruption, or poor policies.

Scaling up

For the countries that qualify, the Millennium Challenge Account could bring a significant scaling up of aid funds. According to its original design the program could reach $5 billion in funding by 2006, all of it to be disbursed as grants and fully additional to current assistance programs. This figure represents about a third of U.S. net official development assistance and about 7 percent of global net official development assistance in 2003 (OECD 2004). Only 20–25 countries are likely to qualify once the program reaches full speed, so the allocation to each country could be quite large. Radelet (2003) calculates that for a set of 20 countries that are reasonably likely to qualify, the additional funds would constitute about 6 percent of national income.

There is considerable doubt, however, that MCA funding will ever reach $5 billion. Growing U.S. budget deficits are leading lawmakers to begin to question the size of the Millennium Challenge Account. The administration requested $2.5 billion for the MCA in 2005 but Congress approved just $1.5 billion. But even at a more realistic $2.5 or $3 billion a year, the Millennium Challenge Account would still represent significant new resources.

The new funds may not be fully additional for the recipients, however, for two reasons. First, while Millennium Challenge Account countries will still be eligible to receive other forms of U.S. assistance, they will likely receive less of it. The U.S. Agency for International Development will retain its presence in recipient countries, but is likely to focus on a more limited set of activities. Second, other donors may reduce their funding to Millennium Challenge Account countries. The extent of this substitution will not be fully evident for several years.

Performance-based management

The U.S. claims that the MCA will be performance-based, with the Corporation generously funding initiatives that achieve their goals and reducing or eliminating funding for those that do not. Of course, many donors make the same pledge, while few actually implement it. Again, the Global Alliance for Vaccines and Immunizations and the Global Fund to Fight AIDS, Tuberculosis, and Malaria are two exceptions. For the Millennium Challenge Account this will require collecting good baseline data, establishing measurable benchmarks, and implementing a strong monitoring and evaluation program, none of which are easy.

CHALLENGE PROGRAMS: PUSH OR PULL?

A fundamental difference between challenge programs and most other aid programs is the incentive structure for introducing policy and institutional reforms. Traditional aid programs are push instruments, in two related ways. First, donor agencies typically allocate a certain amount of funding for each country and then design projects and programs to meet that funding level. The amounts allocated at senior levels drive the process, rather than need or the quality of the proposed project.

Second, since the early 1980s donors have used aid funds to push countries to implement reforms that donors see as desirable for the recipient country, its region, or the world. Typically, donors negotiate policy reforms that will be implemented as conditions for receiving the aid, matching a schedule of reforms with a schedule of aid disbursements. Countries are required to implement some of these reforms before they receive any aid (sometimes called “prior actions” or “condition precedents”), and they pledge to make the remaining reforms in line with aid flows. Sometimes specific reforms are matched precisely with new disbursements in individual funding agreements (as with International Monetary Fund and World Bank loans); at other times they are matched with entire aid programs (as through policy reform pledges to annual donor consultative group meetings).

The conditionality approach has not worked well (World Bank 1998; Collier 1997; Burnside and Dollar 2000; Easterly 2001). Collier (1997) points out that there is little relationship between aid flows and changes in policy. Donors have at times repeatedly “bought” the same reforms from recipient countries, paying for reforms that never materialize or that are soon reversed. In Kenya, for example, the World Bank provided four agricultural adjustment loans during the 1980s and 1990s based on government promises to implement the same basic set of reforms. Each time the government implemented the reforms, took the aid, and reversed the reforms (Collier 1997; Easterly 2001).

The failure of conditionality-based aid does not mean that recipient countries never introduce promised policy reforms. Many countries do. Rather, there is no relationship between aid disbursements and countries following through with promised policy changes: the evidence suggests that aid has played a very limited role as an incentive for countries to introduce reforms that they would otherwise not introduce. Countries reform when it is in their interest to do so, not otherwise. Aid disbursed as a *quid pro quo* for specific reforms plays only a minor role in shifting those interests and cannot significantly push countries into reform. This is especially the case if recipients see no real link between aid flows and the reforms, believing that they will receive the aid even if they do not implement the promised reforms.

The Millennium Challenge Account and other similar challenge programs work more as a pull instrument through the country selectivity process. Countries must have already implemented good policies to become eligible, and aid flows are not tied to specific reforms. Countries must score high enough on a minimum number of pre-established, publicly announced policy and institutional indicators to qualify. To be effective these standards should not be negotiated and should not differ across country groups (although they might differ between low income and middle income countries). Subsequent disbursements are tied to achieving specified targets directly related to the aid flows (building a certain number of miles of roads, for example) rather than broad policy reforms. Thus aid goes to countries that for their own reasons have introduced policy and institutional reforms, not to countries that only promise such reforms.

The performance-based allocation systems used by the multilateral development banks share some of these characteristics. They tie the level of financing to a country's rating on broad policy and institutional quality and not directly to promises of specific reforms. Thus, to some extent they are a pull instrument that rewards countries for previous policy choices. Most loans, however, continue to be tied to specific future policy changes and thus act like push instruments. In these mixed aid programs a pull system determines overall country allocations, while individual loans under that cap push countries toward further reforms. Challenge programs such as the Millennium Challenge Account go further in the direction of a pull instrument by using indicators to determine eligibility and by tying disbursements to results rather than broad policy reforms.

While challenge programs may be a new idea within the foreign aid context, they are an established modality nationally, notably within the philanthropic context. For example, the Kresge Foundation offers challenge grant programs for building facilities and purchasing scientific equipment.[7] The U.S. Environmental Protection Agency offers challenge grants to nonprofit organizations to fund innovative solutions to specific environmental problems.[8] The U.S. Department of Education's Technology Innovation Challenge Grants provide funding to low-income areas for technology-based education initiatives.[9] In Australia the Landcare Greenhouse Challenge program provides grants to farmers, community groups, and businesses for programs to reduce agricultural greenhouse emissions.[10]

These facilities designate funds for a particular purpose and then invite potential recipients to apply for funds—large or small—for activities that the recipients design and that are aimed at achieving the intended goals. Within the international cooperation domain, the Global Fund to Fight AIDS, Tuberculosis, and Malaria and the Global Alliance for Vaccines and Immunization are similar to these challenge grant programs.

The Millennium Challenge Account goes beyond these programs and adds a further pull dimension by imposing strict eligibility requirements on potential recipients before they can apply for funding. Most other challenge grants do not restrict the applicant pool by measuring the “quality” of the recipient. Potential Millennium Challenge Account recipients must already have introduced demonstrable policy reforms of a certain standard before applying for funding for programs that they design in accordance with their highest priorities.

As a selectivity-based pull instrument the Millennium Challenge Account has many advantages, but its design also raises several important concerns. A critical issue is defining the eligibility criteria. There is considerable debate about just what policy and institutional conditions are necessary for aid to be effective and therefore what the eligibility requirements should be. Even with agreement on the indicators, weaknesses in the quality of the data lead to errors in measurement and inaccurate evaluations.

Performance-based allocation systems have been at the center of similar debates, such as those over the content and weighting of the components of the World Bank’s CPIA scores. The same is true of private sector ratings systems, such as bond ratings by Standard & Poor’s, Moody’s, or Institutional Investor, which use slightly different systems to rate the creditworthiness of countries. Thus, although it might be desirable for donors to agree on a single rating system for all their aid programs, reaching agreement on such a system would be very difficult. Donors will differ on how selective programs should be as well as on issues of content and weighting.

Perhaps most important, selectivity-based programs by definition eliminate aid to countries that do not qualify. Taken to the extreme, selectivity-based aid would argue for halting aid to countries with weak policy and institutional environments. However, recent research has shown that certain types of aid can be effective even in these settings (Clemens, Radelet, and Bhavnani, 2004). A more appropriate conclusion for selectivity-based aid is for donors to use different approaches in countries with weaker governance. In other words, donors could develop a more sophisticated toolkit with a range of approaches for delivering aid in different country circumstances.

EXPANDING THE TOOLKIT: DIFFERENTIATING AID STRATEGIES ACROSS COUNTRIES

The logic of the Millennium Challenge Account is that better governed countries should not only receive more aid but that they should receive it in ways that take advantage of their record of good governance. It takes the debate about country selectivity beyond simply reallocating funds to designing different aid delivery instruments for different kinds of countries. This suggests that challenge programs could be at one end of a continuum of aid instruments that vary roughly in line with the quality of governance. Donors could deliver different quantities of aid and deliver it differently depending on quality of governance and commitment to strong development policies.

Varying aid delivery dimensions

At least five dimensions of aid delivery can be adjusted through gradation and phasing to better match aid delivery strategies to country conditions.

Recipient or donor control. Providing countries with more flexibility and ownership in determining national aid priorities makes sense in well-governed countries, but not in poorly governed ones. Countries with stronger governance could be given responsibility for setting broad priorities and designing aid-financed programs. This should start with designing poverty reduction strategies and move on to specific donor activities that grow out of that process. In weak, failing, and poorly governed countries, where governments have shown little commitment to good development policy, donors should retain a strong role in setting priorities and designing activities.

Program or project financing. Well-governed countries should receive a greater share of aid as programmatic or budget support, while poorly governed countries should receive primarily (or exclusively) project financing. Programmatic or budget support gives countries greater flexibility to use funds for their highest priority, adapt to changing needs, and finance recurrent as well as capital costs, as necessary. Budget support allows aid to be more consistent with the government's development strategy (since the budget provides a blueprint for allocating public sector resources) and more readily integrated with government financial resources for development. Aid in this form tends to strengthen government financial institutions, whereas project support can weaken them by pulling resources away from budget systems to individual satellite projects.

Well-governed countries could be given the discretion that comes with programmatic financing and budget support, so long as they have adequate financial systems (including regularly published budgets, appropriate accounting and auditing standards, and regular public monitoring) and are able to continue to show results. Donors could still provide some funds to these countries as project aid, but most aid should be in the form of program assistance or budget support.[11]

In poorly governed countries with high levels of corruption, opaque budget procedures, and poor monitoring and auditing, programmatic funding and budget support make little sense. Instead, donors should continue to direct their funds to well-defined projects that offer less discretion to recipient governments. Although project aid is partially fungible, it is less fungible than budget support, so donors can exert some control. In poorly governed countries more aid could go through NGOs than through the government, which should also reduce fungibility.

Delivery through central government or through local governments, NGOs, and civil society. In well-governed countries most donor assistance should be channeled through the government, while in poorly governed countries a larger share could go through NGOs and civil society groups. Aid to the central government can be more easily aligned with the government's development strategy and better integrated into the budget. But not all aid should go though the central government, even in well-governed countries, since the government is unlikely to have the capacity to implement all worthwhile projects. Doing so could create a larger than desirable public sector and would reduce the possibility of providing aid effectively through other channels. For some donor-financed programs provincial and local governments can provide services effectively.

In poorly governed countries more aid should go through NGOs or civil society groups, at least some of which may be more capable than the government to deliver basic social services to the poor. In countries with very weak governance, perhaps no aid should go through the government. While there is a possibility that a growing NGO sector will undermine government capacity building, governments in these countries have shown little commitment to strong development policies or little ability to use aid resources well. This approach permits more funds to be directed through institutions that can deliver stronger results.

NGOs are not a panacea. Some are more effective than others, and some may be even less effective and more corrupt than governments. Donors must carefully assess the NGOs they work with and how they work with them. The important point is that the most effective implementing partners for donors are likely to vary across countries, which should be recognized in donor strategies.

Broader or narrower range of activities. In well-governed countries donors should support a broad range of activities consistent with programmatic and budget support. Donors could finance the poverty reduction strategy as a whole, including a wide array of activities in different sectors. This does not mean that everything can or should be funded. There is still a need to set priorities, perhaps with individual donors focusing on areas in which they have the strongest skills and experience. But donors as a group, working closely with the recipient government, should be thinking in terms of supporting a fully fledged development strategy rather than individual projects.

In poorly governed countries donors should narrowly focus on specific targets of opportunity. In the weakest states that could be basic consumption or social services for the poor, while in slightly stronger countries support could broaden to sectors in which the government has shown some commitment and potential for progress.

Longer or shorter term financial commitments. Donors should provide longer term financial commitments in well-governed countries than in poorly governed countries. Achieving development goals can take many years, even in well-governed countries. A country with an income of $300 per capita that records rapid economic growth per capita of 5 percent a year will take more than 30 years to reach a per capita income of $1,465, the historical cutoff for International Development Association eligibility.[12]

Aid funds are typically committed at most three years in advance—too short for planning purposes for many long-term investment projects in well-governed countries. In well-governed countries donors should consider making commitments over a five-year time frame, contingent on countries achieving their short- and medium-run targets and otherwise continuing with good governance. Funds could taper off over time as per capita incomes rise and recipients gain access to private capital markets (see chapter 7 by Collier in this volume). In poorly governed countries, shorter commitments are appropriate, especially for funds going through the government.

Linking assistance strategies with country characteristics

Some countries fall between well-governed and poorly governed, and for them mixed strategies are appropriate. Thus donors might have three distinctive strategies to deliver aid to low-income countries based primarily on quality of governance (table 2).

Countries with good governance. Donors could provide large amounts of financing to countries with good governance, predominately as budget support or program aid. Recipients could be given much of the responsibility to set priorities and design activities consistent with their own development strategies. Most of the aid would be channeled through the central government, which should take the lead in coordinating donors. Depending on the country, local and provincial governments and NGOs could also receive significant funding. Donors could focus less on micromanaging activities and more on measuring and achieving broad results. Donors could commit funding for five years or more, subject to the strict requirement that recipients show continued good governance and achieve reasonable results. The amount of funding could gradually decline as these economies grow and gain access to private capital markets.

Countries with average governance. Governments in countries with average governance could receive less funding than those in well-governed countries. Although recipients could play an active role in setting priorities and designing projects, donors could work to ensure broad-based participation and technical rigor. If used at all, budget and program support would be limited. Most funding could come in the form of well-designed projects consistent with the country's overall development strategy, focusing on activities to which the government has shown the strongest commitment and with the potential for progress. Financial commitments could be for three to five years, contingent on progress. A larger share of funding could go through NGOs or civil society groups than in well-governed countries. Project performance should be monitored carefully, with clear performance standards. Strong performance could lead to increased financial support and longer commitments, while weak results could lead to less aid. Donors must be prepared to reduce funding when agreed performance standards are not met.

Countries with weak governance. Countries with weak governance must be dealt with on a case-by-case basis since circumstances vary widely—some are failed states, others are failing, while still others are weak or fragile. Bilateral aid is likely to be heavily influenced by strategic and security considerations. For example, the United States has expressed strong concern about failed states as part of the war on terrorism and has allocated substantial sums to weak states that are its allies in the war. Assistance to poorly governed countries could be tightly focused on humanitarian relief and basic services for the poor. Donors could focus on a limited set of high priority activities with the potential for demonstrating quick results to policymakers and the public, to help consolidate the reform process (World Bank 2001).

Donors could play a greater role in setting priorities and designing activities than in countries with strong governance. Program aid and budget support should be used rarely, if ever. Where governance is particularly weak, aid should be provided through NGOs and civil society groups rather than the government. The World Bank (2001) and Collier (2002) have suggested establishing independent service authorities to oversee the delivery of basic services.[13] Working in these countries is much riskier than working elsewhere. Programs in poorly governed states require careful monitoring, regular reappraisal, flexible responses as initiatives begin to work or fail, and a higher tolerance for failure.

More pull than push

With three distinctive, graduated approaches that vary along several dimensions, donors will be relying more on pull instruments and less on push strategies. Since the first of the three approaches outlined above is more attractive to recipients than the second, and the second is more attractive than the third, this framework provides strong incentives for recipients to take the steps necessary to become eligible for the more favorable approach. Whether a recipient moves from one category to the next will depend on the demonstrated quality of governance and policy, not on promises of further reform. Within each strategy continued funding could be based more on achieving results directly related to the funding (building a certain number of roads, increasing the immunization rate by a prescribed amount) and less on promises for broad policy reforms. To the extent that push instruments continue, donors will have to be more firm about reducing funding when promises remain unfulfilled.

CONCLUSIONS

By and large donor programs have not differentiated their delivery instruments to countries based on good or bad policies or good or bad governance. Rather, donors have tied disbursements to promises for broad policy reforms in an attempt to push recipients to implement reforms that donors view as desirable.

The Millennium Challenge Account breaks with practice on both of these important dimensions. It takes country selectivity much further than previous programs by establishing high qualification standards based on good governance and strong policies, providing large amounts of funding to the countries that qualify, and delivering the assistance more flexibly and efficiently. By identifying policy standards for entry to the program rather than tying aid disbursements to promises for specific policy reforms, the Millennium Challenge Account serves as a pull instrument for development. Well-governed countries that have already introduced policies that will benefit their country and region are thus rewarded with larger and more flexible assistance flows.

Challenge programs could be a first step toward designing distinct aid delivery approaches for different countries, depending on the quality of their governance and policy structure. Approaches could differ by size of flows, formulation as program (including budget support) or project support, the role of recipient countries in setting priorities and designing programs and projects, reliance on governments or NGOs as implementing partners, and other aspects. If the Millennium Challenge Account succeeds, other donors may establish their own challenge programs. Ideally, donors would agree on the eligibility standards for such programs so that programs reinforced each other with a consistent message to recipients.

More differentiated strategies would allow donors to tailor aid delivery instruments more closely to the strengths and weaknesses of recipient countries, making aid more efficient and effective. Such strategies would also introduce more of a pull structure across the continuum of aid delivery instruments, rewarding countries that have better policies and stronger governance with more flexible and larger amounts of aid, without tying the aid to specific reform measures.

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Table 2. Three strategies for aid modalities and country governance

Aid modality	Good governance	Average governance	Weak governance
Amount of funding	Large	Average	Small
Responsibility for setting priorities and designing projects and programs	Mostly with recipients (country ownership)	Combined donor and recipient	Mostly with donors
Program or project funding	Mainly program and budget support	Primarily projects, but some program and budget support	Almost entirely projects
Breadth of funded activities	Broad—support full poverty reduction and development strategy	Moderate—support areas with most promise for progress	Narrow—look for specific opportunities where some progress is possible; focus on humanitarian relief and providing basic services
Degree of donor flexibility	Most flexible	Limited flexibility	Very little flexibility
Recipients	Mostly government, with some to NGOs and private sector	Mix of government, NGO, and private sector	Larger share to NGOs, with some to governments
Length of donor commitment	Long (5 years or more)	Moderate (3–5 years)	Short (1 year)
Monitoring and evaluation	Strong monitoring and evaluation with good baseline data; primarily focus on outputs and outcomes	Strong monitoring and evaluation with good baseline data; focus on inputs as well as outputs and outcomes	Strong monitoring and evaluation with good baseline data; very tight oversight and regular re-appraisal

NOTES

[1] The notion of country selectivity is based on research by Isham, Kaufmann, and Pritchett (1995), Burnside and Dollar (2000), and Collier and Dollar (2002) that indicates that aid has a stronger relationship with growth in countries with stronger policies and institutions. The robustness of the results of the latter two studies have recently been questioned, however (Easterly, Levine, and Roodman, 2004). Clemens, Radelet, and Bhavnani (2004) find that subcategories of aid aimed primarily at growth have a positive impact on growth across all countries, but they find some evidence that the relationship is stronger in the presence of good institutions.

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[2] Under sector-wide approaches all significant government and donor funding for a sector supports a single sector policy and expenditure program, with the government leading the policymaking and implementation. Common approaches are adopted across the sector by all funding parties (government and donors), with increasing reliance on government procedures to disburse and account for donor funds (www.eldis.org/healthsystems/aid/#swaps).

[3] Available to eligible borrowers from the International Development Association (IDA), the Poverty Reduction Support Credit is a quick-disbursing lending instrument. So far Uganda, Vietnam, and Burkina Faso have been approved for such lending (www.worldbank.org/).

[4] For more detail on the qualification process, see Radelet (2003) and MCC (2004c, d).

[5] The “Washington consensus” is a term originally coined by John Williamson (1990) to summarize the set of 10 policy reforms that most of official Washington thought was the appropriate basis for reform in developing countries, including fiscal discipline, tax reform, trade and capital account liberalization, privatization and deregulation, and secure property rights. It has come to be used as a synonym for neoliberalism or market fundamentalism, although that was far from Williamson’s intent.

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[6] Brief descriptions of these mechanisms can be found in the Inventory at the end of this volume.

[7] See www.kresge.org/programs/index.htm.

[8] See www.epa.gov/ecocommunity/sdcg/.

[9] See www.ed.gov/programs/techinnov/index.html.

[10] See www.landcareaustralia.com.au/.

[11] Project aid has some practical advantages, even if it is inefficient. Overseers of donor budgets—parliamentarians and members of congress—like to be able to connect at least some of their money to specific activities. Moreover, project aid is less susceptible than program aid to politicized charges that the money was diverted to something else (such as a presidential airplane), even though the fungibility of money means that in reality there may be little difference between the two modes.

[12] For 2005 in 2003 dollars (www.worldbank.org).

[13] Collier (2002) likens these to an expenditure-side version of an Independent Revenue Authority. He describes six features of the ISA, suggesting that it would:

a) Be autonomous from government with high standards of accountability to donors;
b) Have an incentive system for its staff which motivates them to achieve the objectives of the donors, i.e. in terms of health and education outcomes;
c) Act as a "wholesaler" through which donors would channel their funds to "retail" providers of services;
d) Contract with retail providers for a flow of services rather than pump-priming a project;
e) Serve as a channel for funds, ideally equivalent to prior levels of spending on the services it would provide; and,
f) Serve as a channel for all donor funding to the country for basic health care and primary education, or whatever it is providing.