

**The Millennium Challenge Account
Testimony for the House International Relations Committee
March 6, 2003**

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The Millennium Challenge Account (MCA) could bring about the most fundamental change to U.S. foreign assistance policy since President Kennedy introduced the Peace Corps and the U.S. Agency for International Development (USAID) in the early 1960s. The significance of the proposed program lies partly in its scale: the proposed \$5 billion annual budget represents a 50 percent increase over the \$10 billion annual foreign aid budget in FY '02 and a near doubling in the amount of aid that focuses strictly on development objectives.

Perhaps even more important than its size, however, is its potential to distinguish itself from existing aid programs. Through four guiding principles, the MCA could greatly improve the allocation and delivery of U.S. foreign assistance:

- It selects a relatively small number of recipient countries based on their demonstrated commitment to sound development policies;
- It provides them with sums of money large enough to make a real difference;
- It gives them more say in how the funds are used (relative to current programs); and
- It holds them much more accountable for achieving results, including being willing to increase funding for successful programs and reduce it for weaker programs.

Foreign assistance policy in the United States stands at an important crossroads. The MCA could be a turning point towards improving foreign aid, if it is well-implemented, supported by strong program design, has sufficient staffing (especially in recipient countries), is well-coordinated with other programs, and produces more effective results. In this case, it could be a model for other assistance programs and lead to stronger support from the public and Congress for initiatives supporting low-income countries. However, if diplomatic and strategic criteria come to dominate the selection process, the new corporation creates more policy fragmentation than coherence, or program evaluation is not taken seriously, the MCA could fail, which could weaken other programs and undermine the government's ability to achieve our national security goals.

Overall, the MCA initiative is worthy of support. It builds on America's core values of generosity, commitment to progress, and the expectation of clear results. Many of the ideas in the administration's proposal are appropriate and would make the U.S. foreign aid program more effective. With some adjustments, the initiative could be strengthened further. There are five key areas that require further consideration:

- the country selection process;
- the administrative structure within the USG;
- operations on the ground once countries are selected; and
- a strategy for the countries that will not qualify for the MCA.

- The consistency of other USG policies (especially trade policies) with the objectives of the MCA to support sustained economic growth and poverty reduction in poor countries.

I first comment on the strengths of the administration's proposal, and then on each of the five key areas for further consideration.

Strengths of the Proposal

There is much in the administration's proposal that should be commended and preserved.

1) Focus on poverty and economic growth. The MCA is clearly aimed at reducing poverty and stimulating economic growth in low-income countries, and not to reward diplomatic partners for strategic initiatives. The program's sharp focus will enable it to define specific goals, ensure that resources are better allocated to meet those goals, and allow for stronger and clearer evaluation of results. This should help ensure that both recipient countries and the American public get better outcomes from the program.

2) Country Selectivity. A central idea of the MCA is that aid can be more effective if it is focused on nations with governments that are committed to establishing policies and institutions conducive to economic growth and poverty reduction. Larger, more flexible programs like the MCA should be used in countries with a strong development record, while different strategies with more limited funding and more structured programs should be used in other countries.

3) Recipient country participation. The proposal implements a new approach in which government and non-government groups in qualifying countries take the lead in developing and defending their own ideas for using aid. This so-called "foundation" approach makes particular sense in well-run countries where there is the freedom and the capability to develop and manage programs. It has the advantage of allowing for real participation by civil society groups in recipient countries, both in the design of the overall MCA strategy and in implementation of funded projects and programs. The "selectivity" principle of the MCA goes hand-in-hand with improved recipient country participation.

4) Transparency. The proposed process is remarkably transparent, from the use of publicly available selection criterion, to wide public participation in formulating strategies and programs, to posting agreed "contracts" on the internet (although the legislation should ensure that *all* agreed contracts are thus posted). The administration is proposing a process through which *it* can be held publicly accountable for choosing appropriate countries and funding strong programs.

The Country Selection Process

Basic Methodology

The administration has proposed using 16 specific indicators to choose countries for the MCA (Table 1), grouped into the three broad categories proposed by the president: "ruling justly," "investing in people," and "establishing economic freedom." Countries must score above the median (measured against all broadly eligible countries) on half or more of the indicators in each of the three groups to qualify for the MCA. That is, they must surpass the median in three of the six "ruling justly" indicators, two of the four "investing in people" indicators, and three of the six "establishing economic freedom" indicators. In addition, a country must score above the median on corruption, regardless of how well it does on all the other indicators. This proposed methodology is basically sound, with some caveats as discussed below.

Using publicly available data and this methodology, I have produced an illustrative list of countries that might qualify for the MCA during its first three years.¹ It is crucial to emphasize that this list is illustrative: data on all 16 indicators will be updated before the program actually starts in October, so the group of top countries will change. In fact, the 16 indicators (from the World Bank Institute's governance data set) are due to be updated by the end of March 2003, so the list is likely to change within a few weeks.

Moreover, the administration proposes to reserve the right to add or subtract a limited number of countries in determining the final set of qualifying countries. This last step introduces an element of subjectivity that probably is necessary given the weaknesses in the data, but must be used very selectively to guard against too much political influence in the selection process.

Possible Qualifying Countries

In the **first year**, the administration has proposed that the pool of countries eligible for consideration for the MCA should be those that have an average annual per capita income below \$1,435 and are eligible for concessional borrowing from the World Bank. There are 74 countries in this group. Table 2 shows that 13 of these countries might qualify for the MCA based on data currently available. Two other countries (Moldova and Nicaragua) failed to qualify because their corruption scores were below the median, although they met all the other requirements. Seven other countries miss qualifying by one indicator.

In the **second year**, the administration proposes expanding the pool of eligible countries slightly in line with an increase in program funding to include all countries with average per capita incomes below \$1,435, regardless of their borrowing status with the World Bank. This change increases the total number of eligible countries to 87. The new countries tend to be better off on average than the original 74, so the median values that a country must exceed to qualify rise on most of the indicators.

¹ For a detailed description see Steve Radelet, "Qualifying for the Millennium Challenge Account," http://www.cgdev.org/nv/Choosing_MCA_Countries.pdf

As a result, only 11 countries qualify in the second year, including 8 that had qualified the first year. The three new countries are China, the Philippines and Vietnam, although China will not received MCA funds.

In the **third year**, the administration proposes sharply expanding the pool of eligible countries in year three (in line with the increase in annual funding to the full targeted amount of \$5 billion) to include 28 nations with average per capita incomes between \$1,435 and \$2,975. This group of countries would be judged separately from the 84 countries with average incomes below \$1,435, with their own median scores used to assess country qualification. Adding this last group of nations is controversial. The administration's main reason for including them is that many people in these countries still live in poverty. However, as conveyed by Table 3, this group of nations is far better off than the 87 countries eligible in year two, with average incomes more than four times higher, much lower infant mortality rates, and much higher literacy rates. They also have much greater access to alternative sources of financing, with higher private capital flows, saving rates, and government revenues.

Thus, including this new group of countries would divert aid resources away from countries with greater needs and fewer financing alternatives. In addition, adding this group heightens the possibility that MCA funds will be diverted to support political allies as it includes Colombia, Russia, Egypt, Jordan, and Turkey, among others. In my opinion, these 28 countries should not be eligible for MCA funds. Alternatively, if they remain eligible, the administration should allocate only a limited portion (a maximum of \$1 billion) of the annual \$5 billion for them, with the rest reserved for the poorest nations.

Based on data available today, 4 of these 28 nations -- Bulgaria, Egypt, Namibia, and South Africa -- would qualify in year three if the administration's proposal were adopted, as shown in Table 2. Note that these countries are in addition to those that qualify in year two (not instead of), since they compete to qualify as a separate group.

Thus, based on the administration's proposal, over the course of the first three years 19 different countries (excluding China) might qualify for the MCA. Eighteen others miss qualifying by one indicator (including corruption). Conceivably several of these countries could improve their scores and attain qualification within a few years, thus increasing the number of MCA countries. Of the 19 countries most likely to qualify, 8 are in sub-Saharan Africa (SSA), 5 are in South and East Asia, 3 are in Eastern Europe and Central Asia, 2 are in Latin America, and 1 is in North Africa.

Strengthening the Selection Process

In my opinion, **the selection process should not be legislated** -- the administration will need some flexibility to adapt the system during its early years -- **but Congress should expect regular and thorough reporting on the selection process**. The administration's proposed methodology to select MCA countries is a reasonable initial approach, by and large. However, the process could be improved with some relatively modest changes:

- As discussed, eliminate the countries with incomes between \$1,435 and \$2,975 from eligibility to focus the MCA on countries with the greatest needs and least alternative financing options.
- Change the qualification standard from median scores to fixed levels (e.g., a 75% immunization rate) for the indicators where this is possible. Median scores will change from year-to-year, creating a moving target for countries hoping to qualify. Moreover, as additional countries strive to qualify and improve their scores, medians will rise, moving some of the initial countries out of the qualification pool.
- Modify the requirement that countries must score above the median on corruption to qualify for the MCA. Although corruption is extremely important, the data are not reliable enough to be used to eliminate countries.
- Strengthen some of the indicators, especially the trade deficit, the budget and expenditure data, and days to start a business.
- Consider adding a limited number of additional measurable indicators, including the ratio of girls-to-boys in school, an additional health indicator, and a measure of state ownership of productive assets in manufacturing and retail trade (but not in utilities and basic service delivery).

Finally, although the indicators give a strong weight to democracy (through 3 of the 16 indicators), there is no firm requirement for a country to be a democracy to qualify for the MCA. A small number of non-democracies appear on the list of possible qualifiers shown in Table 2. The question is whether the MCA should be aimed at all low-income countries that are committed to use aid effectively to fight poverty and stimulate growth, or limited to democracies with that commitment. A rule requiring countries to pass a democracy hurdle (while leaving other selection criteria the same) would reduce the number of qualifying countries during the first three years from 19 to 14.

Administrative Structure

A New Corporation?

The U.S. foreign aid system, particularly USAID, is bogged down under heavy bureaucracy, overly restrictive legislative burdens, and conflicting objectives. The MCA is intended to be different. The administration has proposed that the program be administered through a new "government corporation" designed to reduce administrative costs and increase effectiveness.

The biggest advantage of establishing a new organization is that it could avoid the political pressures, bureaucratic procedures, and multiple congressional mandates that weaken current aid programs. Its status as an independent body could make it more flexible and responsive as well as allow it to attract some top-notch talent. Since the MCA is supposed to do business differently than other aid programs, with a narrower focus, higher standards, and more flexibility, it follows that there is a strong case for situating the MCA in a new institution.

However, establishing a new corporation risks further fragmenting foreign assistance programs across the Executive Branch. Major foreign assistance programs currently reside at USAID, the State Department, Treasury, and the Peace Corps, with other programs at HHS, the Department of Agriculture, the African Development Foundation, the Inter-America Foundation, and several other agencies. Adding yet another agency could impede coordination and increase redundancy.

An alternative structure would be to house the MCA in a new office or bureau at USAID. It would report to the Administrator, but would otherwise be separate from the existing USAID bureaucracy. It would require separate authorizing legislation to ensure greater efficiency and reduced administrative burdens. Staff could be a combination of USAID personnel and staff detailed from other agencies. This structure would put the major development programs under a single presidential appointee and ensure greater coordination of programs.

If the plan to establish the corporation goes forward, several steps should be taken to ensure it works as effectively as possible:

- The Board should include the administrator of USAID rather than the Director of OMB. In addition, it should include a small number of outside experts representing private business, NGOs, or others with development expertise. Alternatively, an outside advisory panel could support the Board's operations.
- Staffing needs to be adequate for the task, especially on the ground. The administration hopes to keep the corporation small, but its projected staffing of 100-200 people seems insufficient for a program with an annual budget of \$5 billion. It would be unfortunate if the zeal to make the new corporation as lean as possible resulted in poor evaluation, oversight, and coordination. Furthermore, It is not clear who will represent the MCC on the ground in the qualifying countries, where a strong presence will be required to achieve success.
- Much stronger coordination mechanisms will be necessary, both amongst USG agencies and with multinational organizations. One of the biggest concerns is the impact of the new corporation on USAID and the relationship between the two organizations. The corporation is likely to draw staff and resources from USAID, furthering weakening the agency, possibly engendering some resentment, and making cooperation more difficult. Having both agencies operate simultaneously in recipient countries could be very confusing for recipient countries, create coordination problems and unnecessarily duplicate services. To date, these coordination issues apparently have received very little attention.

Operations on the Ground Once Countries Qualify

Contracts

The proposal to enter into "contracts" with recipients is basically sound, as it puts program design and implementation responsibilities squarely with the recipient country while building in clear accountability for achieving agreed benchmarks. However, the administration's proposal seems to envisage that a recipient government would coordinate

a variety of proposals from government and non-government groups, and, through a local consultative process, consolidate them into a single contract with the MCC. This could inadvertently enlarge the power and bureaucracy of the recipient government. **A better approach would have the MCC accept proposals from a variety of organizations within eligible countries, including sub-national governments and non-government groups.** This would create a larger administrative burden for the new corporation, but it would lead to better quality and more effective programs on the ground.

Monitoring and Evaluation

To be successful, the MCA will require a very strong monitoring and evaluation (M&E) system. Strong M&E will be central to allocating funds appropriately, learning what works and what doesn't, avoiding absorptive capacity problems, and otherwise making the program more effective. Each "contract" should include clear plans for the recipient to establish internal M&E operations. In addition, an independent outside M&E function will be crucial, perhaps through the GAO. Without a much stronger monitoring and evaluation (M&E) capacity than in past programs, the MCA will be doomed to fail.

The results of these evaluations must be taken seriously if the MCA is to succeed. Strong M&E programs will help redirect activities that have gone off course, provide the basis for increasing funding for successful activities, and reducing funding for weak programs. **The USG must be willing to reduce or eliminate MCA funding for programs that are not achieving results.** Recipient countries will quickly recognize whether program benchmarks are taken seriously or not. Where programs are succeeding, they should be funded generously; where they are off-track, funding should be reduced; and when they fail, funding should be directed elsewhere. Being true to this principle will certainly distinguish MCA from existing aid programs.

Program Duration

Although the focus on results is critical, at the same time it is important to keep expectations in line with reality. Development takes time. Recent analysis of the experience of 22 relatively successful developing countries (such as Korea, Thailand, Chile and Botswana) shows that for those countries it took on average 12 years before their aid levels were reduced by 50 percent, and 24 years before their aid levels fell by 75 percent.² Many MCA recipients will continue to be low-income countries with limited access to private sector financing for many years, even if all goes very well. Consider Ghana, a prime candidate for the MCA, with current per capita income of \$350. If it does everything absolutely right and achieves per capita growth of 7% per year (equivalent to about 9% overall growth, a rate achieved by only Korea, Botswana, and a few other countries), it will take Ghana 21 years to reach per capita income of \$1,435.

Earmarks and Tied Aid

² See Michael Clemens and Steven Radelet, 2003, "The Millennium Challenge Account: How much is too much, how long is long enough?" www.cgdev.org/nv/features_MCA.html.

The Congress can play an important role in shaping this legislation and helping pave the way for the program to be both more responsive to needs on the ground and more cost-effective in achieving results. The promise of the MCA to be different -- to make a measurable difference in the lives of the poor -- requires that both the Administration and Congress act differently than they have in the past. Congress, of course, has both the right and the responsibility to direct where appropriated dollars should be spent. However, too much detail in this directive process is counterproductive.

Congress should resist the temptation to earmark, even to target what may seem like important activities and countries. The accumulation of such earmarks, even when they seemed sensible and enlightened, gradually undermined USAID's ability to respond flexibly and efficiently to the changing needs of recipient countries. Congress should also resist the temptation to "tie" MCA assistance to U.S. goods and services, as has been the case with the vast majority of past U.S. bilateral assistance. Tied aid reduces the effectiveness of foreign assistance, by some estimates reducing the ultimate value to the recipient by 25%.

Working in Countries That Do Not Qualify

The MCA promises to be a terrific program for the countries that qualify, providing them with generous funding and more flexibility in setting program priorities. However, it will reach a relatively small number of countries, and so by itself is not a complete foreign assistance strategy. Other strategies are needed to reach the many countries that will not qualify.

Of particular importance are the countries that just miss qualifying for the MCA, the so-called "tier II" countries. If the MCA is to fulfill its promise for a growing number of countries over time, strong programs will be necessary in countries that aspire to qualify. USAID should work closely with these countries to develop strategies to help them eventually gain eligibility for the MCA. For example, traditional aid programs could be changed to allow them to write limited proposals focused on the specific areas where they fall short of qualification. It may make sense to use some MCA funding for this purpose. But the second tier countries should not be part of the MCA until they meet the eligibility requirements.

Other developing countries further from qualifying for the MCA will require more limited and clearly focused strategies, perhaps working through NGO organizations where appropriate. In countries with less committed and capable governments, we must provide greater oversight and less flexibility to recipients. Other strategies are necessary for weak and failed states that have little hope of qualifying for the MCA, but are none-the-less critical for U.S. security interests. These are the toughest cases. In many situations, the most the USG can do is provide humanitarian assistance, and in some countries we should provide no assistance at all.

The important point is that USAID needs to develop a clear strategy for its programs in countries that do not qualify for the MCA. USAID staff members are currently in the

early stages of developing such a strategy, and this process should be supported and nurtured. Congress can help by rethinking some of the strictures that encumber USAID's operations, especially the amount of funds earmarked for specific purposes and tied to American suppliers. Moreover, non-MCA programs will require strong funding. **It is crucial that MCA funding not come at the expense of these other programs.** These steps and others would help improve the efficacy of the overall foreign assistance program.

Policy Coherence

Improving foreign aid will not be enough to achieve the goals of spreading greater openness and prosperity around the globe. While most of the burden lies with developing country governments to implement sound policies, the U.S. must re-think some of its non-aid policies that affect these nations. The most important are trade policies. U.S. textile quotas, high tariffs on agricultural products, and farm subsidies undermine competition and deny workers in poor countries the opportunity to make better lives for themselves. The African Growth and Opportunity Act was a good start, but it was too limited in leveling the playing field for poor countries. If the USG is serious about helping the poor countries, we must reduce the impediments that we have created that undermine the opportunities for growth in low-income countries.

Table 1. Eligibility Criteria for the MCA

Note: To qualify, countries must be above the median on half of the indicators in each of the three sub-groups.

Indicator	Source
I. 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
II. Investing in People	
7. Immunization Rate: DPT and Measles	WHO/World Bank
8. Primary Education Completion Rate	World Bank
9. Public Primary Education Spending/GDP	World Bank
10. Public Expenditure on Health/GDP	World Bank
III. Economic Freedom	
11. Country Credit Rating	Institutional Investor
12. Inflation	IMF
13. Regulatory Quality	World Bank Institute
14. Budget Deficit/GDP	IMF/World Bank
15. Trade Policy	Heritage Foundation
16. Days to Start a Business	World Bank

Source: "Fact Sheet: Millennium Challenge Account," distributed by the administration on November 25, 2002, available at www.cgdev.org.

Table 2. Possible Qualifying Countries Using the Administration's Criteria

	Year 1: IDA Eligible Countries With Per Capita Incomes Less Than \$1,435	Year 2: All Countries With Per Capita Incomes Less Than \$1,435	Year 3: Countries With Per Capita Incomes Between \$1,435 and \$2,975
QUALIFYING COUNTRIES			
1.	Albania	Bangladesh	Bulgaria
2.	Bangladesh	Bolivia	Egypt
3.	Bolivia	China	Namibia
4.	The Gambia	Honduras	South Africa
5.	Ghana	Lesotho*	
6.	Georgia	Malawi	
7.	Honduras	Mongolia	
8.	Lesotho*	Philippines	
9.	Malawi	Senegal	
10.	Mongolia	Sri Lanka	
11.	Mozambique	Vietnam	
12.	Senegal		
13.	Sri Lanka		
ELIMINATED BY CORRUPTION			
1.	Moldova	Ecuador	
2.	Nicaragua	Moldova	
3.		Nicaragua	
4.		Ukraine	
MISSED BY ONE INDICATOR			
1.	Cambodia	Albania	Jamaica
2.	Guyana	Cambodia	Jordan
3.	India	The Gambia	Tunisia
4.	Mali	Georgia	
5.	Nepal	Ghana	
6.	Uganda	Guyana	
7.	<i>Vietnam</i>	India	
8.		Kazakhstan	
9.		Kyrgyz Rep.	
10.		Mali	
11.		Morocco	
12.		Mozambique	
13.		Uganda	

* For Lesotho, data for the corruption indicator are currently unavailable, so technically it would not qualify. However, these data are expected to become available within the next few months, and Lesotho is likely to qualify when the MCA begins in late 2003.

Source: Steven Radelet, updated from "Qualifying for the Millennium Challenge Account," www.cgdev.org

Table 3. Development Status, Resources Flows and Financing for Three MCA Country Groups (medians)

	IDA eligible countries with income less than \$1435	Countries with income less than \$1435	Countries with income between \$1435-\$2975
Development Status			
GNI per capita, 2001	\$380	\$460	\$1965
Adult illiteracy rate, adult total, 2000 (%)	36	33	14
Life expectancy at birth, 2000 (years)	54	56	70
Mortality rate, infant, 2000 (per 1,000 live births)	75	69	27
Resources Flows and Financing			
Aid/GNI, 2000 (%)	10.8	8.5	1.4
Gross private capital flows/GDP (%)	6.9	8.7	10.3
Tax revenue/GDP (%)	11.7	12.6	21.8
Gross domestic savings/GDP, 2000 (%)	7.3	8.4	16.2
Number of Countries	74	87	28

Source: Steven Radelet, "Qualifying for the Millennium Challenge Account," www.cgdev.org