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A Commentary on the Millennium Challenge Account

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The Millennium Challenge Account (MCA) is the Bush administration's major new initiative to reward "good performing" developing countries with substantial new amounts of foreign assistance. A new government-owned corporation, the Millennium Challenge Corporation (MCC), would implement the initiative. Under the MCA, announced in March 2002 in Monterrey, Mexico, "good performance" would be evaluated against a number of objective, pre-set indicators measuring: governing justly (just and democratic governance, including rule of law, human rights, transparency, and accountability); promoting economic freedom (including supporting private-sector growth and participation in global product and capital markets); and investing in people (for example, expenditures on primary education and health, etc.). To quote one observer, "the MCA promises to bring about the most fundamental change to U.S. foreign assistance policy since President John Kennedy introduced the Peace Corps and the U.S. Agency for International Development in the early 1960s."[1] Initial funding for MCA is proposed to be $1.3 billion in FY2004 and to grow to $5 billion a year by FY2006, the most substantial increase in development assistance in many years. Authorization and appropriation legislation has already been introduced in Congress, with initial markup scheduled for this month and final passage targeted for June.

The MCA represents a new and fundamentally different approach to development assistance, offering an extraordinary opportunity to change the way U.S. assistance is administered and delivered. The core MCA concept of selectively rewarding "performing" countries with significant amounts of untied financial flows is a big and laudable idea. So is the MCA's explicit focus on economic growth through investments that raise the productivity of a recipient country's citizens and firms and help integrate its economy into global product and capital markets. Implemented properly, these ideas should gain bipartisan congressional support, be seen internationally as a positive U.S. initiative, complement antiterrorism efforts, and most importantly, have a positive impact on the well-being of people in the world's poorest countries. Accordingly, the following comments should be considered in the context in which they are offered. They are suggested as possible ways to improve MCA; they should not be read as critical of the core concepts.

The suggestions below focus on implementation, for, while the concept of the MCA is a bold and promising departure from the status quo, many of the proposals to implement it look like business as usual. This is particularly surprising because some of the proposals seem alien to the philosophy and goals of the current administration. The implicit assumption in the MCA proposals seems to be that government employees will direct and administer all of the flows. It is hard to believe that President Bush really wants to establish a new Washington-based bureaucracy staffed by government employees to administer traditional foreign assistance programs much as they have done in the past; yet, it could be argued that is what is being proposed under the draft MCA legislation. This contrasts markedly with recent initiatives by governments of other countries. For example, the innovations underlying the Emerging Africa Infrastructure Fund (discussed below) are occurring under the aegis of a UK Labor Party–led government whose policies would normally be expected to be well to the left of those of the Republican Bush administration. If the Labor Party can overcome ideology to implement private-sector involvement and some of the other innovations suggested below, it should be possible to instill similar innovations in a signature initiative that will be emblematic of a U.S. administration with a more complementary philosophy and goals.

In short, the underlying concepts of MCA are innovative, and this innovation should be reflected in its implementation as well. Specifically, the following ideas could be incorporated.

1. Involve the private sector: The current proposal does not sufficiently recognize the potential role of the private sector as a development catalyst, as a source of funds, and as a decisionmaker. Indeed, the words "private sector" rarely appear either in the draft legislation or in the supporting

[1] Steven Radelet, "Will the Millennium Challenge Account Be Different?" *Washington Quarterly* (Spring 2003): 171.

documentation.

One of the most dramatic changes affecting emerging markets in recent years has been the change in the composition of capital flows to them. Historically, government payments, official development assistance, and multilateral and bilateral aid constituted the majority of such flows. However, the composition of flows has changed markedly over the last 20 years. As the table below shows, government-provided flows have been roughly flat over this period, while private flows, driven by foreign direct investment (FDI), have increased more than 5-fold. FDI has increased by more than 15-fold.

Table 1. Capital Flows to Emerging Markets
(in $ millions)

	1985	1995	2002
Official Development Finance	36,712	54,053	36,508
of which, official development assistance	25,953	45,004	39,766
Private capital flows	31,542	206,140	159,970
of which, foreign direct investment	10,867	106,817	168,238

Sources: UNDP; *S&P Emerging Markets Handbook*.

This change in mix has been accompanied by a number of innovative approaches to introduce private-sector skills and expertise, along with capital, into the delivery of official development assistance. Specific examples of the above are the advent of private-sector funds devoted to making investments in basic infrastructure on commercial terms and the retention of private-sector fund managers by the UK, Canada, and certain European governments to administer some of their foreign aid monies. Private-sector managers have been asked to use their skills and experience to allocate flows to good investments. These innovations have not been incorporated, or seemingly even recognized, in the administration's initial MCA proposals.

Among the earliest of these efforts is the sponsorship by the UK Department for International Development (DFID), of the $305-million Emerging Africa Infrastructure Fund (EAIF). This fund finances the development of basic infrastructure—transportation, power, telecommunications, and water—in sub-Saharan Africa, with the additional objective of helping develop a much-needed commercial long-term debt market. Under its investment policy, EAIF can only lend to private-sector companies and not to government-owned utilities and parastatals, which have traditionally received much multilateral and bilateral assistance. DFID's major innovation, however, is that in essence, through a public tender, it has turned over the management of some of the UK's foreign aid to the private sector, with the understanding that the government's funding will be leveraged with private-sector capital. DFID's effort has attracted the interest of other European governments, and recently the Netherlands, Sweden, and Switzerland have invested in the effort.[2]

An effort similar to DFID's is now underway in Canada, where the government is in the final stages of a tender for the Canadian Investment Fund for Africa (CIFA). Although CIFA will invest equity rather than make loans, it incorporates the EAIF concepts of using a private-sector fund manager and creating a vehicle to mobilize private capital to supplement foreign aid flows.

Efforts at more embryonic stages include an ongoing World Bank tender for a pre-feasibility study of an EAIF-type effort for Asia and a variety of development initiatives in Nordic countries.

The suggestion here is not that the MCA should be turned completely over to the private sector to manage or to receive funds. Limited private-sector absorptive capacity in the recipient countries and the existence of functioning government-run programs in donor countries would not make this an optimal solution for meeting MCA objectives. Inevitably, a large percentage of the initial MCA flows will and should go through traditional mechanisms. Nonetheless, the markets and private sector can play an important catalytic role that grows over time, and this role should be incorporated into MCA philosophy and legislation.

2. Introduce the concept of profitable investment: On a related point, and perhaps reflecting the absence of private-sector thinking, the concept of making profitable investment is also missing from the current MCA implementation proposals before Congress.

[2] Note that having accepted the concept of private-sector involvement, DFID also took specific steps to insulate EAIF from the problems perceived to affect early 1990s U.S. initiatives to introduce private-sector management and analysis into aid efforts. Specifically, DFID selected a fund manager who was at the top of potential candidates in terms of substantive experience. In addition, board members representing the public sector's interest were selected through a competitive search process administered by a recruitment firm. Criteria for selection were based on substantive qualifications and market experience, not political connections, thus helping to insulate decisionmaking on policies, operations, and individual investments.

Indeed, the language and concepts regarding flows appear quite dated at points. There are references to grants, but the concepts of making good investments, generating financial returns from the growth they generate, and getting money back as "profits" or as a return on invested capital are missing. These "profits" could be recycled to new MCA initiatives or returned to the U.S. government for other purposes. For example, DFID in the EAIF captures them in a trust to be recycled to new developmental initiatives. What is important, however, is that the core discipline of assessing the use of funds against their ability to stimulate growth and a financial return is instilled into the EAIF program, and should be instilled into the language of—and thinking about—the MCA's implementation. This discipline is inherent in most private-sector investment analysis, reinforcing the benefits of incorporating greater private-sector participation into MCA.

3. Reconsider the MCA "contract": One of the core concepts in the administration's MCA proposals is the signing of a contract with each MCA recipient country setting overall performance standards for the country. These performance standards would be imposed on top of the 16 standards that countries have to meet to qualify for the MCA, and the contracts would be public and published on the Internet.

This is an interesting idea that merits further discussion. Dialogue around a contract could facilitate emerging country input—and leadership—in setting their development goals and plans. This would be in marked contrast with prior decades in which donors and multilateral institutions were frequently perceived to be imposing their own standards and goals. There also clearly will be a need within MCA to ensure transparency, accountability, and coordination of MCA's efforts within a country, and a contract-based approach could satisfy these goals. However, to date, the case for requiring as a matter of law that an additional level of centrally planned and monitored standards be established and that it be implemented through a formal public contract, has not been made. Nor is it clear-cut.

Before establishing a rigid legislated requirement for contracts, further consideration should be given to a number of dimensions:

- First, will recipient countries accept the idea? Has this idea been market tested, and has anyone discussed the concept with key emerging market leaders to see how they respond to the idea?
- For example, will recipient governments object to having the goals to which they commit made public, particularly if some of these goals may be politically unpopular with key domestic constituencies? Will they object to being measured publicly with their performance published on the Internet? Most people I know prefer to keep their report cards private.
- What will be the proposed contracts' impact on the achievement of MCA's objectives and program effectiveness? Will it help or frustrate overall MCA goals?
- Will the contracts discourage leaders from taking on more ambitious objectives where the risk of failure is higher? Will they give the wrong signal to emerging country leadership? For example, could they be seen as another example where an arrogant United States or the West tries to preach or dictate to the developing world? There is already some risk of this in the MCA criteria themselves. However, in the case of the criteria, they have been set by international bodies and measure generally accepted goals. Moreover, it is up to the individual emerging market governments to decide how to meet the criteria. This is considerably different than a one-off set of measures determined by MCC staffers who also may be tempted to prescribe how the measures will be accomplished.
- Will formal contracts frustrate the fundamental purpose of MCA by over-constraining the process?
- The fundamental purpose of MCA is to encourage countries to meet the MCA criteria, so that they can benefit from increased capital flows. Having to meet the separate terms of a contract adds an additional test on the flows, and may over-constrain the process.

At its heart, the proposal to establish a country program for each country with individual standards for each program is not new. It closely resembles the system used by the World Bank in the 1970s, together with the structural adjustment lending implemented in the early 1980s. These programs also started with multiple levels of tests and constraints. Over time, these constraints were removed as it became clear that they were overly inhibiting the flow of capital under the programs. MCA could learn from the past experience of these programs.

Finally, underlying the "contract" proposal seems to be the belief that a small group of decision makers within MCC should decide how and in what form a country gets the MCA funds. If other U.S. government programs and initiatives are functioning well (for example, housing assistance or the administration's new Emergency Plan for AIDS Relief), should they be subject to further review and negotiation with a recipient country by a central MCA administration that is providing some supplemental funding?

As an alternative, consideration should be given to decentralizing decisionmaking. Multiple decisionmakers allocating funds to good programs and investments within their area of expertise may be a better model. Under this approach, the MCC's board or management could make initial allocations to individual programs and managers and let the managers make the decisions on how to invest. There would be no second test of having met the terms of an overall contract—that is, the concept of a contract would be reduced or dropped, and a country would be able to receive funds so long as it met the MCA criteria.

4. Corporate structure and compensation: The proposed compensation structure and other elements of the Millennium Challenge Corporation (MCC) need further thought if the MCC is to attract and retain new talent, particularly if this talent is to be provided by other than existing government employees. Instead of the current proposal, which seems to envisage a traditional civil service organization and compensation structure, consideration should be given to building the MCC along the lines of other government corporations like the Federal National Mortgage Association (FNMA).

Similarly, it may be hard to attract and retain a good CEO, with sterling credentials and capable of implementing the kind of innovation envisioned for the MCC, if he or she is a political appointee subject to replacement with each national election and has compensation capped by civil service pay grades. This could especially be a problem for an initial CEO, who would risk being replaced after the first year in the middle of the corporation's start-up phase. An alternative worth considering would be to appoint the CEO for a fixed term, say five years, and to give MCC's board the discretion to set a compensation level adequate to attract and retain the best candidate.

The Bush administration's background papers supporting the MCA proposals introduce the concept of the private sector seconding staff to the corporation, but this idea needs further development. It is not clear why any private company would support and pay for such a secondment or how the possible conflicts of interest would be managed.

5. Location: Why should the MCC be based in Washington? Its location is certainly not a "deal breaker," but if the Bush administration wanted to make a statement that the MCA is a new and different initiative and not a traditional Washington-run bureaucracy, it could locate the headquarters somewhere else, for example near a center of international capital markets like the New York area.

To summarize some of the ideas above into specific proposals that may help crystallize discussion, the following ideas could be introduced into the implementation of MCA:

1. Involve the private sector in the management of some of the MCA monies, and, possibly, in sourcing external funds.
2. Introduce the concept of profitable investment.
3. Rethink and market test the MCA contract concept. Rather than having the legislation mandate contracts, give discretion to the MCC board and management to decide whether to enter into them.
4. Design MCC's corporate structure and compensation along the lines, for example, of FNMA, rather than as a traditional government bureaucracy.
5. Consider locating the MCC outside of Washington.

Creation of the MCA presents the opportunity for newer and out-of-the box thinking that takes advantage of experience and ideas developed elsewhere over the past two decades. In the implementation of MCA, there is an opportunity to do something really new and creative in line with the scope and innovation of the core MCA ideas themselves.

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