Millennium Challenge Corporation
FY 2005 Budget Justification

Introduction

Since the President's announcement of a new compact for global development two years ago in Monterrey, Mexico, the Millennium Challenge Account (MCA) has gone from vision to operation. Congress authorized the new Millennium Challenge Corporation (MCC) in January 2004 to carry out the mission of achieving lasting economic growth and poverty reduction in countries with a demonstrated commitment to governing justly, investing in people, and encouraging economic freedom. Over the past few months, the Corporation has quickly begun operations, named candidate countries, published a methodology for selecting eligible countries, engaged Congress through formal and informal consultations, welcomed the nomination and confirmation of its CEO, implemented a major communication and outreach effort to its key constituencies and, most recently, announced the selection of 16 nations that are eligible to submit proposals for MCA assistance.

In the coming year, the MCC will continue to build upon this work. The promise of MCA participation has already had a marked impact on potential participant countries even before a single dollar has been committed. A number of countries have already begun to discuss improving their policy performance in order to qualify for future MCA selection rounds. The FY 2005 budget request of $2.5 billion is crucial to fulfilling the promise of this new development agenda and paves the way to reaching the President's commitment of $5 billion in annual funding by FY 2006.

This first budget justification submitted by the MCC will highlight our key operating principles, present the countries selected by the Board of Directors on May 6, 2004, outline our plans for developing MCA Compacts with eligible countries over FY 2004 and FY 2005, and summarize our operations to date. Because of legislative requirements making May 6th the earliest possible date for country selection, the MCC will approach the next 17 months as a single planning period for purposes of our operations. This will allow the MCC to adequately review proposals submitted by eligible countries and to seek to negotiate and finalize Compacts with as many of the eligible countries named on May 6, 2004, plus those additional countries named for FY 2005, as the merits of the proposals and the combined FY 2004 and FY 2005 funding will allow. As the MCC moves forward in negotiating Compacts, implementing programs, and preparing for the next round of selection of MCA eligible countries, MCC staff will continue to consult with Congress on operations and lessons learned.

Key Operating Principles

The following principles guide the unique mission of the MCC:

- **Encourage Policy Reform and Reward Performance:** Using objective indicators, countries are deemed eligible to receive assistance based on their performance in governing justly, investing in their citizens, and encouraging economic freedom.

- **Target Growth:** The MCC will focus specifically on promoting sustainable economic growth in MCA partner countries through investments in areas such as agriculture, education, private sector development, government regulation and transparency, and capacity building.

- **Operate in Partnership:** MCA participation will require a high-level commitment from the host government. Working closely with the MCC, countries that are deemed eligible to receive MCA assistance will be responsible for identifying the greatest barriers to their own development and their highest priorities for growth, ensuring civil society participation, and developing an MCA program. Each country will be required to enter into a public agreement with the MCC – an MCA Compact – that includes a multi-year plan for achieving the country's development objectives, and the responsibilities of the country in achieving those objectives.

- **Focus on Results:** MCC will work with countries which develop well-designed programs with clear objectives, establish baselines for measuring performance, provide for an objective evaluation of results, and a plan to ensure fiscal accountability for the use of MCA assistance. Programs will be designed to sustain results after the funding under the MCA Compact has ended.

FY 2004 Country Selection

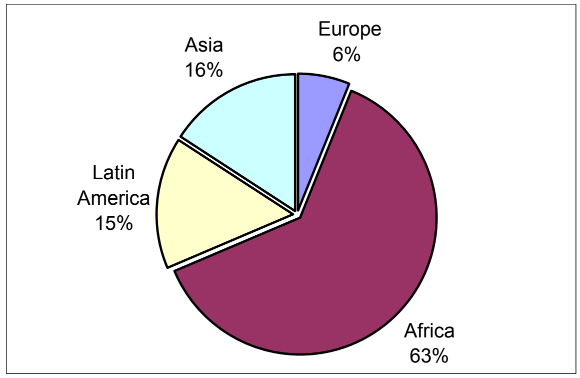
The selection of 16 countries by the Board of Directors happened exactly 90 days after the candidate countries were identified – the very earliest the Board could do so under the law -- and represented a major milestone for the start up of the MCC. On May 6, 2004, the Board determined that the following countries were eligible for FY 2004 MCA assistance and were invited to submit proposals: Armenia, Benin, Bolivia, Cape Verde, Georgia, Ghana, Honduras, Lesotho, Madagascar, Mali, Mongolia, Mozambique, Nicaragua, Senegal, Sri Lanka, and Vanuatu.

In accordance with the Act and with MCC's "Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2004," submitted to the Congress on March 2, 2004, selection was based on a country's overall performance in relation to its peers in three broad policy categories: Ruling Justly, Encouraging Economic Freedom, and Investing in People. The Board relied on sixteen publicly available indicators to assess policy performance as the predominant basis for determining which countries would be eligible for assistance. Where appropriate, the Board also considered other data and quantitative information as well as qualitative information to determine whether a country performed satisfactorily in relation to its peers in a given category, including performance with respect to investing in their people, particularly women and children, economic policies that promote private sector growth, the sustainable management of natural resources, and human and civil rights, including the rights of people with disabilities. The Board also considered whether any adjustments should be made for data gaps, lags, trends, or strengths or weaknesses in particular indicators.

MCA FY 04 Eligible Countries	Income	Pop.
Armenia	790	3.1
Benin	380	6.6
Bolivia	900	8.8
Cape Verde	1250	0.5
Georgia	650	5.2
Ghana	270	20.3
Honduras	930	6.8
Lesotho	550	1.8
Madagascar	230	16.4
Mali	240	11.4
Mongolia	430	2.4
Mozambique	200	18.4
Nicaragua	710	5.3
Senegal	470	10.0
Sri Lanka	850	19.0
Vanuatu	1070	0.2
Population Weighted Avg.	482	
Median Country	600	

Distribution by Region for FY 04 Eligible Countries

	Population	Number
Europe	8.2	2
Africa	85.3	8
Latin America	20.9	3
Asia	21.6	3
Total	**136.1**	**16**



Armenia, Benin, Ghana, Honduras, Madagascar, Mali, Mongolia, Nicaragua, Senegal, and Vanuatu, were selected because (i) they performed above the median in relation to their peers on at least half of the indicators in each of the three policy categories, (ii) they performed above the median on corruption, (iii) they did not perform substantially below average on any indicator, and (iv) the supplemental information available to the Board supported their selection.

The Board also selected three countries that performed above the median in relation to their peers on at least half of the indicators in each of the three policy categories, and above the median on corruption, but that were substantially below average on one indicator. The following is some of the information that was available to the Board in making its eligibility determinations that suggested that each of these countries was taking measures to improve their performance against the substantially below average indicators:

- **Cape Verde**'s low score on Trade Policy indicator did not capture improvements resulting from a recent shift to a Value Added Tax that reduced Cape Verde's reliance on revenue from import tariffs. Cape Verde is also making good progress in its efforts toward World Trade Organization accession.
- **Lesotho** scored substantially below the median on the "Days to Start a Business" indicator, however it recently established a one-stop shop to facilitate business formation. Lesotho also performs well on other measures of starting a business. For example, it costs 68% of per capita income to start a business in Lesotho, versus a sub-Saharan Africa average of 256%, and Lesotho's minimum capital requirement for new businesses is only a tenth of the sub-Saharan average.
- **Sri Lanka**'s Fiscal Policy score falls substantially below the median. However, the deficit has declined each year since 2001, reflecting a positive trend over the past several

years. Additionally, Sri Lanka's non-concessional borrowing in 2004 is expected to be less than half of the 2002 level.

Finally, three countries were determined by the Board to be eligible despite the fact that they (i) were not above the median in relation to their peers on at least half of the indicators in one of the three policy categories and/or (ii) were at or below the median on the corruption indicator. The Board made a positive eligibility determination on these countries in light of the notable actions taken by their governments and positive trends contained in supplemental information available to the Board. The following is some of the information that was available to the Board that suggested the policy performance of each of these countries was better than was reflected in the indicator data:

- **Bolivia** is right at the median on the "Corruption" indicator and is above the median on all of the other indicators in the "Ruling Justly" category. However, its current score on the "Corruption" indicator does not reflect changes made since President Mesa assumed power in October 2003. For instance, President Mesa has created a cabinet-level position to coordinate anti-corruption efforts as well as establishing an office to provide for the swift investigation of police corruption.
- **Georgia** – Although Georgia is at or below the median on more than half of the "Ruling Justly" categories, including the "Corruption" indicator, this data does not capture the substantial progress made by the newly elected Georgian government in only three months time. The Government of Georgia has, among other things, created an anti-corruption bureau, a new bureau to investigate and prosecute corruption cases, a single treasury account for all government revenue to ensure transparency and accountability, and has started revamping procurement legislation to ensure an open and competitive process.
- **Mozambique** – The trends and supplemental information that filled in data lags for Mozambique's "Investing in People" indicators demonstrated Mozambique's progress and achievement that were not reflected in the indicators. Primary education completion rates, for example, have been steadily rising in Mozambique, and this positive trend is backed by the fact that enrollment rates have increased to over 90% in 2000, from 60% in 1995. Girls' primary school enrollment rates rose even faster, increasing by 60% between 1995 and 2000. Although Mozambique scores above the median in four of the six "Ruling Justly" categories, it falls below the median on the World Bank's anti-corruption indicator. However, certain indications suggest that this data is lagged and that Mozambique is making significant progress to fight corruption. Mozambique has passed new legislation to fight corruption and has created a special Anti-Corruption Unit that is conducting numerous investigations. These recent improvements on corruption are in fact reflected in another source -- Transparency International's anti-corruption index -- a more up-to-date indicator, in which it scored well above the median (74th percentile).

Developing MCA programs

The 16 countries selected by the Board are now eligible to submit proposals for MCA assistance. MCC teams will soon travel to all 16 of these countries to meet with representatives of host central, regional and local governments, civil society, the business sector and bilateral and multilateral donors and explain the MCA program development process. During these visits, MCC staff will provide an introduction to the philosophy of the MCA, discuss the Guidance for Developing Proposals for Assistance in FY 2004 (available on the MCC website: (http://www.mcc.gov/Documents/Compact_Proposal_Guidelines.html), and explain the steps that the MCC and the eligible country should take to try to finalize an MCA Compact.

While achieving the opportunity to partner with the MCC is a positive step forward, the countries selected by MCC's Board last week are not guaranteed assistance. Countries should maintain their performance on the selection indicators in order to preserve their status as MCA eligible. Most importantly, the quality of the initial proposal -- including how well the country has demonstrated the relationship between the proposed priority area(s) and economic growth and poverty reduction -- will likely determine how quickly the MCC can begin substantive discussions with a country on a Compact and influence the speed with which a Compact can be negotiated and the amount and timing of any MCA assistance approved by the Board. The MCC will consult with Congress not later than 15 days prior to the start of negotiations of a Compact with an eligible country.

In developing an MCA program, the partner country takes the lead in developing and making the Compact proposal. As the MCC evaluates country proposals, it will look for sound investment programs that show a high-level political, social, and financial commitment; solid management capacity; and an exceptional degree of public accountability and transparency.

A typical MCA program should have a clearly articulated economic development goal with specific components to achieve well-defined project and policy objectives. While program implementation arrangements will vary by country, the MCC will provide funding based on performance and partner countries will likely take the lead role in managing implementation. The MCC will assess country capacities, capabilities, monitoring systems and activities to ensure financial responsibility and accountability. It will review overall budget data to demonstrate that MCC resources, domestic resources and other development resources are used in a complementary manner. MCC will also conduct audits of partner nation programs and monitor achievement of specific benchmarks.

Start Up of the MCC

In the short period since its creation, the MCC has worked hard to develop a strong track record of efficiency and transparency.

Operations: MCC has moved into its temporary corporate headquarters in Rosslyn, VA and has staffed a core team to begin operations. Within the next year, it is anticipated that MCC will be relocating to Washington, D.C. MCC initial planning called for a total staff of 60 by the end of the FY 2004, growing to a total staff of about 150 to 200 by the end of FY 2005. The MCC is on target to meet its ambitious staffing plan and currently has a staff of approximately 30 detailees, full-time employees and contractors at the end of the first 3 months of operations. The MCC has also established the fundamental internal operating procedures for financial management, human resource management, procurement, and travel. Internal controls for these administrative services will be established and maintained by MCC, or by service providers in those cases where services are procured under outsourcing contracts or interagency agreements. During its start-up phase, MCC outsourced its financial management and human resource management functions to the Department of Interior's National Business Center, and is analyzing the cost savings that would result from adding travel management and procurement to the same Interagency Servicing Agreement. These are now currently being fine-tuned and improved to meet MCC's specific business needs. In addition, MCC has engaged a private contractor to develop an Enterprise Architecture Plan that will allow the Corporation to migrate off the State Department's Pace Computer Network, which the MCC has been using for start-up purposes. The intermediate phase of the plan offers a "best in class" computer solution to the Corporation that is robust and versatile.

Program: As of week 15 of the MCC, the corporation has conducted two Board meetings and has reported to Congress and the public on countries eligible to compete for MCA assistance, the methodology for selecting eligible countries, and the countries selected by the MCC Board of Directors. In this short period, MCC has conducted three public meetings for open comment; published data on countries and opened them for public comment; published guidance on proposal development and made them available to the prospective countries; met with many of the Finance Ministers and/or Ambassadors of nations potentially eligible for MCA assistance; conducted outreach meetings with umbrella non-governmental organizations such as Interaction and Women's Edge Coalition; and consulted closely with other bilateral and multilateral donors. In addition, MCC has conducted at least seven meetings (formal and informal) with staff and members of the Appropriations and Authorizations Committees of Congress.

FY 2005 Budget Request

Given our track record of moving forward as quickly as the law allows, the MCC is confident that it will need and can effectively use the full amount of its FY 2004 appropriation of $1 billion and the requested $2.5 billion for FY 2005. These funds will cover assistance to MCA FY 2004 and FY 2005 eligible countries, a threshold program for countries that nearly qualified for MCA participation in both years, and MCC's administrative costs.

From all indications the demand for MCA funding is very high. The Board selected a number of countries that was larger than many anticipated, and these countries have indicated a desire and a willingness to participate in the MCA as partners. Many countries not selected in this initial round are seeking to improve data availability in the areas of social investment and other qualification criteria and are demonstrating a keen interest in a threshold program that would be targeted on improving policy performance in order to qualify for MCA participation. The incentives inherent in the MCC's core concepts are already at work. In addition, FY 2005 will expand the list of candidate countries to all countries with incomes below the historic cutoff for IDA assistance (currently $1,415) and who are not otherwise barred by law. The MCC anticipates that this could add up to 13 countries to the list of candidates from which the Board will select eligible countries in FY 2005.

Because MCC was legally established in late January 2004 and, in accordance with the Millennium Challenge Act, did not determine eligible countries until last week, the MCC is approaching the last two quarters of FY 2004 and all of FY 2005 – a period of about 17 months – as a single period for planning purposes. While the MCC will take on these tasks with urgency, this longer planning period will enable the MCC to adequately review country proposals, enter into substantive discussion with countries and negotiate and sign Compacts in a manner that gives meaning to our concepts and allows us to reach decisions with prudence, discipline and sound business judgment.

Two operating principles in particular provide the framework for the MCC in its decisions to approve MCA Compacts with partner countries:

1. The MCC will seek to establish multi-year programs with partner countries that involve significant up-front funding commitments. As MCA countries maintain their performance on policies and actions that promote growth, the MCC will deliver a significant level of financial assistance to achieve mutually agreed and tangible development objectives. MCC's assistance to our partners will help to provide them the incentives and the resources they need to deliver on their end of the bargain.
2. MCC allocation and funding decisions will be driven by the quality of the proposals rather than by the number of eligible countries submitting proposals. MCC may not finalize Compacts with all eligible countries if the programs proposed do not meet MCA standards.

Given that we do not yet know the specific development priorities of the eligible countries – and in light of the principles for the approval of MCA Compacts outlined above – it is impossible to provide a precise country breakout for FY 2004 and FY 2005 countries. However some of the assumptions that the MCC has used to plan for the funding of individual Compacts are outlined below. Our intent is to use the Compact as an obligating document. Per current authorization legislation, by country the MCC will notify the Committees on Appropriations of both Houses of Congress 15 days in advance of obligating funds.

To be an effective incentive for both eligible and threshold countries, command the attention needed for breakthrough country proposals, and help galvanize the political will essential to success, the MCA should be among the largest providers of assistance in a country. To underscore this commitment, the MCC plans to fully fund multi-year Compacts at a magnitude that would make it one of the largest donors in each country. In an analysis earlier this year, the GAO estimated that, if the MCC sought to be one of the top donors in each country, it could fully fund three-year Compacts in 8 to 13 countries with a funding level of $3.5 billion. Our own calculations, based upon the actual countries selected, is consistent with the GAO analysis. However, in practice, the MCC will likely engage in a number of Compacts that are longer than three years, thereby requiring more funding per Compact than assumed above. In summary, a funding level of less than the requested $2.5 billion for FY 2005 will reduce the number of Compacts that the MCC will be able to finalize. In addition, a reduction in funding would dampen the incentive effect and therefore the MCA's ability to stimulate policy reform, economic growth, and poverty reduction in MCA eligible countries and countries trying to qualify for MCA assistance.

Consistent with the Act, the Board of Directors has also reserved up to $40 million for a threshold program for countries that just missed selection for eligibility in the FY 2004 round. This program would make MCA funding available for targeted programs in these countries to improve their policy performance. The MCC and USAID intend to develop a joint strategy for the program. The MCC will update Congress on the details of the threshold program when it is developed.