FY 2006 Millennium Challenge Corporation and
Budget Presentation to Congress

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Executive Summary

"I'm here today to reaffirm the commitment of the United States to bring hope and opportunity to the world's poorest people, and to call for a new compact for development defined by greater accountability for rich and poor nations, alike… We fight against poverty because hope is an answer to terror. We fight against poverty because opportunity is a fundamental right to human dignity. We fight against poverty because faith requires it and conscience demands it. And we fight against poverty with a growing conviction that major progress is within our reach… Developed nations have a duty not only to share our wealth, but also to encourage sources that produce wealth: economic freedom, political liberty, the rule of law and human rights.

– President George W. Bush, Monterrey, Mexico. March 22, 2002

The President has requested $3.0 billion in Fiscal Year 2006 funding for the Millennium Challenge Corporation (MCC). To meet the strong demand from countries already eligible for Millennium Challenge Account (MCA) funding and those likely to become newly eligible in FY 2006, and to preserve the strong incentive for positive policy reform in these countries, it is critical we fulfill the commitment of the U.S. to assist countries who have earned our support with sound proposals that are likely to reduce poverty through economic growth.

MCC was created following the President's initiative at Monterrey and was strongly supported by Congress as a new way of bringing U.S. assistance to the poorest people in poor countries that have concretely demonstrated the capabilities and commitment to use the money effectively. This initiative is a key element in enhancing national security and projecting American values.

The mission of the MCC is to reduce poverty through sustainable economic growth by providing assistance to the poorest countries that show they are ruling justly, investing in their citizens and encouraging economic freedom. Our business model has been built on the lessons of 50 years of development assistance – the successes and failures. Our programs are defined with measurable results and quantifiable benchmarks. We support countries with sound policies; they are the most likely to use scarce aid dollars well to transform their economies and societies, lifting millions of people from a cycle of poverty and misery. To give a sense of what is at stake (and as detailed further in Annex A), here are some statistics of the seventeen eligible countries selected in FY 2004 and FY 2005:

- There are almost 170 million people;
- Over 90 million of them live on less than $2 per day;
- Per capita income is less than $700 a year; and
- Of the 177 countries rated by the United Nations' Human Development Index, the average MCC-eligible country is 126th with the lowest ranking country being 174th.

Despite this poverty, these seventeen countries -- compared to their peers -- are not only committed but are demonstrating that commitment in areas such as fighting corruption, investing in girls' education, allowing businesses to form and operate, and creating a better rule of law. We are also working with thirteen more countries (listed in Annex A) in our Threshold Program (*see* below) with another 240 million people and even worse poverty.

The FY 2006 request of $3 billion is in addition to the funds Congress appropriated in FY 2004 and FY 2005. We have in hand solid proposals from all but one of the countries already selected for eligibility that total roughly $3 billion, exceeding our current resources. Based on our current activity, we forecast we will commit almost $2.3 billion in up to twelve Compacts out of FY 2004 and FY 2005 funding. Having worked hard in our first year to staff up, develop our processes and refine proposals with our initial eligible countries, we expect to sign our first Compact early in the third quarter of FY 2005, and to continue at the pace, on average, of approximately two to four per quarter through the end of FY 2006.

MCC anticipates FY 2006 funds will be necessary to complete the funding for programs in a few carryover FY 2005 countries, to fund a few amendments, to fund proposals for new eligible low income countries that have made progress on the explicit policy indicators we use for country selection, and, finally, to fund a new category of lower-middle income countries that become candidates for the first time in FY 2006 and will further increase our funding requirements.

	Funding FY 2004 / FY 2005			**Funding FY 2006**		
	Number of transactions	Average Amount	Totals	Number of transactions	Average Amount	Totals
	($ Millions)					
Low-income countries	12		2,278	6	291	1,745
Amendments to earlier Compacts	-		-	3	100	300
Low-middle income countries	-		-	4	170	680
Total Compacts and Amendments	**12**		**2,278**	**13**		**2,725**
Threshold Programs			130			140
Total Assistance			**2,408**			**2,865**
Administrative expenses			55			85
Due Diligence/Monitoring & Evaluation			17			48
Audit Expenses (Inspector General-USAID)			2			2
Recissions – FY 2004 and FY 2005			18			-
Total Administrative, Due Diligence, M&E			**92**			**136**
Total Obligations			**2,500**			**3,000**

MCC's key operating principles – selecting eligible countries based on objective criteria, having countries set their own priorities and ensuring that MCC invests in programs with measurable results – make the above projections and any projections in this document uncertain. MCC does not know which countries will be selected, the number of countries that will be selected, what proposals will be submitted, when those proposals will be submitted, the amounts requested the types of components in the proposals, or whether any program will ultimately merit approval. While we are actively assisting countries in developing Compact programs, the size and speed of Compact programs are ultimately driven by the countries. In this document, we have tried to project numbers and amounts of Compacts based on our best estimates from our experience to date.

Due to these uncertainties, another way of analyzing program size for the eligible countries is to use a methodology that the GAO has used. The MCA is intended to provide to candidate countries a significant policy incentive large enough to command the attention and galvanize the political will essential for successful economic growth and sustainable poverty reduction. A way of estimating what that incentive would need to be is to compare the financial size of an MCC program to programs funded by other donors. Using data on the first sixteen eligible countries, the GAO estimated that, under different scenarios, MCC would need to have total resources of roughly $3.4 billion to be one of the largest donors in eight to fourteen countries in order to have that significant impact.

MCC operates very efficiently; almost all of MCC's funding goes for direct assistance. We project that development programs for the targeted poor will consume almost 97% of our available resources through FY 2006.

Working with USAID, we have launched a Threshold Program for countries that do not qualify immediately for MCA assistance, but are close to qualifying and demonstrate a commitment to improve their performance on specific policy indicators needed to qualify. Threshold Program funds support reform efforts and provide an incentive to move a potential partner country toward MCA eligibility. As their efforts bear fruit, MCC must be in a position to respond and fund quality programs that they put forward. MCC's Board allocated $40 million of FY 2004 funds for the Threshold program. This amount could increase depending on the programs that are currently being developed. As of this date, the Board has not allocated any amount of FY 2005 funding for Thresholds. We project approximately $130 million of FY 2004 and FY 2005 funds will go to Threshold Programs.

MCC is already having an impact in countries currently eligible and in candidate countries who seek eligibility for MCA-funding. Reflecting real country ownership of the proposed programs, developed through a comprehensive consultative process involving broad participation, some of the very highest officials in these countries have become deeply engaged in the process. The prospect of MCC funding is already having the desired effect, broadening commitment to development and incentivizing policy reforms. As explicitly directed by Congress, Compacts are fully obligated at the outset to ensure availability of the funds committed, reassuring our partners of our continuing support. The assurance of full program funding committed up-front -- contingent only on continued policy performance and good Compact program execution --- has already had a positive effect in moving a number of countries to undertake reforms. To highlight just a few examples of the impact that MCC is having -- even prior to funding a proposal:

- Since the announcement of the MCA indicators in early 2003, the median number of "days to start a business" has dropped from 61 to 46 in MCA candidate countries.
- Many countries have targeted corruption -- a primary MCC indicator-- and are making strides to remedy corruption within their governments. One country, for example, passed four pieces of anti-corruption legislation and began enforcement, publicly justifying the need to act on the hope of receiving MCA assistance.
- One MCC eligible country minister said, "even if we receive less than requested, the intangibles gained from taking control of our own development destiny are the most important part of the process."

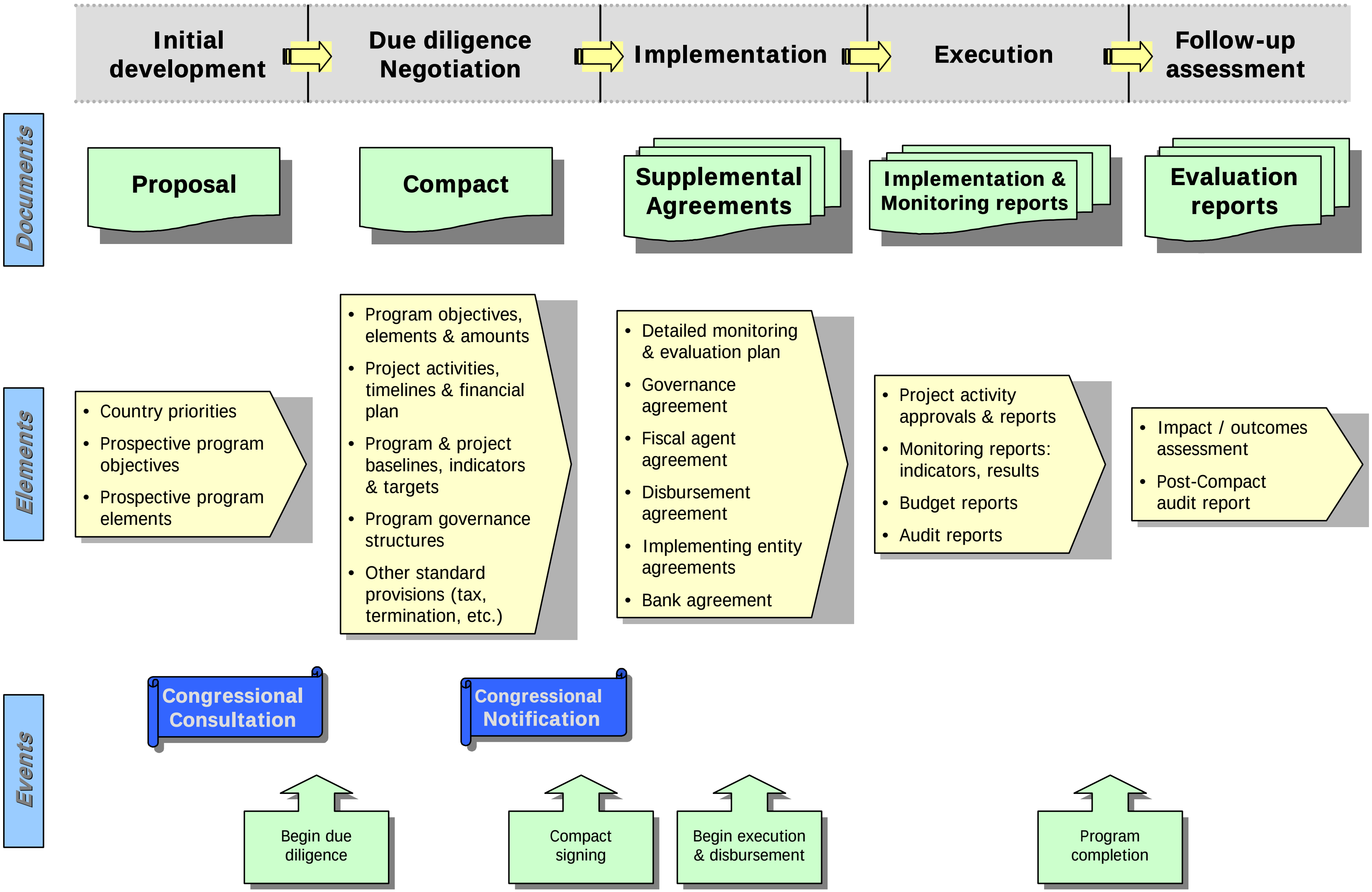
The 9/11 Commission recommended "A comprehensive U.S. strategy to counterterrorism should include economic policies that encourage development, more open societies, and opportunities for people to improve the lives of their families and to enhance prospects for their children's future." For these reasons and those described in the body of this report, MCC is requesting the full $3.0 billion requested to begin to meet the development demands from eligible countries and those likely to "graduate" from the Threshold Program; to substantiate the strong commitment of the President and Congress; to support the efforts of courageous leaders in the poor countries with whom we work; and to encourage the spread of freedom.

What Makes MCC Different?

While elements of the MCA approach have been in use previously and elsewhere, MCC combines the best practices learned over the past fifty years into an integrated process:

- *MCC is focused*. While most agencies have multiple mandates, MCC has a single mandate that ensures a long term focus on reducing poverty through sustainable economic growth.
- *MCC rewards performance, not promises*. MCC works with countries that have already shown they are committed to policies that promote economic growth and poverty reduction and that perform better than many of their peers in the areas of ruling justly, investing in people, and encouraging economic opportunity. By selecting countries based on transparent criteria using independent indicators, MCC provides both a reward for past performance and an incentive for continuation of sound policies.
- *MCC gives responsibility to its partners*. Programs with a broad base of in-country support are more likely to succeed. Instead of telling a country what it needs, MCC asks MCA-eligible countries to design their own priorities in consultation with civil society and the private sector and then actively helps the countries' develop economic growth and poverty reduction programs based on those priorities.
- *MCC insists on mutual accountability*. The partner country will oversee implementation. MCC and its partner both have a stake in, and a responsibility for, program performance. MCC monitors fiduciary responsibility.
- *MCC measures success by results, not inputs*. MCC integrates measures of success and how to monitor and evaluate them from the design of MCA country programs and incorporates them in MCA Compacts. Failure to perform can result in reduction or loss of funding.
- *MCC assistance is an investment*. MCC conducts an investment analysis and due diligence process, to identify beneficiaries, targets and results, seeking to ensure American taxpayer investments are used wisely. The key difference is that MCC does not measure the return on its grants in monetary terms, but rather assesses the poverty-reduction and economic growth return.
- *MCC's governance combines the best of public and private approaches*. MCC's high-level Board members from the public and private sectors, as well as civil society, provide coherence across U.S. foreign policy, trade, finance, aid, and other policies critical to development; give support and judgment to MCC's mission; and enable MCC to operate in a more business-like way.
- *Congress gave MCC operational flexibility so it can do its job*. MCC grant assistance is "non-earmarked" so MCC can respond to country priorities and "no-year funding" so MCC can provide countries reasonable assurance that the funds will be available when a Compact is finalized, while avoiding pressure to fund programs before they are ready, increasing the likelihood that MCC can work with countries to develop strategic, transformative programs.

MCC Process Overview



FY 2006 Millennium Challenge Corporation Program and Budget Presentation to Congress

FY 2004 Appropriated	FY 2005 Appropriated	FY 2006 request
$994.1 million	$1.488 billion	$3.0 billion

Introduction

"We must tie greater aid to political and legal and economic reforms.
And by insisting on reform, we do the work of compassion.
The United States will lead by example."

– President George W. Bush, Monterrey, Mexico. March 22, 2002

With his announcement in Monterrey, President Bush launched a major new commitment by the United States to bring hope and opportunity to the world's poorest people. In proposing the Millennium Challenge Account (MCA) and the Millennium Challenge Corporation (MCC), the organization that would oversee and manage the account, President Bush made clear that this program would be unlike any other in America's long history of foreign assistance. Along with significant new resources to fight world poverty, the President promised that we would insist on the reforms necessary to make this a fight we could win.

The program envisioned would be substantial, providing significant new resources to the global fight against poverty. MCC country programs would be funded in multi-year Millennium Challenge Compacts of sufficient size to enable MCC to be among the largest donors in each country that receives funding (See Exhibit A for a description of the requirements of a Millennium Challenge Compact). The program would build upon lessons learned from development over the past 50 years: reward performance, allow countries to own their priorities, and measure results. In execution, it would amount to a fundamental reordering and redirection of key aspects of previous U.S. development assistance.

As President Bush's September 2002 National Security Strategy paper candidly acknowledged:

> *Decades of massive development assistance have failed to spur economic growth in the poorest countries... Results of aid are typically measured in dollars spent by donors, not in the rates of growth and poverty reduction achieved by the recipients. These are the indicators of a failed strategy.*

President Bush offered such an approach -- a poverty reduction program for poor countries implementing good policies, to be designed and run by these countries with wide participation by civil society and other non-governmental institutions. Elements of this approach had been tried elsewhere, but a concerted U.S. effort in this field and on this scale had never been undertaken. In January 2004, after carefully weighing and refining the President's proposal, the Congress acted, establishing the Millennium Challenge Account (MCA) and the organization that would administer it, the Millennium Challenge Corporation (MCC). During its first year of operation, MCC has taken the concepts outlined by the Administration and the Congress and built them into an organization designed to operationalize those concepts. Most of the early MCC activity, starting in February 2004, centered on getting the organization in place and operating. The initial MCC core staff consisted of only seven detailed employees working in offices located in Arlington, Virginia. On February 2, 2004, the MCC Board of Directors held its first meeting, during which the Board announced the initial sixty-three candidate countries and named an interim CEO, Under Secretary of State Alan Larson.[1] On February 20, the President announced his intention to nominate Paul V. Applegarth as CEO of MCC. Mr. Applegarth was confirmed by the Senate on May 5, 2004.

Using criteria subsequently adopted by MCC after a public consultation period, the MCC Board named the first sixteen eligible countries on May 6, 2004, the first day it was legally permissible to do so due to a required statutory waiting period. Initial visits by MCC delegations to those sixteen countries were immediately undertaken in May and June. Country proposals and concept papers began reaching MCC in mid-August 2004. All sixteen eligible countries ultimately submitted proposals, totaling nearly $5 billion in initial requests, with the latest arriving in March 2005. The priority-setting and consultative processes spurred innovation in several of the eligible countries in expanding broad public participation of their populations. Many of the initial proposals were quite responsive and in line with the objectives of the MCA; others required substantial additional work.

In July 2004, MCC identified sixty-eight FY 2005 candidate countries and in November 2004 selected sixteen MCA-eligible countries from that group --including fifteen that were eligible in FY 2004 and one additional country. (*See* Annex B for a list of eligible countries and Exhibit B for a description of the selection process, MCA-eligibility requirements, and MCC outreach following selection.)

In its first year, MCC worked in eligible countries with government officials, local civic and business leaders, members of the public, and international donors to explain MCC's approach to assistance and to develop better, more financable proposals; created a Threshold Program, working with USAID, for candidate countries that were close to MCC eligibility and selected a total of thirteen Threshold Program countries in FY 2004 and FY 2005 (*see* description of Threshold Program below); begun negotiations with an initial group of five countries which are expected to lead to the earliest Compacts; held five public outreach sessions and four Board meetings attended by the public; and created an operational and administrative structure, building staff to over a hundred by the end of the first year of operations.

The grinding poverty that afflicts half the world is the strongest reason for continuing to fully fund MCC. As described below, progress by MCC and MCA-eligible countries during FY 2004 and FY 2005 make FY 2006 a promising and potentially watershed year in the development of

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[1] The MCC Board of Directors initially consisted of the Secretary of State (Chairman), the Secretary of the Treasury, the U.S. Trade Representative and the Administrator of the U.S. Agency for International Development. Two public members, Kenneth Hackett, President of Catholic Relief Services, and former New Jersey Governor Christine Todd Whitman, who had served as Administrator of the Environmental Protection Agency, were subsequently nominated by the President and confirmed by the Senate, as was the MCC CEO.

the program. The full $3 billion requested by the President for FY 2006 is essential to the continued success of the program.

Demand for MCA Funds

MCC anticipates signing about 6 or 7 Compacts exceeding $1 billion in FY 2005, some 12 Compacts for a total of about $4 billion in FY 2006, and another 3 or 4 Compacts for $0.5 billion in FY 2007 for those countries eligible in FY 2006 that did not complete a Compact in FY 2006. The current demand for Millennium Challenge Account (MCA) funding included in country proposals from FY 2004 and FY 2005 MCA-eligible countries already greatly exceed the appropriated funds. Initial requests from FY 2004 eligible countries alone totaled nearly $5 billion, about twice the combined appropriated level for the compressed FY 2004-FY 2005 planning period; this amount was subsequently pared down to approximately $3 billion following feedback from MCC during the course of subsequent due diligence and Compact negotiations. In FY 2006, good requests are likely to exceed further the funds available as an entirely new group of lower-middle income countries are added to the MCA candidate country list. Some 25 to 35 new countries potentially could become candidates, many of which have large populations. Even though many of these new candidates will ultimately not qualify as eligible countries, those that do will create significant new funding demands on MCC's budget.

MCC estimates that the addition of new FY 2006 candidate countries, along with amendments to existing compacts (for example, to add components identified but that were not ready for full funding in the initial Compacts) will increase the total demand by as much as $3 to $5 billion in 2006.

Although the total demand from FY 2004, FY 2005 and FY 2006 MCA-eligible countries is expected to exceed the total appropriated and requested amounts ($5.5 billion), MCC believes it can manage that potential shortfall by a combination of (1) eliminating components from country proposals; (2) delaying slower moving components to future year amendments or subsequent Compacts; and (3) working to improve proposals and components that do not as clearly contribute to economic growth and poverty reduction.

MCC estimates signing up to twelve Compacts funded with FY 2004 and FY 2005 money and projects that about thirteen new Compacts and amendments to earlier Compacts could be funded with the forecasted $3 billion funding for FY 2006. The table below summarizes our projections based on an estimate of how country selection, eligibility and Compact development will proceed. It should be recognized, however, that in light of the uncertainties -- regarding the numbers of countries selected, the specific countries, the amounts, and the timing of proposal development -- this is an inherently speculative process and, as such, the funds that will be committed during a particular fiscal year cannot be projected with any certainty. Nonetheless, these estimates are supported by the analysis of the Government Accountability Office, which found that, using data on MCA-eligible countries, under different scenarios, MCC would need to have total resources of roughly $3.4 billion to have the impact of one of the top three donors in eight to fourteen countries eligible countries, based on three- to five-year programs. Combined with our experience to date, this analysis forms the basis for our projections. MCC must focus its available resources to fulfill its mission of supporting transformative development programs. MCA is intended to provide a significant policy incentive to candidate countries by commanding the attention needed to galvanize the political will essential for successful economic growth and sustainable poverty reduction, and needs substantial resources to have that incentive effect. It is critical that MCA-eligible countries be confident that MCC is capable of funding sound programs, based on the hard work of policy reform they have undertaken; the $3 billion request for FY 2006 helps provide such assurance.

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Audit Expenses (Inspector General-USAID)			2			2
Recissions – FY 2004 and FY 2005			18			-
Total Administrative, Due Diligence, M&E			**92**			**136**
Total Obligations			**2,500**			**3,000**

As required by the MCA legislation, the Compacts will be multi-year programs that involve significant up-front funding commitments. The legislative authority of "no-year" funding allows MCC to demonstrate to eligible countries that there will be adequate funding available when the time comes to sign a Compact. Indeed, as the House Committee on Appropriations Report on the 2004 Foreign Operations, Export Financing and Related Programs Bill noted:

> *The Committee is concerned about the possibility that MCC will enter into multi-year compacts with countries without obligating full funding for the Compact. The Committee opposes committing future Congresses to funding prior year compacts. Therefore the Committee directs the MCC to only enter compacts for which it has complete funding available from existing appropriations and has recommended bill language on this matter.*

The expectation of full, up-front funding has already had a positive effect in moving a number of countries to undertake reforms -- the incentive effect noted above -- and underlines MCC's current need for funds.

Compact "Pipeline" Is Robust and Growing

The pace of program development and the signing of Compacts are, of course, very much driven by the eligible countries. Several countries moved quickly into effective program development with MCC. (*See* Exhibit C for a description of "Early Successes in the Consultative Process.") While it is not unusual for donors to take some eighteen months or more to develop projects, the MCC program development and assessment process with eligible countries has taken about six to nine months to get to or near the signing stage on its first few Compacts, all while developing MCC's organization from scratch and designing the process by which proposals are reviewed, due diligence is conducted, and Compacts are negotiated and finalized. Only six months will have passed since receipt by MCC of the Madagascar proposal in October 2004 until the

Compact signing with Madagascar which is expected in April 2005. A detailed summary of the components of the Millennium Challenge Compact with Madagascar approved by MCC's Board on March 14, 2005 -- including at the program, project and activity level -- are included in the "Congressional Notification" submitted to the Congress on March 15, 2004. Four more eligible countries are currently in Compact negotiations.

Other MCA-eligible countries, however, were initially unfamiliar with the new approach and have taken longer to develop effective programs which MCC can support. While proactively helping eligible countries, MCC has adhered to the principles of neither pushing money out the door nor meeting artificial deadlines for signing Compacts. To succeed, MCC has needed to work with countries to design workable programs with detailed plans for monitoring and evaluating performance, fair and transparent procurement procedures, fiscal accountability (*See* Exhibit D for a description of MCC's fiscal accountability requirements), and donor coordination.

While the concept of preparing their own development proposals was not entirely new to many of these countries, that notion had rarely been translated into action. Most of these countries, even those with poverty reduction strategies in place and development goals in mind, have not had the experience of taking charge of the process and leading a donor-supported effort. Some eligible countries remain accustomed to having donors set priorities, design programs, handle implementation, procure goods and services, and manage most other aspects of these activities. Not surprisingly, many of these countries initially looked to MCC to do the same. Other countries reflexively produced "laundry lists" of projects which had been left on the shelf from earlier donor programs. In most cases, the initial proposals touched off intense consultation between MCC and the eligible countries, resulting in a better understanding of the proposed program.

In certain instances, eligible countries were informed that the initial proposals required greater involvement from civil society and other stakeholders in the countries' development process. In other cases, extended eligible country/MCC consultations on the proposals were required since the proposals needed more work in defining the planned poverty reduction impact.

Specific problems have also surfaced in developing key components in the proposals, sometimes reflecting a simple shortage of institutional capacity to put a comprehensive proposal together. In such cases, MCC has worked with the countries to develop that capacity locally. It is a process that has taken patience and diligence on both sides to ensure that the proposal is the final product of the eligible country's analysis and decision making, while MCC supports each country to move the process along as rapidly as possible. MCC continues to explore ways to facilitate faster, better Compact development by MCA-eligible countries consistent with the principle of country ownership, such as more extensive use of Compact development assistance under Section 609(g) of the Millennium Challenge Act.

The result is that MCC has a robust pipeline of countries in varying stages of Compact development, many of which will be finalized during the remainder of FY 2005. The Board of Directors approved the first Compact in the second quarter of FY 2005 (which is expected to be signed in April) and MCC estimates finalizing, on average, two to four additional Compacts per quarter through the end of FY 2006. MCC has "no year" money and some of its FY 2006 funds may remain unobligated at the end of the fiscal year for Compacts in development but not yet completed as of the end of the fiscal year. As indicated above, MCA-eligible countries are likely to submit proposals which exceed the total funds already appropriated combined with the President's request.

Incentive Effect of Multi-Year, Fully Funded Compacts

Early indications are that the incentive effect -- namely, the prospect of substantial sums to finance a country's development priorities -- are a significant benefit of the MCA program, even before the first program dollars have been disbursed. Continuing progress by MCC in finalizing Compacts with MCA-eligible countries and full funding of the President's FY 2006 budget request will be important components of delivering on the promise of MCA and continuing this powerful incentive effect. One country passed and is enforcing four new pieces of anti-corruption legislation, publicly tying these improvements directly to their efforts to qualify for MCC funding. More recently, a minister of finance in a country that scored low on MCC's anti-corruption indicator has openly called for corrective measures to improve prospects for future MCC eligibility. The president of yet another eligible country, in a major annual public address, cited his country's selection for MCA funding as a "positive effect of (his country's) resolve and an example of its improving stature." And the president of another eligible country said that MCC selection was the third most significant event in his country's history, after independence and the creation of an open domestic market economy.

Commitment of U.S. Government to Fund Good Proposals from MCA-Eligible Countries

In proposing the MCA program, President Bush provided a spark of hope to a number of honest governments poised to lift their poverty-afflicted populations onto a growth path. MCC has spent much of the last year addressing those hopes, eliciting solid proposals and moving rapidly toward sound Compacts and development programs. Although MCC has made it clear that MCA-eligibility does not itself ensure that a country will finalize a Compact and receive MCA funding, MCC believes the U.S. government has an obligation to live up to its commitment with respect to those countries that do in fact develop solid proposals for assistance.

Threshold Country Program

The Threshold Program was established to assist countries that do not qualify for MCA assistance but are close to qualifying and have demonstrated a commitment to meeting the MCA-eligibility requirements in the future. The program is directed toward helping such countries improve their performance on the specific policy weaknesses indicated by the country's scores on the sixteen policy indicators that are critical to MCA eligibility and methodology. Threshold funds are then used to support reform efforts and to provide an incentive to move a potential partner country toward MCA eligibility. However, selection for the Threshold Program does not ensure eventual MCA eligibility. In selecting Threshold Program participants for FY 2004 and FY 2005, the Board considered countries that had to improve their performance on no more than two indicators to qualify for Threshold eligibility. In cooperation with USAID, MCC is working with thirteen Threshold countries (*see* country list at Annex B) to design programs.

Section 616 of the Act provides that up to 10 percent of total FY 2004 MCC funding may be used for Threshold Program countries. That provision was extended to the FY 2005 program. The MCC Board reserved $40 million of FY 2004 money for this program, with the authority to provide up to approximately $100 million of FY 2004 funding and a maximum of $150 million of FY 2005 funding. The final level of funding will depend on the quality of Threshold proposals that are developed in the coming months and on demands for funds from the MCA-eligible countries. We currently project some $130 million of FY 2004 and FY 2005 money, as well as approximately $140 million of FY 2006 funds, will be used for Threshold Programs.

Summary of Budget Request

As indicated in the following chart, funding for MCC is divided into three categories: (1) Program budget; (2) Administrative budget; and (3) Audit budget.

		2004 (Actual)	2005 (Planned)	2006 (Request)
			$ 000s	
PROGRAM BUDGET				
	Development Program under Compacts	-	1,289,056	2,724,828
	Threshold Programs	-	130,000	140,000
	Due Diligence and Assessments	-	15,860	45,155
	Monitoring and Evaluation	-	1,140	2,845
	Total Program Budget		**1,436,056**	**2,912,828**
ADMINISTRATIVE BUDGET				
	Salaries and Benefits	2,013	20,948	32,102
	Contracted Services	1,043	5,520	13,841
	Travel	444	7,990	18,248
	Information Technology	502	4,424	4,987
	Rent	323	6,850	4,444
	Overseas Presence Costs	-	2,976	10,135
	Other Administrative Expenses	482	1,292	1,243
	Total Administrative Budget	**4,807**	**50,000**	**85,000**
AUDIT BUDGET (USAID Inspector General)				
Note: The USAID Inspector General budgets independently and submits a separate budget justification which is appended.				
	Salaries and Benefits	172	890	1,000
	Investigative Support - USAID	42	316	517
	Contract Support	125	595	505
	Travel and Training and Miscellaneous	17	143	150
	Total Audit Budget	**356**	**1,944**	**2,172**
RECISSION		5,900	12,000	**-**
APPROPRIATED (UNOBLIGATED)		988,937	**-**	**-**
	TOTAL MCC BUDGET	**1,000,000**	**1,500,000**	**3,000,000**

Program Budget

The program budget includes funding for development programs under Millennium Challenge Compacts as well as the Threshold Programs. Due diligence expenses directly related to assessing and structuring a program prior to signing an eventual Compact, as well as monitoring and evaluation costs required during the implementation of a program, are also budgeted as program items. Key due diligence activities focus on program component analysis, investigation of country capabilities, assurance of financial accountability systems, development of Compact documents, and developing data and systems for impact analysis. Within its program, the Corporation may also fund activities in eligible countries in advance of a Compact to facilitate development and implementation of a Compact proposal, and has begun to support accelerated development of sound proposals and monitoring processes. MCC's efficient processes result in some 97% of total funding going directly to programs helping the targeted poor.

Administrative Budget

The administrative budget, which is projected to be less than 3 percent of total MCC funding in FY 2006, covers all direct hire staff, full-time contractors, rent, supplies, training, overseas staff-related costs, administrative outsourcing (including information technology, procurement, and financial management functions), travel and in-house support and administrative functions.

Staffing

As of the date of this Report, MCC has a current staff of 120. At the end of FY 2005, MCC expects to have reached a staff level of 170, which will increase to 200 during FY 2006. MCC staff have been recruited from Federal agencies, the private sector, non-governmental organizations, universities and development organizations. Considering the amount of due diligence required to evaluate eligible countries' proposals and the expected funding levels that will be provided for each Compact, this limited staffing level compares very favorably with other development organizations, both within government and the private sector. MCC anticipates it will be able to carry out its mission with this small number of staff and limited administrative budget by employing a very talented and highly professional group of people, designing streamlined, careful processes from the outset to accomplish its targeted mission, and utilizing a model that highlights the importance of partnership with the recipient country over a "we will do it all" mentality. In addition, a limited number of contractual personnel have been engaged for specific skill requirements that are not otherwise readily available. MCC staff are highly motivated, focused and dedicated to ensuring that the mandates and programs funded by MCC will be properly implemented, monitored and evaluated. As described in detail in this justification, those are critical functions and responsibilities of this program

Once the first Compacts are signed during FY 2005, and as the number of signed Compacts increases markedly through FY 2006 and later years, it will be necessary to have an in-country staff presence to monitor properly country programs and to provide guidance to countries in carrying out their programs. In-country staffing plans currently call for typical staffing of one U.S. direct hire and two or three local-country persons in each country. At this time we estimate that by the end of FY 2005, we will have four offices overseas, with some twenty by the end of FY 2006.

To attract, motivate and retain the small, highly professional staff from government, the development community and the private sector, MCC has created a results-oriented, high performance workplace. Working with expert consultants, MCC expects to institute a compensation system with a strong incentive component to attract and retain the best staff from all recruiting pools, and to reward high performance focused on its critical development and strategic missions, while remaining good stewards of taxpayer money.

No funds have been provided by MCC to any Threshold Program-eligible country as of the date of this report. MCC has to date transferred approximately $20.0 million to USAID to implement the Threshold Program. As of the date of this report, MCC has transferred a total of approximately $6.0 million of program funds to other U.S. government agencies in furtherance of MCC's mission, including:

- Treasury Department - Financial systems and sector assessments ($1.2 million)
- U.S. Army Corps of Engineers - Infrastructure program assessments and feasibility study reviews ($1.8 million)
- USAID - Base line household data survey in Madagascar ($1.3 million)
- USDA Foreign Agriculture Service - Agriculture program assessments ($1.0 million)
- Census Bureau - Program monitoring and baseline studies ($0.75 million)

Travel
MCC's budgeted travel expense reflects its distinctive approach to development, requiring intensive consultation with local civil society, private sector and government groups in its MCA-eligible and Threshold countries, while maintaining a very limited in-country presence. MCC's staff is directly involved in refining proposals, program design, Compact negotiation, program implementation, and monitoring and evaluation, necessitating frequent in-country contact from Washington-based staff.

Audit Budget
The estimated audit budget is provided by the USAID Office of the Inspector General, which is legislatively designated as responsible to MCC's Board for oversight of MCC activities. The budget request is developed independently and submitted separately; it is appended to this document.

Additional Context for Request
Although we continue to learn from experience and continually refine our model -- and will for the foreseeable future respond to the challenges inherent in any start-up operation -- MCC believes it has developed a largely effective and efficient process to work with eligible countries to develop worthwhile programs. MCC anticipates signing a number of Compacts in the coming months, following program development and due diligence ranging from six to twelve months. Comparatively, multilateral institutions often take eighteen months or more to make a lending decision. In the private equity world, even with an excellent initial proposal and parties that are used to doing business, four to five months is generally considered a minimum amount of time to complete an agreement, even under very favorable circumstances. Under such circumstances, the parties involved in the investment proposals usually have been through the process before, the objectives are known (e.g., financial return or credit worthiness) and the management organization and implementation plans are in place. Clearly, that is not the case in MCC's countries.

The best way to promote and sustain an MCA program is to make sure it gets off to a positive, effective start. As a result, no programs will be undertaken, no country Compact signed, until MCC's Board is satisfied that the proposed Compact will achieve real measurable results in poverty reduction and economic growth. The current "pipeline" of proposals for MCA funding from eligible countries now amounts to approximately $3 billion, greater than the total level of funding that was made available for FY 2004 and FY 2005. As indicated above, one Compact has been completed and will soon be signed, four proposals are in a formal negotiation process and proposals from an additional eleven eligible countries are moving through the due diligence phase toward possible formal negotiations and funding. One country, Morocco, was added to the list of eligible countries more recently and MCC is prepared to work with its proposal when it is submitted.

Beyond that, an entirely new group, the lower-middle income countries -- roughly 25 to 35 potential countries -- will become candidates for MCA assistance in FY 2006. These new candidates will significantly increase the number of potential partners in the program, thereby increasing the importance of funding at the FY 2006 request level. As CEO Applegarth pointed out during October 5, 2004 in testimony before the Senate Foreign Relations Committee:

> *As we evaluate proposals and really build a pipeline, it is crucial that we receive adequate funding. If you come back to what we are really about, it is to provide an incentive to countries to enact reform. It would be a fundamental problem if countries gave us good proposals…and that as a result of the cutbacks in funding, we had to eliminate countries that had good proposals…if there is a proposal before us that has good merit, that clearly leads to poverty reduction and growth, and we are unable to fund it, we have built expectations in the countries…and if we fail to deliver on the Monterrey promise that, if they take those steps, we will be there to help provide assistance, we are going to be questioned: 'What happened?' I think it is important for U.S. credibility and I think it is important in terms of poverty reduction and growth.*

MCC's Compact programs will typically span three to five years, with full funding committed at the execution of each country Compact and the actual disbursement of funds tied to performance over the life of the Compact. The full "up-front" funding permits the partner countries to undertake the transformative programs the MCA was designed to support and to address root causes of poverty. MCC believes it is equally important for adequate current funding to be in place when MCC begins formal negotiations -- at which point country expectations will be very high -- even for negotiations which may not be finalized by the end of the fiscal year. As the pace of Compact signing is expected to pick up substantially in the future, and as the base of eligible countries grows, any shortfall in FY 2006 funding could substantially dilute the impact of MCC. We, therefore, request full funding of the President's request of $3.0 billion for FY 2006.

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Operating Expenses of the Inspector General [2]

Dollars in Thousands

Funding Categories	FY 2003 ACTUAL	FY 2004 ACTUAL	FY 2005 ESTIMATE	FY 2006 REQUEST
Reimbursement Request	N/A	360	1,944	2,172

The Office of Inspector General (OIG), U.S. Agency for International Development (USAID) plans on spending $2.2 million on work related to its statutory responsibilities as the Inspector General for the Millennium Challenge Corporation (MCC). This request will allow the OIG to accomplish mandatory and priority audit and investigative work that can help reduce MCC's exposure to fraud, waste and abuse. This request will also enable the MCC to increase the credibility and confidence of programs that it operates in highly vulnerable areas of the world.

On January 23, 2004, with the enactment of Public Law 108-199 (The Consolidated Appropriations Act of 2004), the MCC was established. The Act designates the Inspector General of USAID to serve as the Inspector General for the MCC and states that up to $5 million annually is authorized to be made available to the Inspector General to conduct reviews, investigations and inspections of operations and activities of the MCC. In addition, the legislation states that in carrying out this responsibility, the Inspector General shall report to and be under the general supervision of the MCC's Board of Directors.

Established under the Inspector General Act of 1978, the OIG is statutorily required to:
(1) conduct audits and investigations relating to the programs, operations and personnel of MCC; (2) recommend policies for activities designed to promote efficiency and effectiveness and to detect waste, fraud and abuse in MCC programs and operations; and, (3) provide a means for keeping the MCC Board of Directors, MCC management, and the Congress informed about MCC's state of operations.

The OIG's goal is to promote and preserve the integrity, effectiveness and efficiency of MCC. Our work plan for FY 2006 would continue to focus on mandatory and priority audit and investigative activities. These would include audits of the financial statements, information security management and MCC progress in establishing controls over its administrative and program activities. Other work would also include Compact monitoring and evaluation and oversight of Compact financial audits. A more detailed discussion of our planned audits and investigative plan is shown as Appendix I.

During the abbreviated FY 2004, with a $360 thousand budget, the OIG held meetings with the MCC Board Chairman and executives to emphasize the need for early involvement of the OIG in MCC activities to better understand the vulnerabilities of MCC programs and operations. For example, the MCC program is based on an innovative model of development assistance and staffed by personnel with varying levels of government and private sector experience who will

[2] Supplied by the Office of the Inspector General, USAID

provide assistance to countries that have weak accountability models, lack transparency and have high levels of corruption.

The OIG initiated extensive coordination efforts with MCC management, the Office of Management and Budget and the Government Accountability Office. These efforts resulted in the issuance of our first semi-annual report to Congress, the first MCC Annual Audit Plan, two audit/review reports and acceleration of the due date for the financial statement audit. We also conducted a fraud awareness briefing for MCC staff and completed a cognizance visit of the service provider of MCC's payroll, procurement and accounting functions.

The MCC is subject to the Government Corporation Control Act which establishes the reporting requirements for wholly owned government corporations. That Act requires the submission of an annual management report to the Congress no later than 180 days after the end of the government corporation's fiscal year, which includes a set of audited financial statements. The Federal Government norm for issuance of audited financial statements is 45 days after fiscal year end. We reached an agreement with the MCC to accelerate the preparation and audit of the Corporation's financial statements to 90 days after fiscal year end we will continue our efforts to help MCC meet the Federal Government norm of 45 days for FY 2005.

The Federal Information Security Management Act of 2002 (FISMA), Public Law 107-347, requires agencies to report annually on their information system security program to the Office of Management and Budget, Congressional committees, and the Government Accountability Office. The MCC reported on its information security program in accordance with the FISMA. However, the MCC had not yet documented its information systems security program. The OIG will work closely with the MCC to assist in fully meeting the requirements of this Act.

Our proactive fraud awareness activities were well received by the MCC. During FY 2004, in an effort to familiarize MCC staff with indicators of fraud and illegal activity, the OIG staff conducted a fraud awareness training session at the MCC headquarters. More briefings are planned for Compact countries. The ultimate goal of our fraud awareness program is to educate employees and recipients to a point that we detect and prevent fraudulent activity in MCC programs.

Appendix I

Office of the Inspector General Audit and Investigative Plan for the Millennium Challenge Corporation for FY 2006

This is our general plan for audit and investigative services for the Millennium Challenge Corporation for fiscal year 2006. Our plan is in the preliminary stages as we continue to work with MCC officials in its development and as MCC begins to implement, monitor and evaluate Compacts with individual countries. Our plan is subject to change and refinement as these developments change and as risks are identified and mitigated. We will continue to maintain an ongoing dialogue with MCC officials and other stakeholders regarding this plan. The general concept of OIG's audit and investigative plan for the Millennium Challenge Corporation during fiscal years 2006 is to:

(1) conduct the statutory audit of MCC's financial statements and conduct a review of computer security controls;
(2) continue to monitor the implementation and documentation of effective internal controls over MCC programs and operations and compliance with applicable laws and regulations;
(3) oversight the development of MCC monitoring and evaluation programs at headquarters and at the country level;
(4) review MCC's development of performance measures for accomplishment reporting;
(5) provide MCC fraud awareness training; and
(6) operate an Inspector General Hotline for the MCC where employees of the organization, contractors, country participants, the general public and others, can report potential instances of possible fraud, waste or abuse for subsequent review.

We also work very closely with the Government Accountability Office to discuss our audit and investigative plans to coordinate work and to avoid duplications.

Exhibit A

Millennium Challenge Compacts

Each country that is selected for MCA funding will negotiate and sign a public Millennium Challenge Compact with MCC. Each Compact will include, among other things: a limited number of specific objectives that the country and the U.S. expect to achieve during the Compact term; regular benchmarks to measure progress towards achieving the objectives; the responsibilities of the U.S. and the country in achieving the objectives; identification of intended beneficiaries; a multi year financial plan; a description, where appropriate, of the participation of other donors; a plan to ensure fiscal accountability for the use of assistance; a requirement for fair and transparent procurement and a process, where appropriate, for consideration of solicited and unsolicited proposals under the Compact; and the strategy of the country to sustain progress made towards achieving the objectives of the Compact after the end of the Compact Term. Compacts will also include clear targets with which to measure results. MCC wants to ensure that U.S. taxpayer money is invested in those programs where MCC believes funding will lead to poverty reduction and economic growth. Targets will also ensure that both MCC and the country are accountable for the success of the Compact.
The agreement gives the country ownership of the activities and programs funded by MCA assistance, reflects wider participation by that country's civil society and other non-governmental groups, and is expected to encourage a stronger commitment on the part of that country to achieve results. This approach also imposes only a reasonable administrative and reporting burden on the part of the partner country.

MCC partner countries are therefore responsible for the execution of a wide range of activities*:*

- ensuring that private sector and civil society are involved in developing and implementing an MCC Compact;
- coordinating among MCC and other donors to maximize development impact and avoid overlap or duplication of efforts;
- ensuring an open and unbiased process that would identify the most promising activities to accomplish MCA goals;
- publicizing the terms of the Compact, making it clear that the responsible actors within the country will be held accountable for performance by their constituents as well as MCC;
- monitoring and assessing activities needed to meet Compact benchmarks and goals and evaluate progress.

Countries will need to maintain their performance on the selected indicators in order to preserve their MCA-eligible status. 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 MCC can begin substantive discussions with a country on a Compact.

Exhibit B

Selection Process for MCA-Eligible Countries; Outreach to Selected Countries

Candidate Countries

MCC's Board of Directors approves a candidate country list each fiscal year, as described above. Section 606 of the Act outlines how candidate countries are to be selected.

FY 2004 candidate countries had per capita annual income of $1,415 or less (the historic IDA cut off level for assistance that year); were eligible to receive assistance under the International Development Association (IDA); and were not ineligible to receive U.S. assistance under Part I of the Foreign Assistance Act. Sixty-three countries were identified by MCC as meeting the FY 2004 requirements to be a candidate country.

For FY 2005, candidate countries had a per capita income of $1,465 or less (a more recent IDA ceiling), but the IDA eligibility requirement itself was dropped as a requirement for country candidacy; and, were not ineligible to receive United States assistance under Part I of the Foreign Assistance Act. A total of 68 countries were identified by MCC as meeting the FY 2005 requirements to be a candidate country.

In FY 2006, candidate countries will compete in two separate groups: the low income countries and a new set of lower middle income countries. The income levels for these two categories for FY 2006 will be set by the World Bank in June 2005. The total amount of assistance provided to this second group may not exceed 25 percent of the total assistance provided to all MCA-eligible countries in FY 2006. Again, no FY 2006 candidate countries may be ineligible to receive U.S. assistance under Part I of the Foreign Assistance Act.

Eligibility Requirements

The Board must then measure and evaluate the comparative policy performance of each of the candidate countries. The purpose of this evaluation is to help MCC select *eligible* countries from among the *candidate* countries.

Section 607 of the Act requires that an MCC Board determination of eligibility be based "to the maximum extent possible upon objective and quantifiable indicators of a country's demonstrated commitment" to the criteria set out in the Act. These selection criteria and methodologies are discussed in public outreach sessions, contained in a Federal Register notice, and formally reported to Congress each year.

The selection process involves a measurement of the candidate countries' overall performance in three broad policy categories: Ruling Justly, Encouraging Economic Freedom, and Investing in People. The Board used 16 indicators to assess policy performance within these three major policy categories. There were changes in these indicators between FY 2004 and 2005. Additional changes are possible in FY 2006 (see "Changes in Selection Criteria and Methodology in FY 2006" below). These indicators are grouped in the three policy categories as follows:

RULING JUSTLY	ENCOURAGING ECONOMIC FREEDOM	INVESTING IN PEOPLE
1. Civil Liberties. *Source: Freedom House*	1. Country Credit Rating *Source: Institutional Investor Magazine*	1. Public Expenditures on Health as a Percent of GDP *Source: country data*
2. Political Rights *Source: Freedom House*	2. One year Consumer Price Inflation *Source: International Monetary Fund*	2. Immunization Rates: DPT and Measles *Source: World Health Organization*
3. Voice and Accountability *Source: World Bank Institute*	3. Fiscal Policy *Source: IMF World Economic Outlook*	3. Public Primary Education Spending as a Percent of GDP *Source: country data*
4. Government Effectiveness *Source: World Bank Institute*	4. Trade Policy *Source: Heritage Foundation*	4. Girls Primary Education Completion Rate *Source: World Bank*
5. Rule of Law *Source: World Bank Institute*	5. Regulatory Quality *Source: World Bank Institute*	
6. Control of Corruption *Source: World Bank Institute*	6. Days to Start Business *Source: World Bank*	

In assessing possible indicators, MCC favored those that: (1) are developed by an independent third party, (2) utilize objective and high-quality data, (3) are analytically rigorous and are publicly available, (4) have broad country coverage and are comparable across countries, (5) have a clear theoretical or empirical link to economic growth and poverty reduction, (6) are policy-linked, i.e. measure factors that governments can influence within a two to three-year horizon, and (7) have broad consistency in results from year to year.

The source for each indicator is shown above as a single organization. In many cases, however, that organization was dependent on multiple sources in developing the aggregate indicator. In developing indicators in the "Ruling Justly" category, for example, MCC relied heavily on the governance data compiled by the World Bank Institute. The Institute, in turn, used data from twenty major sources and eighteen separate organizations.

In making its determination of eligibility with respect to a particular candidate country, the Board considered whether the country performs above the median in relation to its peers on at least half of the indicators in each of the three policy categories and above the median on the corruption indicator.

The use of these indicators was the predominant basis for determining which countries would be eligible for MCA assistance. In addition, the Board exercised discretion given it under Section 607 of the Act to evaluate candidates and translate them into a final list of eligible countries. In this regard, the Board also considered whether any adjustments should be made for data gaps, lags, trends, or other weaknesses in particular indicators. Further, the Board could deem a country ineligible if it performs substantially below average on any indicator and has not taken appropriate measures to address this shortcoming. Where necessary, the Board could take into account 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.

Selection of and Outreach to Eligible Countries

Having met or bettered the deadlines established in the Act for Congressional and public notification of candidate countries and eligibility criteria, on May 6, 2004 MCC selected sixteen eligible countries for FY 2004 from among the sixty-three candidate countries. These selected countries, which have a combined population of more than 130 million people, are: **Armenia, Benin, Bolivia, Cape Verde, Georgia, Ghana, Honduras, Lesotho, Madagascar, Mali, Mongolia, Mozambique, Nicaragua, Senegal, Sri Lanka and Vanuatu**.

Within ten days of the announcement of the selection of FY 2004 MCA-eligible countries, five MCC delegations departed for consultations in the sixteen selected countries. The purposes of these preliminary visits, which occurred in May and June 2004, were:

1) To advise the countries formally of their eligibility for the program, and to describe the program. It was made clear that eligibility was not a guarantee of MCA funding and that funding would depend ultimately on the quality of the proposals.

2) To encourage participation in the proposal development process by both government and non-government entities in these countries.

3) To discuss the issues that eligible countries would have to address in their proposals: How would the programs described in the proposals lead to poverty reduction through growth? How would the proposal development process by an eligible country be made open to its public? What additional policy reforms would the countries adopt as a result of MCC funding?

4) To invite into the proposal process representatives of the private sector, civil society, non-government organizations and opposition parties in each of the countries visited.

5) To encourage and in some cases begin a broad consultative process, one which was not limited to just a few people in Washington, D.C. or a few officials in the eligible countries.

The results of these initial forays into the eligible countries were highly positive. The major finding was that getting workable proposals was going to take time. Although MCC delegations were welcomed enthusiastically by potential partners, it became obvious that to move the process from an initial concept to a full proposal to a formal negotiation would take considerable time and effort. The process was likely to be iterative, extended in both time and scope, as proposals were developed and reviewed.

The staff had notified eligible countries well in advance that MCC intended to fund programs that had partner country "ownership." The concept, however, seemed new to most of the countries. Some looked for MCC direction in establishing program priorities; other countries seemed inclined to take earlier planned projects "off the shelf" for funding without particular reference to the strategic growth and poverty reduction policies which are required for MCC funding.

In describing the initial response of eligible countries, an MCC staff member at a subsequent public outreach meeting described a typical country visit as follows: "We found initial skepticism on the part of the eligible countries, followed by enthusiasm (as the substance and format of the program was confirmed); and, finally, a sober realization that the proposals would need to be crafted carefully and integrated closely into other donor activities."

In some cases, more than one follow-up visit by an MCC delegation was requested by the eligible country in order to get the proposal process on track. Most eligible countries began work on their proposals in late July, by which time eligible country websites had been linked to MCC's website.

Changes in Indicators in FY 2005

MCC continually evaluates and refines the selection criteria. In FY 2005, MCC substituted the indicator "Girls' Primary Completion Rates" for the previous indicator, "Primary Completion Rates." Using primary school completion rate data disaggregated by gender continues MCC's focus on the importance of countries investing in the education of their people, and highlights the strong empirical linkage between investments in the education of women and girls and a country's economic growth and poverty reduction. Another indicator – one-year consumer price inflation rate – was reduced from a ceiling of 20 percent to 15 percent to be a more stringent test of a government's commitment to economic discipline.

Changes in Selection Criteria and Methodology in FY 2006

As indicated above, in FY 2006, the candidate countries will be divided into two groups based on per capita annual income levels: (1) candidate countries that have a per capita income below the historic IDA cut off (currently $1,465); and 2) candidate countries with per capita income between that cutoff and the World Bank's income ceiling for lower middle income countries (currently $3,035). By creating two groups, MCC can keep to a minimum any potential income bias that may affect the policy indicators. Section 606(b) (2) limited the total amount of MCC assistance provided to the lower middle income group to no more than 25 percent of the total funds provided by MCC annually.

Further, as a result of public input and early experience in the start up phase of the program, MCC announced that it would explore indicator changes for FY 2006. Specifically under consideration are measurements for entrepreneurial activities, investments in people, and trade barriers (perhaps an indicator measuring trade policy services). Beyond that, a group of experts is being established to identify an existing indicator or to promote the development of a new indicator to measure candidate countries' policies regarding the management of natural resources. That group will be chaired by Board member Christine Todd Whitman and will work with outside groups and other experts to evaluate ideas for such an indicator.

After the Board has identified candidate countries in FY 2006, it will determine the final list of eligible countries. The Board will be guided by the aforementioned sixteen indicators as well as other factors, including the amount of funding available.

Exhibit C

Early Successes in the Consultative Process

The ongoing consultative process in MCA eligible countries has revealed a willingness on the part of many to democratize and include broad public participation in the setting of economic development priorities in order to qualify for MCC funding. While this process of consultation is new to many MCA countries, eligible countries are making strides in managing more transparent, inclusive and continuous consultations that provide opportunities for citizens to have input into the identification, prioritization, and subsequent development of programs proposed for MCC funding.

For example, one country's proposal was prepared by the central government working with development councils which represent 144 local nongovernmental organizations, private sector entities and other groups across the country's regions. This process marks the first time in that country's history that the central government has employed these councils to develop the components of a foreign assistance program, giving these groups unprecedented local "ownership" of the process. The proposal itself is for a four year program which focuses on an area with both the most extreme rural poverty in the region and a high potential for economic growth. It includes measures to modernize land registration, and to promote agribusiness through irrigation, extension services, financing, export promotion, and market development.

Another country's proposal was submitted after months of interactive dialogue through various media that helped the eligible government use new ground rules for development projects: meaningful public dialogue and citizen participation, full transparency, greater accountability, responsibility and ownership of projects, and the need for tangible results. In this vein, the new government formed its own Millennium Challenge organization. Their board of directors includes non-governmental organizations, members of parliament and central government ministers, allowing for continuous involvement and input throughout program design and implementation. The eligible country's MCC counterpart organization will screen elements of the proposal to ensure that the program focuses on areas that will directly impact poverty reduction and economic growth, complement private sector and other donor activities, remove critical barriers, and provide long-term stability. The aim is to rehabilitate infrastructure that is critical to reducing local poverty and to spurring local job creation. The first elements include building a primary road in one of the poorest regions of the country, developing a comprehensive energy plan to ensure sustainability in the electric power sector, and creating a mechanism to finance high-impact investments in the agriculture sector. Here is how a newspaper in that country described public involvement in the proposal development process:

> *"The public awareness campaign included a website, banners, television ads, submission guidelines in newspapers, and, of course, the presentations in the regions. Ideas have poured in through e-mail, post, suggestion boxes, direct phone calls and even proposals hand delivered to the (eligible government MCC) offices. Some presentations include colored graphs and glossy covers, others are written by hand… Over the last two months they have organized six regional presentations drawing as many of 500 local residents at each event. They have received over 1,000 public submissions and recommendations on how to use the Millennium Challenge money to help the economy and reform the government."*

In fact, these early consultative efforts have been successful in many of the eligible countries. In another instance, inviting the participation of a labor union on an MCC proposal committee resulted in the union's eventual understanding and involvement in a project it had initially opposed. In yet another country, a newspaper editorial writer, assessing his country's proposal, said that he was happy to report that the proposal's business development component, which accounts for about two-thirds of the total request, is "the best of all because it includes business people, international experts, and public officials, and, if effectively implemented, has the potential to significantly improve the lives of the private sector in the country."

Similarly, a U.S. foundation reported to MCC that one African country abandoned the expatriate consultant route to proposal development and instead opened the process to civil society and the private sector. An official in that country remarked, "even if we receive less than requested, the intangibles gained from taking control of our own development destiny are the most important part of the process." United Nations representatives in that country observed that MCC's process stimulated unparalleled discussion among donors, government and a broad cross-section of the population.

We have seen sufficient positive results in many of the eligible countries to discern a pattern. The promise of this program has touched off unprecedented participation in the process, including widespread public meetings, not just in the capitals but throughout the country using television, radio, internet and the print media to broadly disseminate information as well as finding innovative ways to solicit input through two-way exchanges with citizens and potential beneficiaries all around the country.

In short, the consultative process -- getting to true country "ownership" and wide stakeholder participation and buy-in of a coherent proposal -- has required great investments of resources, time and effort. Still, we have encouraged eligible countries to engage their citizens fully in the process, rather than just doing them quickly, because such public participation will result in programs that better reflect the nation's priorities and have a higher likelihood of success.

Exhibit D

Fiscal Accountability

A key element of all Compact development and execution is fiscal accountability -- the mechanisms and processes that assure that funds are managed properly and procurements are undertaken in a fair, open, and transparent manner. The following is a summary of guidance that was provided to countries eligible to receive Millennium Challenge Account (MCA) assistance:

Principles
MCC is very aware we are using U.S. taxpayer funds and are accountable for those funds. The requirement to meet the standards of accountability has guided the design of the Compact development process and will be a key element of final program documents and program execution.

As in many elements of MCC's approach, the lessons learned about development assistance over the last few decades have shaped MCC fiscal accountability strategy. The core of the strategy is that each MCC Compact must include a financial accountability mechanism for MCC-funded activities that ensures the funds and procurements are managed properly and in an open and transparent manner.

In determining the appropriate financial accountability mechanism for each country, MCC will be guided by the following principles:

- The mechanisms should result in maximum transparency of financial transactions and activity.
- The mechanisms should have clear lines of authority and responsibility to assure accountability.
- Performance standards must be clear.
- The mechanisms should produce maximum integrity of financial information and assurance that the funds are used for the purpose intended.

MCC will seek, wherever possible, to build upon existing systems, mechanisms, and previous assessment work. The mechanisms should, wherever possible, build capacity that will remain in place at the end of MCC's program.

In developing a specific mechanism for a particular country, MCC and the country will seek an optimal balance among speed of program and project execution, efficiency of operation, minimization of overhead costs, sustainability of outcomes, and effectiveness of accountability.

Mechanisms
The guidance provided to eligible countries indicates that MCC proposals should include a section on financial accountability mechanisms outlining the countries' ideas on what mechanisms would best serve the underlying elements of the overall proposal. Therefore, different approaches will undoubtedly be used in establishing the mechanisms in different countries.

Examples of mechanisms to be used could be financial and accounting institutions, existing government financial systems, project management firms, newly established financial management units and accounts within government, or creation of a trust managed by an independent party to oversee and account for MCC program funds.

The specific financial accountability mechanisms will vary by country depending on the nature of the program, the specifics of the country, and the activities being funded under the agreement. While the mechanisms will differ, some common elements will be part of fiscal accountability in every MCC program. The common elements include:

- Financial information will be provided on a periodic basis (e.g., monthly) and in a standard accounting framework that will allow information to be compared over time and across countries. MCC will seek to have financial information posted on MCC's website and on a local website maintained in country.
- All significant procurement actions must be available on a website (or some other method that would make the procurement process transparent) including notifications of procurements, solicitation documents, and final contract awards including change orders.
- Actual cash disbursements from MCC will be made periodically (e.g., quarterly) based on certified cash requirement needs, financial management and procurement standards, and achievement of program milestones.
- Ongoing disbursements will be subject to satisfactory performance on Compact goals and objectives.
- At a minimum, an independent auditor approved by MCC's Inspector General will conduct an annual audit. The financial accountability mechanism must address any audit recommendations promptly and transparently.
- Regardless of what mechanisms are used to control funds, wherever possible, the financial information related to an MCC Compact must be reflected in the recipient country's budget documents to assure transparency and comprehensiveness of budget impact.

In addition to formal external audits, MCC staff or outside experts will review in-country the financial accountability mechanisms often to assure that they are operating as agreed.

Annex A
Statistics of Eligible and Threshold Countries Selected in FY 2004 and FY 2005

	Population (millions)	Gross national income per capita	Human Development Index Rank	% Population living on less than $2 a day
Eligible Countries				
Bolivia	9.0	$ 890	114	34
Honduras	7.0	970	115	44
Nicaragua	5.5	730	118	80
Cape Verde	0.5	1,490	105	n.a.
Ghana	20.4	320	131	78
Lesotho	1.8	590	145	56
Mozambique	18.8	210	171	78
Benin	6.7	440	161	n.a.
Madagascar	16.9	290	150	83
Mali	11.7	290	174	90
Morocco	30.1	1,320	125	14
Senegal	10.0	550	157	67
Armenia	3.1	950	82	49
Georgia	5.1	830	97	15
Mongolia	2.4	480	117	49
Sri Lanka	19.0	930	96	45
Vanuatu	0.2	1,180	129	n.a.
Total	**168.2**			
Threshold Countries				
Albania	3.2	$ 1,740	65	12
East Timor	0.8	430	158	n.a.
Kenya	31.9	390	148	59
Sao Tome & Principe	0.2	320	123	n.a.
Tanzania	35.9	290	162	60
Uganda	25.3	240	146	n.a.
Yemen	19.2	520	149	45
Burkina Faso	12.1	300	175	81
Guyana	0.8	900	104	6
Malawi	11.0	170	165	76
Paraguay	5.6	1,100	89	30
Philippines	81.5	1,080	83	46
Zambia	10.4	380	164	87
Total	**237.8**			
All developing countries				
All low income countries		430		
All lower middle income countries		1,400		
All upper middle income countries		5,110		

Population: 2003 data from World Development Indicators 2004
GNI: 2003 data in current US dollars, from World Development Indicators 2004
Human Development Index (HDI) from Human Development Report 2004. HDI combines measures of life expectancy, the adult literacy rate, the combined primary, secondary and tertiary gross enrolment ratio, and GDP per capita (in purchasing power parity terms) into a single index for 177 countries.
% Population / less than $2 per day: data from World Development Indicators 2004

All developing countries and country income groups are classified by The World Bank's World Development Indicators

Low income countries include Afghanistan, Angola, Bangladesh, Benin, Bhutan, Burkina Faso, Burundi, Cambodia, Cameroon, Central African Republic, Chad, Comoros, Congo, Dem. Rep, Congo, Rep., Cote d'Ivoire, Equatorial Guinea, Eritrea, Ethiopia, The Gambia, Ghana, Guinea, Guinea-Bissau, Haiti, India, Kenya, Korea, Dem Rep., Kyrgyz Republic, Lao PDR, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Moldova, Mongolia, Mozambique, Myanmar, Nepal, Nicaragua, Niger, Nigeria, Pakistan, Papua New Guinea, Rwanda, Sao Tome and Principe, Senegal, Sierra Leone, Solomon Islands, Somalia, Sudan, Tajikistan, Tanzania, Timor-Leste, Togo, Uganda, Uzbekistan, Vietnam, Yemen, Rep., Zambia, and Zimbabwe.

Lower middle income countries include Albania, Algeria, Armenia, Azerbaijan, Belarus, Bolivia, Bosnia and Herzegovina, Brazil, Bulgaria, Cape Verde, China, Colombia, Cuba, Djibouti, Dominican Republic, Ecuador, Egypt, Arab Rep., El Salvador, Fiji, Georgia, Guatemala, Guyana, Honduras, Indonesia, Iran, Islamic Rep., Iraq, Jamaica, Jordan, Kazakhstan, Kiribati, Macedonia, FYR, Maldives, Marshall Islands, Micronesia, Fed. Sts., Morocco, Namibia, Paraguay, Peru, Philippines, Romania, Russian Federation, Samoa, Serbia and Montenegro, South Africa, Sri Lanka, Suriname, Swaziland, Syrian Arab Republic, Thailand, Tonga, Tunisia, Turkey, Turkmenistan, Ukraine, Vanuatu, and West Bank and Gaza.

Upper middle income countries include American Samoa, Antigua and Barbuda, Argentina, Barbados, Belize, Botswana, Chile, Costa Rica, Croatia, Czech Republic, Dominica, Estonia, Gabon, Grenada, Hungary, Latvia, Lebanon, Libya, Lithuania, Malaysia, Mauritius, Mayotte, Mexico, Northern Mariana Islands, Oman, Palau, Panama, Poland, Saudi Arabia, Seychelles, Slovak Republic, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago, Uruguay, and Venezuela, RB

Annex B

Millennium Challenge Account Eligible Countries

FY 2004	FY 2005
• Armenia • Benin • Bolivia • Cape Verde • Georgia • Ghana • Honduras • Lesotho • Madagascar • Mali • Mongolia • Mozambique • Nicaragua • Senegal • Sri Lanka • Vanuatu	• Armenia • Benin • Bolivia • Georgia • Ghana • Honduras • Lesotho • Madagascar • Mali • Mongolia • Morocco • Mozambique • Nicaragua • Senegal • Sri Lanka • Vanuatu

Threshold Program Eligible Countries

FY 2004	FY 2005
• Albania • East Timor • Kenya • Sao Tome and Principe • Tanzania • Uganda • Yemen	• Burkina Faso • East Timor • Guyana • Kenya • Malawi • Paraguay • Philippines • Sao Tome and Principe • Tanzania • Uganda • Yemen • Zambia