Can Governments Create Bureaucratic Structures That Overcome Knowledge and Incentive Problems? An Analysis of the Millennium Challenge Corporation

A thesis submitted in partial fulfillment of the requirements for the degree of Master of Arts at George Mason University

By

Rosemarie Fike

Director: Peter J. Boettke, Professor
Department of Economics

Summer Semester 2009
George Mason University
Fairfax, VA

ACKNOWLEDGEMENTS

I would like to thank Virgil H. Storr for his comments, suggestions, advice and his incredible ability to keep me sane while working on this thesis. Additionally, I thank Peter T. Leeson, and Peter J. Boettke for their guidance and support. Astrid Arca, Heather Allen and Daniel J. D'Amico provided valuable comments on this paper as well as many conversations that helped shape my ideas; I am thankful that I have such brilliant people in my life. In addition, I thank the Mercatus Center for their financial support as well as their entire staff who has been so willing to assist me in whatever way possible, particularly Daniel Sacks, Karol Boudreaux, and Claire Morgan. Thank you all!

TABLE OF CONTENTS

LIST OF TABLES

ABSTRACT

CAN GOVERNMENTS CREATE BUREAUCRATIC STRUCTURES THAT OVERCOME KNOWLEDGE AND INCENTIVE PROBLEMS? AN ANALYSIS OF THE MILLENNIUM CHALLENGE CORPORATION

Rosemarie Fike, MA

George Mason University, 2009

Thesis Director: Peter J. Boettke, PhD

The recent formation of the Millennium Challenge Corporation represents an attempt by the government to create a bureaucracy that claims to be aware of and to have corrected the major problems often cited by critics of bureaucracies in general and of aid bureaucracies in particular. This thesis examines the unique institutional design of the Millennium Challenge Corporation and evaluates whether or not such an organizational design is capable of overcoming both the knowledge and incentive problems facing government agencies as laid out by the Public Choice and Austrian Schools of Economics.

CHAPTER 1: Current State of the Foreign Aid Debate

Since Adam Smith, economists have been fascinated with understanding what accounts for such a disparity in the levels of wealth of different nations. Smith argued that the path to economic prosperity is through the increases in productivity that arise out of a highly specialized division of labor combined with trade openness and a government that does not burden its citizens with predatory taxation. P.T. Bauer (1984, 2000) echoed Smith's emphasis on the importance of engaging in both small and large-scale trade, and both stressed the importance of private property in order to accomplish this.

These ideas have fallen in and out of favor with the economics profession throughout the years. The growing prestige of the international development aid community has resulted in a massive amount of research for alternative causal explanations for the disparity in the wealth of nations. For instance, Sach and Warner (2001a, 2001b, 2003) have argued that geographic location is causal factor in why some nations remain poor. Alternatively, work by LaPorta et. al. (2004; 2008) and Glaeser and Shleifer (2002) argues that the legal origin of a country determines the differing levels of economic development. Additionally, Acemoglu, Johnson and Robinson (2001; 2002) argue that a nation's level of wealth today is a result of the types of institutions, either productive or extractive, that were set in place at the time of colonization.

Furthermore, there is a constant back and forth in the academic conversation about the impact foreign aid assistance has on the development progress of recipient nations. Overwhelmingly, the failure of the aid community to achieve any significant results after 60 years and billions of dollars leads one to believe that, at best, their efforts are a wash.

While economists have come to understand a little about what does not cause economic development, there has been little progress in finding a panacea for what will. Mostly, this is because one does not exist. William Easterly (2002a, 2002b, 2003, 2006), pleads with the aid community to stop looking for such a "magic bullet." Each impoverished nation is unique in the factors responsible for their present conditions. What unites alot of these nations in their plight, however, is an institutional context that is not conducive to economic development, and that does not protect the institutions of private property that were praised by Smith and Bauer.

North (1990 and 1991) notes that a society's institutions, both those that are formally codified and those norms and traditions that remain informal, govern the rules of human interaction. When these rules favor a specific group over another, or are exogenously introduced in such a way that does not meld with the culture and attitudes of the indigenous people, as is often the case with foreign aid reform policies, the result is often worse (Boettke, Coyne & Leeson 2008).

Certainly, there are some institutions that appear to be conducive to growth in *almost* every situation. The mantra of the Washington Consensus Era development community, "stabilize, privatize, and liberalize" was one of the aid community's more recent attempts to write a prescription for economic growth (Rodrik 2006). Formalized property rights, as emphasized by Hernando De Soto (2000), for example, have been widely recognized by aid agencies and policy makers as providing individuals with both the incentive to improve upon their situations through investing time and labor into what they own, and the means to access credit markets using their titles as collateral. In some underdeveloped cultures, however, formal property rights may not align with local traditions, they may allow for easier expropriation by the state, or at best they may be unnecessary.

For much of the 1990s, those academics analyzing the efforts of foreign aid agencies focused on empirical questions regarding the relationship between development aid and economic growth. Burnside and Dollar (2000 and 2004) were among the first to study this relationship. Their initial analysis, which circulated as a working paper in the late 1990s, found that foreign aid is positively correlated with economic growth in situations where there exist good institutions. This analysis spurred a series of replies and over a decade of regression analyses attempting to either confirm or overturn their initial finding. Easterly, Roodman and Levine (2004) took the initial step toward criticizing Burnside and Dollar's results. Using the same dataset extended further into the future, their results showed that at its best, aid does nothing in the way of economic growth, but at its worst can often impede economic progress. Other research examines the effectiveness of foreign aid controlling for the quality of various sets of institutions (Gwartney, Holcombe and Lawson 1999; Knack and Keefer 1999; Brautigam and Knack

2004; Knack 2001, 2004). For development aid policy, the major take away is that aid may have a slight positive effect when placed in the right institutional context.

The recognition in foreign aid policy that institutions matter for economic growth was a byproduct of the empirical investigations, and has indirectly led to a shift in the conversation concerning foreign aid. Through focusing on the kinds of institutional contexts in which aid is most effective, the conversation has turned toward a possibility of reforming the process of aid distribution in such a way to improve results. This possibility has brought hope to those who are optimistic about aid's impact on its recipients and its usefulness as a tool to achieve economic growth.

Still, researchers recognize that there have been few examples of what can be clearly labeled as aid success stories. Massive investment in development programs in Latin America in the 1990s brought disappointing levels of economic growth, while the Asian Miracle that occurred during the same decade is a result of policies promoting economic freedom, not a result of foreign aid assistance. The instances in which aid efforts have had positive impacts, the Green Revolution in India is one frequently cited example, are rare.

The current state of the foreign aid debate is such that both advocates and critics of aid agencies agree over the industry's past failures. There is a consensus about the lack of results and about a number of areas in which improvements are possible (Easterly 2006:1). In short, both opponents and advocates of aid agency efforts suggest that the lack of success is due in a large to several reasons I discuss below. These include (a) aid organizations have lofty and unclear missions that are difficult, if not impossible, to attain; (b) there is no ownership over implemented projects or accountability for poor results; (c) there is little ex post evaluation of projects or utilization of results-based management; and, (d) there is no cohesive plan among different, often competing, aid agencies.

a. *Aid organizations have lofty and unclear missions that are difficult, if not impossible, to attain.* (Easterly 2003:39-40).

When aid agencies are created there are broad and vague goals set in place. These goals include such grand ambitions as providing sustainable development or empowering women. The Millennium Challenge Corporation's goals, for instance, are to provide United States assistance for global development in a manner that promotes economic growth and the elimination of extreme poverty and strengthens good governance, economic freedom, and investments in people.[1] In spite of its merits, this mission is both broad and vague and so is open to several different interpretations. The problem with these broad missions is that there is no clear path to achieve them, and no obvious mechanism to evaluate performance. If the stated goals of an organization were narrower, i.e. to provide vaccinations to 30% of children in Nairobi, it would be easier to determine how the organization is performing. Currently, the situation is such that aid agencies have not made an effort to transition to more narrowly defined goals but continue operate under vague value statements that allow them to become involved in a wide variety of programs without appearing to have drifted from their mission. This is

[1] Millennium Challenge Act of 2003 Section 602.

why many aid agencies tend to become involved in projects seemingly unrelated to economic development.

b. *There is no ownership over implemented projects or accountability for poor results with either donor or recipient governments* (Radelet, 2006; Svensson, 2006:133).

Recipients of aid have little say in the process of designing aid programs. Donor countries usually provide aid with a number of strings attached, and often in the case of tied aid, there is zero flexibility in the permitted uses of aid. Aid organizations have been largely ineffective at achieving sustainable policy changes in developing countries. The agencies are slowly realizing that imposing policy and institutional changes externally via aid conditionality is not always ideal.[2] There is the overwhelming attitude among aid agencies that donors know more about achieving economic growth than the recipients, simply because they are in the position to be providing aid in the first place.

However, as the money that funds development projects is obtained via taxation, aid bureaucracies suffer from extensive principal-agent problems. The taxpayer (i.e. the primary donor) may actually disagree with the aid and be unwilling to give it if given the choice. Additionally, donor governments and recipient governments face different incentives. As such, official aid may come with many conditions attached to it in order

[2] Boettke, Coyne and Leeson (2008) discuss the concept of *metis*, or the cultural attitudes of a society as it relates to institutional changes. The "stickiness" or sustainability of an institution is directly related to how closely aligned that policy is with the *metis* of the society. Exogenous institutional changes attempted by aid agencies frequently ignore the local culture and fail to incorporate input from individuals living in recipient countries, making it less likely that the institutional change will be sustainable and more likely that the change will have a negative impact by destroying the efficiency of existing norms and informal institutions.

to better align recipient behavior with the wishes of donor governments. Aid, for instance, may be dependent upon the acceptance of technical assistance and commercial supplies from the donor country; it may be conditional on adopting policy changes and implementing institutional reforms that do not conform to the recipient's own preferences; it may supply goods and services that do not conform to the recipient's own standards, etc. In any case, the goals of the donor government predominately drive the terms of any aid agreement.

Furthermore, Martens (2005) models aid transactions as a dissonance reduction model in which donors transfer resources to the recipient in return for a reduction in dissonance in the donor's mind. Martens claims that satisfaction in aid donations can only be achieved if the transfer changes the recipient's situation in line with the donor's expectations. In other words, if the recipients respond to aid in the way that donors wish then the process will be satisfying to donors. If the donor has incorrect expectations about the recipient's response to the gift or if donors overlook the importance of cultural norms or potential unintended consequences associated with a particular donation, they may observe outcomes that are different than expected. In these cases, the donors will not be satisfied with aid allocation. Martens emphasizes that donors and recipients should have closely aligned preferences concerning the use of the transfer, in order to have a successful transfer where both donor and recipient are satisfied. However, as Buchanan's Samaritan's Dilemma is rampant in aid situations, we know that the act of providing aid is the dominant donor strategy and will likely not cease even if recipients do not adhere to the donor's expectations. The lack of accountability or incentives to commit to cutting off programs that do not achieve intended results contributes to the lack of positive outcomes in foreign aid.

c. *There is little ex post evaluation of projects or utilization of results-based management* (Radelet 2006; Easterly 2003:38)

When there exists a fixed amount of annual funding and a pressure for agencies to show that they are initiating as many programs as possible, there is little incentive to evaluate what has already been done. The choice between evaluating an existing project and implementing a new project is simple for most aid agencies. Another new program increases the importance of the agency while evaluation means agencies risk having to admit to failure, something that few aid agencies seem willing to do.

Furthermore, if there are funds allocated for the express purpose of evaluation, there remains the decision of which programs to evaluate. Of course, even if ex post evaluation of every project is possible, it would not be a cost-effective strategy. Thus, even when agencies commit to evaluation, that process is susceptible to selection bias as the agencies themselves are choosing which programs to evaluate. It is in the interest of the individual aid agency to evaluate only their most promising projects. The lack of results-based decision-making in the foreign aid industry contributes to the continuation of programs that are ineffective.

d. *There is no cohesive plan among different, often competing, aid agencies* (Riddel, 2006; Radelet, 2006; Svensson, 2006:133; World Bank, 2003).

The network of aid agencies is a complex web of involved parties. The World Bank estimates that each developing country works with at least 30 different aid agencies on projects that cover a wide range of sectors.[3] There are bilateral aid agencies that exist in virtually every developed nation; the United States now has two, USAID and the MCC; Great Britain has one, Department for International Development (DFID). Furthermore, there are multilateral agencies such as the World Bank; the International Monetary Fund; the African, Asian, and Inter-American Development Banks, and various United Nations agencies such as the United Nations Development Programme and the World Food Programme that operate in much of the developing world. Each organization, though broadly defining their mission as combating poverty in developing nations, has different underlying political motivations and differing views on how to achieve economic development. A consequence of this is that determining the effects of a single program initiated by any single entity in a particular country proves to be difficult without the careful collection of baseline data followed by ex post project evaluation.

Although, as discussed earlier, there is broad consensus that the issues listed above are issues which must be address if aid is to be effective, there remains debate, however, over whether aid institutions can be transformed in the ways advocated. Several academics, most vocally ones who have worked within the aid organizations themselves, remain unconvinced that better intentions and increased awareness of institutional shortcomings will necessarily translate to improved results (Easterly 2002a, 2002b, 2006; Shirley 2008). These criticisms cite perverse incentives within the aid institutions

[3] "Cutting the Red Tape," World Bank Development News Media, February 21, 2003.

themselves (Easterly 2002a, 2002b, 2006; Shirley 2008). The major reason why government bureaucracies are inefficient providers of development aid is that such organizations do not rely on market feedback (i.e. a profit-and-loss signal) to determine how to best allocate scarce resources. Instead of relying on prices and profits for performance information, bureaucracies and other non-profit-seeking entities must find alternative methods of determining whether they are achieving their goals.

In an aid context, the common problems with bureaucracies are exacerbated. As mentioned above the goals of aid agencies are often unclear, rendering performance evaluation particularly difficult. Furthermore the intended beneficiaries of programs (poor people, not their governments) typically have little opportunity to provide input into program design, and even if they are able to provide input there is no effective sanctioning mechanism that indicates to aid agencies whether or not resources are being matched with need.

Easterly (2002a, 2002b, 2006) argues that well-intentioned bureaucracies create environments that define their output as money disbursed, produce many low-return observable outputs (e.g. reports) and few high-return outputs (e.g. ex post evaluation), and that agencies are structured in a way that allows for little learning from the past failures and successes. While Easterly remains unconvinced that knowledge and incentive problems can be solved by the aid agencies themselves, he concludes that these problems are lessened in situations where aid efforts are more decentralized and allocated by *searchers* instead of *planners*. In his framework, aid might be improved if allocated in narrowly defined, piecemeal efforts.

Additionally, Shirley (2008) argues that foreign aid, as it is an external force, does little to inspire the type of sustainable institutional change within recipient countries that is necessary to achieve economic growth. Svensson (2006: 133) echoes this view stating, "if there is no strong commitment to these policy changes, they can, and likely will, be reversed at the end of the program."

Individuals remaining hopeful that aid can be reformed, such as the Center for Global Development's Steve Radelet (2004, 2006) are confident that the effectiveness of aid can be improved if the bureaucratic organizations pay close attention to the problems mentioned above. He criticizes the overly optimistic views of prominent aid advocates for arguing that foreign aid has supported poverty reduction and growth in some countries and prevented worse performance in others (Sachs 2004; Riddell 2007). Radelet instead focuses on improving the ways in which aid is allocated.

Radelet criticizes the Bush Administration for missing the opportunity to reform the weaknesses of existing aid programs by creating a new institution to allocate Millennium Challenge Account (MCA) funds, but simultaneously praises the MCA's objective of providing significant support to a small number of low-income countries with good governance and a commitment to strong development policies. The Millennium Challenge Corporation (MCC) provides hope for individuals remaining optimistic that aid efforts can and will be reformed.

Though both sides of the debate point to strikingly similar areas in which policy reforms may improve the effectiveness of aid in such a way that it at least minimizes the negative effects of receiving aid, there still exists major disagreement over whether or not such reforms are able to succeed. Several important questions come to mind: Can the previously mentioned problems be overcome? Will remedying these issues result in more effective aid? The problem remaining is how to structure aid agencies- how to get the “right” conditionality and sustainability in aid projects.

This thesis examines the most recent attempt for the United States to improve upon the performance of foreign aid agencies through the creation of the Millennium Challenge Corporation. The rest of this thesis is structured as follows. Chapter two discusses the creation of the Millennium Challenge Corporation, its founding legislation, and why one would expect this agency to be successful (or unsuccessful) at achieving effective aid reform. The MCC implements many changes that appear to be an improvement over prior donor practices. These improvements include a stringent recipient selection process, a higher level of recipient involvement in the project development process, and the use of results-based management. However, there are other stipulations in the founding legislation, such as restrictions over the types of projects the MCC may fund, as well as stipulations regarding the organizational structure that call into question the MCC’s potential for success. Chapter Three looks more closely at some of the areas in which the MCC potentially suffers from knowledge and incentive problems as a result of the organizational structure, specifically that of the Board of Directors. The Board is responsible for both selecting recipient countries and approving project proposals. These important decisions are based on flawed “objective” indicators that do not contain all the information necessary to make accurate predictions of success. Additionally, the political incentives the Board faces are not always aligned with the mission of the MCC. The combination of knowledge and incentive problems at the top-level of decision-making means it will be difficult for the MCC model to succeed. The fourth chapter concludes by asking important questions regarding the future of foreign aid policy.

CHAPTER 2: Why Might the Millennium Challenge Corporation Be an Improvement?

Creation of the Millennium Challenge Corporation:

The Bush Administration's creation of the Millennium Challenge Corporation in 2004 supposedly represents the recognition of past failures of aid agencies as well a major attempt to shift foreign aid policy practices. The creation of this agency provides an opportunity to evaluate whether or not an innovative approach to aid allocation will achieve better results and will illuminate which side of the foreign aid debate, the skeptics or the optimists, has a more accurate assessment of the plausibility of successful aid reform.

George W. Bush proposed the Millennium Challenge Account during a speech at the International Development Bank on March 14, 2002, the evening before the U.N.'s Financing for Development Conference in Monterrey, Mexico. In this speech, President Bush expressed frustration with bilateral foreign aid efforts, specifically the efforts of agencies such as USAID, as they had become plagued with conflicting objectives resulting from various political pressures, sector-oriented earmarks, and a lack of project evaluation. He employed the findings of the Burnside and Dollar research, emphasizing that aid is most effective when given to countries with sound institutions and economic policies. President Bush committed to increasing the amount of US foreign aid efforts by

$5 billion per year, or about a 50% increase in previous official development assistance (ODA) amounts.[4]

More important than the sheer size of the increase in contribution is the way in which funds are distributed. Unlike any aid effort prior, the MCA would target only the world's poorest nations as defined by the International Development Association (IDA)[5] and would distribute these funds in such a way that rewards governments of impoverished nations that have shown a commitment to adopting policies that allow for greater political and economic freedom. A country's performance on a series of "objective" indicators determines eligibility for funds.[6] The substantial amount of available funding, combined with the eligibility requirement is intended to provide incentives for countries to undertake policy reforms before funds are given, as well as mitigate the risk of providing financial support for corrupt and predatory political regimes. This is the true innovation of the MCC model, and is the driving force behind what has been termed "the MCC effect," or the incentives that underdeveloped nations have to pass policies that will translate into improvements on the MCC's eligibility criteria in order to receive funds in the future.[7] While some view this consequence of such country selection procedures in a positive light (Radelet 2004, 2006; Sautet et. al.

[4] The OECD compiles statistics for ODA each year. They define these funds as "flows of official financing administered with the promotion of the economic development and welfare of developing countries as the main objective, and which are concessional in character with a grant element of at least 25 percent (using a fixed 10 percent rate of discount). By convention, ODA flows comprise contributions of donor government agencies, at all levels, to developing countries ("bilateral ODA") and to multilateral institutions. ODA receipts comprise disbursements by bilateral donors and multilateral institutions."
[5] Established in 1960, the International Development Association (IDA) is the division of the World Bank that helps the world's poorest countries.
[6] There were 16 indicators in the legislation of the Millennium Challenge Act of 2003, covering three broad categories; Investing in People, Ruling Justly and Economic Freedom. By the end of 2005, the organization combined two measures into one and added two new indicators bringing the total to 17.
[7] http://www.mcc.gov/documents/mcc-102108-mcceffect.pdf

2008; Johnson and Zajonc 2006), I discuss possible problems with the objective indicators providing a source of policy reform in the next chapter.

President Bush's original proposal of the Millennium Challenge Account did not stipulate any particular organization that was to administer the funds. Essentially, the administration had three options from which to select. First, the administration could have given an existing aid agency authority over the MCA. USAID, being the United States' established bilateral aid agency, was in a position to handle these funds. Second, the MCA could have been utilized as a means of reforming existing multi-national aid bureaucracies and streamlining the aid allocation process. Third, the administration could have created an entirely new agency to disburse MCA funds. It was in large part the inability or refusal of many traditional development agencies (including USAID) to prioritize governance reforms that led to the Bush administration's choice of the third option, the creation of the Millennium Challenge Corporation (MCC).

The MCC claims to provide underdeveloped countries with an incentive to make governance reforms before they will commit any money to the country. Practically every news article or policy brief that mentions the MCC touts the organization as revolutionary.[8] Often called an innovator in foreign aid, this agency was an attempt to design an institution that avoids the political pressures that have plagued aid bureaucracies in the past. The question remains, is this simply rhetoric or are intentional

[8] The MCC provides an impressive list of academics and development analysts praising the MCC for this innovative incentive based giving process. This list includes Steve Radelet, Simeon Djankov, Michael Gerson and can be found here: http://www.mcc.gov/documents/mcc-102108-mcceffect.pdf. Additionally, on April 12, 2009, an op-ed in the Washington Times by Blaise Comapore called the MCC an "innovative aid program that awards grants only to countries governing justly, investing in health and education and promoting freedom." Most other articles mentioning the MCC use similar language.

attempts to improve upon the central planning process of development aid proving to be a sustainable effort? Are bureaucracies, specifically aid agencies, able to overcome knowledge and incentive problems that have rendered past efforts unsuccessful?

This thesis argues that while the MCC is an attempt to improve upon the ways in which aid bureaucracies have operated in the past, there are still a number of situations in which knowledge and incentive problems still exist. For example, the MCC is still accountable to Congress, as Congress is responsible for approving its budget each year. Ultimately, this agency is a bureaucracy at its core, and the problems that have commonly plagued bureaucracies in the past continue to resonate throughout the operations of the MCC.

Founding Principles: Smart Power to Achieve Sustainable Economic Growth

The MCC's Mission:

To provide United States assistance for global development in a manner that promotes economic growth and the elimination of extreme poverty and strengthens good governance, economic freedom, and investments in people.[9]

This mission is to be achieved by focusing on the following principles which represent an acknowledgement of advancements made in understanding the process of economic growth as represented by current economic development literature. These include (a) reducing poverty through economic growth; (b) an emphasis on good policies; (c) increasing recipient country "ownership" over its own development; (d) a clear focus on results based management.

[9] Millennium Challenge Act of 2003, paraphrased from section 602

a. Reducing Poverty Through Economic Growth

The MCC focuses on promoting sustainable economic growth to reduce poverty. The agency provides support for projects that are linked to economic growth. Through investments in areas such as transportation, water and industrial infrastructure, the MCC hopes to provide individuals in recipient nations with wider access to economic markets. While investments in agriculture, education, private sector development, and capacity building are attempts to build the human capital necessary to support these growing economic opportunities. Furthermore, this principle represents an effort to reduce the likelihood that the MCC will drift from its mission. By restricting efforts to growth-enhancing activities, the MCC hopes to overcome a key problem prior aid agencies face i.e. becoming involved in too wide a range of activities.

b. Good Policies Matter

Using "objective" indicators, the MCC selects countries to receive assistance based on their performance in governing justly, investing in their citizens, and encouraging economic freedom. The majority of these criteria are linked to the current development literature, and the measures themselves are taken from indices created to measure the institutional quality in potential recipient nations.

Because there is strong evidence that corruption undermines every aspect of sustainable development (Frye and Shleifer 1997; Djankov, Montalvo and Reynal-Querol 2005; Murphy, Shleifer and Vishney 1991), the MCC prioritizes battling corruption in developing nations. Specifically, it is the connection between corruption and the undermining of democratic institutions that the MCC attempts to avoid.

c. Country Ownership

The MCC partners with eligible countries and holds the recipient governments responsible for identifying the greatest barriers to their own development. These governments must develop their own priorities for a compact, using input from the public, as well as civil, political, and private sectors. Additionally, these governments are responsible for implementing compact programs once they have been approved. The MCC provides support for recipient governments for these endeavors, however they leave the majority of the project design process up to the national governments. As such, participation in the MCA program requires a high-level of engagement and leadership by partner governments, civil society and other domestic stakeholders in order to increase the likelihood that the voices of the intended beneficiaries of aid are heard.

The emphasis on ownership is an attempt to ensure that recipients of MCC funds are actively involved in every step of the process and that assistance from the MCC solves the Samaritan's Dilemma. Because recipients have the majority of the responsibility in designing and implementing their own projects, they are unable to place the blame solely on the donor if the project fails.

d. Focus on Results

According to Radelet, "donors rarely measure results accurately, so there is little systematic information about what works and what does not" (Radelet 2004: 54). MCC assistance is given to countries that develop well-designed programs with clear goals, collect baseline data, provide benchmarks to measure progress, institute procedures to ensure fiscal accountability for the use of MCC grants, and provide a plan for effective monitoring and objective evaluation of results. Each Compact is designed to be completed in less than five years.

By setting up a situation in which there are smaller, well-targeted goals throughout the Compact implementation process and by collecting enough baseline data against which progress is to be compared, the MCC attempts to increase the quality and quantity of information available to development analysts and taxpayers alike. This is an attempt to improve upon the principal-agent problem. Additionally, through results-based management, the MCC may provide further insight into the effectiveness of various types of aid projects.

Because of the close relationship between the founding principles of the MCC and the common policy reforms suggested by the foreign aid literature, it is easy to see why many in the development community have high expectations for the MCC's performance. The rhetoric used in MCC's reports, press releases, compact agreements, speeches and meeting transcripts is suggestive of an agency that has learned from the past mistakes of other organizations. The organizational structure as well as the constitutional rules set forth by the founding legislation, however, renders it difficult for these principles to translate into outcomes that are significantly different from the failed efforts of the past.

Founding Legislation: The Millennium Challenge Act of 2003

The Millennium Challenge Corporation is organized as a government owned corporation. It has a Board of Directors that are the key decision makers for the entire organization. This act requires the MCC Board of Directors to determine a country's eligibility for assistance based on objective and quantifiable indicators of the country's commitment to specific criteria set out in the act. The MCC is also required to provide to Congress with justifications for the Board's eligibility determinations and to coordinate its activities with those of the U.S. Agency for International Development (USAID).[10]

One of the major concerns that resonates through the aid literature is the relationship between foreign aid and corruption (Svensson 2000; Reinikka and Svensson 2004; Brautigam and Knack 2004; Djankov, Montalvo and Reynal-Querol 2005). Clearly, it is counterproductive to provide development assistance to government officials that are likely to keep resources for personal gain. Past experiences with leaders like President Mobutu in Zaire, have taught the aid community that being more selective about which countries receive foreign aid might make a difference in how such resources are used.

[10] The act also authorizes MCC to help certain candidate countries achieve eligibility, which MCC does through its Threshold Programs. As these programs are administered by USAID, I will largely leave them out of this discussion of the MCC.

The MCC, as such, is designed to be much more selective than previous aid agencies. To illustrate the increased selectivity in the MCC's policy of aid allocation, it is useful to walk through the various steps the Board must complete in order to determine the recipients of MCA funding. The founding legislation requires the MCC to take a number of steps in determining which countries will be eligible for MCA assistance for each fiscal year based on their demonstrated commitment to just and democratic governance, economic freedom, and investing in people as well as the existence of opportunities to reduce poverty and generate economic growth in the country. After the completion of each step, the MCC must submit relevant reports to Congress and publish notices in the Federal Register.

Step 1: Passing the Income Requirement: Making the Long List of Candidates

The first step determines eligible countries by examining their income and poverty levels, as well as U.S. or international sanctions to which they may be subject. As Bush stated in his 2002 speech, this new agency focuses on assisting countries that are most in need of economic development. Thus, in order to qualify for MCC assistance, a country must belong to the group of the world's most severely underdeveloped nations and must not be under any sanctions as dictated by the Foreign Assistance Act of 1961. During the first two years of MCC operations, a country's eligibility for International Development Association (IDA) funds was the sole determinate of their country candidacy for MCA funds. For example, the per capita GNI ceiling in 2004 was set at

$1,415. This resulted in a list of 66 countries that met the income requirement and are not subject to U.S. government or international sanctions.

In 2006, however, the MCC expanded this criterion to include a new category, Lower Middle Income countries. The International Bank of Development and Reconstruction releases an annual World Development Report and these figures provide the basis for Lower Middle Income country candidacy. The inclusion of this newer category drastically increases the number of countries that are candidates for MCC assistance, and represents one way in which the MCC has increased the scope of its operations beyond its initial objectives. For fiscal year 2009, the per capita GNI requirements are set at $1,785 and below for Low Income country candidates and between $1,786 and $3,705 for Lower Middle Income country candidates. Tables 1 and 2 show a list of countries that currently meet the income requirement.

Table 1. Lower Middle Income Country Candidates for Fiscal Year 2009

Lower Middle Income Category		
1. Albania	**11. El Salvador**	**21. Peru**
2. Algeria	**12. Georgia**	**22. Samoa**
3. Angola	**13. Guatemala**	**23. Swaziland**
4. Armenia	**14. Jordan**	**24. Thailand**
5. Azerbaijan	**15. Macedonia**	**25. Tonga**
6. Bosnia and Herzegovina	**16. Maldives**	**26. Tunisia**
7. Cape Verde	**17. Marshall Islands**	**27. Tuvalu**
8. Colombia	**18. Micronesia, Fed. Sts.**	**28. Ukraine**
9. Dominican Republic	**19. Morocco**	**29. Vanuatu**
10. Ecuador	**20. Namibia**	

Table 2. Low Income Country Candidates for Fiscal Year 2009

Low Income Category		
1. Afghanistan	**22. Guinea-Bissau**	**43. Niger**
2. Bangladesh	**23. Guyana**	**44. Nigeria**
3. Benin	**24. Haiti**	**45. Pakistan**
4. Bhutan	**25. Honduras**	**46. Papua New Guinea**
5. Bolivia	**26. India**	**47. Paraguay**
6. Burkina Faso	**27. Indonesia**	**48. Philippines**
7. Burundi	**28. Kenya**	**49. Rwanda**
8. Cambodia	**29. Kiribati**	**50. Sao Tome and Principe**
9. Cameroon	**30. Kosovo**	**51. Senegal**
10. Central African Republic	**31. Kyrgyz Republic**	**52. Sierra Leone**
11. Chad	**32. Laos**	**53. Solomon Islands**
12. Comoros	**33. Lesotho**	**54. Somalia**
13. Congo, Dem. Rep.	**34. Liberia**	**55. Sri Lanka**
14. Congo, Rep.	**35. Madagascar**	**56. Tajikistan**
15. Djibouti	**36. Malawi**	**57. Tanzania**
16. Egypt	**37. Mali**	**58. Timor-Leste**
17. Eritrea	**38. Moldova**	**59. Togo**
18. Ethiopia	**39. Mongolia**	**60. Turkmenistan**
19. Gambia, The	**40. Mozambique**	**61. Uganda**
20. Ghana	**41. Nepal**	**62. Vietnam**
21. Guinea	**42. Nicaragua**	**63. Yemen**
		64. Zambia

Step 2: Evaluation of Performance on the 17 indicators

Next, the MCC publishes a list of the criteria used to determine a country's eligibility for a compact as well as an annual scorecard report on how candidate countries perform on each indicator. Countries must score well on 17 indicators evaluated by third party organizations such as the Heritage Foundation, Freedom House and World Bank Institute. These selection indicators are an integral part of the MCC's key innovation in aid donations. The founding legislation discusses the need for "objective" indicators in decision-making, and allows key decision makers in the MCC to establish their own "best practices" for indicators. In general, the MCC states that when assessing new indicators, they tend to favor ones with the following characteristics:

1. developed by an independent third party
2. utilize objective and high quality data that rely upon an analytically rigorous methodology
3. publicly available
4. broad country coverage
5. comparable across countries
6. clear theoretical or empirical link to economic growth and poverty reduction;
7. policy linked (i.e., measure factors that governments can influence within a two to three year horizon)
8. broad consistency in results from year to year.[11]

The current comprehensive list of indicators used by the MCC to make these decisions are depicted in Table 3.

[11] http://www.mcc.gov/documents/mcc-report-fy09-criteriaandmethodology.pdf

Table 3. Current Criteria for Eligibility: MCC's 17 Indicators

Indicator	Category	Source
Civil Liberties	Ruling Justly	Freedom House
Political Rights	Ruling Justly	Freedom House
Voice and Accountability	Ruling Justly	World Bank Institute
Government Effectiveness	Ruling Justly	World Bank Institute
Rule of Law	Ruling Justly	World Bank Institute
Control of Corruption	Ruling Justly	World Bank Institute
Immunization Rates	Investing in People	World Health Organization
Public Expenditure on Health	Investing in People	World Health Organization
Girls' Primary Education Completion Rate	Investing in People	UNESCO
Public Expenditure on Primary Education	Investing in People	UNESCO and national sources
Business Start Up	Economic Freedom	IFC
Inflation	Economic Freedom	IMF WEO
Trade Policy	Economic Freedom	Heritage Foundation
Regulatory Quality	Economic Freedom	World Bank Institute
Fiscal Policy	Economic Freedom	national sources, cross-checked with IMF WEO
Natural Resource Management	Investing in People	CIESIN/Yale
Land Rights and Access	Economic Freedom	IFAD / IFC

The MCC's Board must identify candidate countries that performed above the median in relation to their income-level peers on at least half of the quantitative indicators in each of the three policy categories: Ruling Justly, Investing in People, and Encouraging Economic Freedom. To be eligible, a country must score strictly above the median on the indicator for control of corruption. In addition, the MCC's Board may consider other relevant information such as whether countries that scored substantially below the median on a particular indicator are taking steps necessary to improve institutions related to that indicator. The MCC's Board is also authorized and encouraged to use supplemental information to address weaknesses in the objective data.

The Millennium Challenge Act of 2003 requires that the MCC Chief Executive Officer submit a report to congressional committees containing a list of the eligible countries and "a justification for such eligibility determination" and publish the report in the Federal Register within five days of the Board's final eligibility decisions.

Step 3: MCA Compact Phase

After the MCC's Board selects the countries eligible for Compact Agreements, eligible countries must begin to put together proposals for projects that address what they consider to be the most binding constraints on economic development. Eligible countries are invited to submit compact proposals, which are to be developed in consultation with members of civil society, including the private sector and NGOs and any other relevant stakeholders.

A country's eligibility does not guarantee that MCC will sign and then fund a compact with that country. MCC is to sign compacts only with national governments, and may only enter into one compact with a particular country at any given time. Under the act, the duration of compacts is limited to a maximum of five years. MCA funds are not earmarked for specific projects or countries, and any money not obligated in the fiscal year for which it was appropriated is permitted for use in subsequent fiscal years. However, as mentioned in the next section, the Millennium Challenge Act of 2003 still provides several restrictions on the types of projects the MCC is permitted to fund.

The Compact Development process itself has four major components:

Component 1. Proposal development

The MCC expects eligible countries to propose projects and implementation plans that build upon existing national economic development strategies. The MCC also requires eligible countries to use a broad-based consultative process to develop their proposals. The MCC staff provides support to country officials during this phase of compact development. Although the MCC does not provide funding to countries for proposal development, some countries receive grants from regional organizations or other aid agencies for assistance with proposal development

Component 2. Proposal submission and initial assessment.

Eligible countries submit compact proposals called concept papers. The MCC does not specify deadlines for proposal submission or declare the limits or range of available funding for individual compacts. This is a key element of the focus on increasing country ownership over aid projects, and the hope is that countries will take initiative in developing proposals. During this stage, the MCC conducts a preliminary assessment of the proposal by drawing on its staff, contractors, and employees of other U.S. government agencies. The MCC works with eligible countries to develop programs that it has the capacity support.

Once the MCC staff determine that they have collected sufficient preliminary information, they seek the approval of MCC's Investment Committee conduct a detailed analysis, known as due diligence.

Component 3: Detailed proposal assessment and negotiation.

The MCC's due diligence review includes an analysis of the proposed program's goals and its costs relative to potential economic benefits. This analysis is called an Economic Rate of Return (ERR) and will be further discussed in the next chapter. Among other things, the review also examines the proposal's plans for program implementation (including monitoring and evaluation), for fiscal accountability, and for coordination with USAID and other donors. In addition, the review considers the country's commitment to MCC eligibility criteria and addresses any legal issues that might affect the program's implementation. During their review, MCC staff seeks the approval of the Investment Committee to notify Congress that the corporation intends to initiate compact negotiations. Following completion of the review, MCC staff request the committee's approval to enter compact negotiations. When the negotiations conclude, the Investment Committee decides whether to approve submission of the compact text to the MCC Board.

Component 4: Board review and compact signing.

The MCC Board reviews the compact draft and has the final say in whether or not the MCC will fund particular projects. Before the compact is signed and funds are obligated, the Board must approve the final draft of the compact and MCC must notify appropriate congressional committees of its intention to obligate funds.

In addition to setting for the country selection process, the Millennium Challenge Act of 2003 sets forth several provisions that limit the types of project proposals the agency is able to fund. An approved proposal cannot do any of the following:

> *Provide assistance that includes military assistance or military training for a country.*
>
> *Provide assistance that is likely to result in a substantial loss of United States jobs or a substantial displacement of United States production.*
>
> *Provide assistance for any project that is likely to cause a significant environmental, health, or safety hazard.*
>
> *Provide assistance for any projects allocating funds for abortions and involuntary sterilizations.*[12]

Clearly, the best interest of the recipient countries is not the only factor driving the inclusion of these prohibitions. These restrictions prevent the implementation of programs that may have significant development benefits for recipient nations and limit the range of options for program selection.

While the Millennium Challenge Act of 2003 suggests that the MCC is a major improvement in terms of country selectivity as well as donor coordination in that it stipulates that the MCC must work closely with USAID, there are still reasons to believe that this attempt to improve the aid allocation process will fall short of its expectations.

[12] Section 605 (e) http://www.mcc.gov/about/reports/mca_legislation.pdf

CHAPTER 3: A closer look at the Millennium Challenge Corporation

Though the Millennium Challenge Corporation is a newer agency, it has received much attention in the development literature. Hook (2008) examines the important shift in foreign policy that occurred with the 2004 creation of the Millennium Challenge Corporation. The author views the president's decision to create the Millennium Challenge Account, whose funds are allocated only to countries that commit to both market-based economic reforms and democratic political reforms, and the placement of the MCA within the newly created, independent aid agency as representing the Bush Administration's vote of "no confidence" in the prevailing aid organizations. Hook (ibid.) examines the ways in which the MCC is different from other aid bureaucracies and the forces driving this policy change. Specifically, the author looks at ideas as independent agents of change that are especially effective when aligned with both principled and causal support of a policy change. The way in which the MCC is different from other aid bureaucracies builds from ideas of both a principled and causal nature.

Hook (ibid.) notes that a new institutional change plays an important role for shaping of future policy, therefore the design and placement of the agency is critically important. Because of the political bargaining process, and the divergent interests of the collective actors, compromises made amongst competing actors often lead to sub-optimal design and performance. This is especially the case with agencies, such as the MCC, that are founded on ideas new to the industry. Hook (ibid.) notes that while insulated agencies (such as MCC) are more likely to remain true to their founding ideals, they are less likely to succeed at achieving their goals. Whereas embedded agencies have a larger influence on other areas of the hierarchy, they have a higher risk of compromising their ideals.

A recent policy comment by Sautet, McKenzie and Rothchild (2008) also questions the political viability of any attempt by an agency to be insulated from political pressure. Sautet et. al. emphasize that "the MCC will undoubtedly face pressure from various interests to meet narrow agendas that may have little to do with, or even be counterproductive to encouraging economic growth" (Sautet et. al. 2008: 4). Additionally, they caution the MCC against drifting from its focus on growth-based poverty reduction in order for this model to remain different from other aid agencies. Furthermore, the eligibility indicators must create incentives that reward countries which are promoting economic growth led by entrepreneurship and trade. Sautet et. al. note that the MCC model has an important role in proving that incentives matter for economic growth.

Similarly, Prud'homme (2007) compares the MCC model with other forms of foreign assistance. His study assesses the effectiveness of aid models by performance in five criteria: (1) how well projects are coordinated; (2) how much the model is based on important principles of development theory; (3) what role politicization or bureaucraticization plays in the allocation process; (4) accountability; and (5) result based decision-making. The analysis concludes that no existing model of aid allocation is a particularly effective method of aid distribution and has little hope for the success of the MCC model. He suggests the limitations of the MCC model result from the restrictions on the number and length of MCC Compacts, and notes that it is difficult to determine how well the agency is adhering to results-based management as the MCC is still fairly new.

Additionally, Prud'homme questions the role of political influence in MCC's decisions on which countries to fund. He notes that in the past, some countries that have met the required scores on the MCC indicators have not been invited by the MCC Board of Directors to apply for the Compact programs. This "may suggest some political finagling within the program" (Prud'homme 2007: 20). Prud'homme also notes that the MCC manages to avoid earmarking, as Congress must flatly approve the MCC's budget leaving spending discretion in the hands of the agency itself. Competing foreign policy programs, such as efforts in Iraq and Afghanistan as well as other politically attractive efforts such as the President's Emergency Plan for AIDS Relief (PEPFAR), restrict the amount of money Congress is willing to appropriate to the MCC.

Additionally, Kaufmann and Kraay (2002) were among the first scholars to address the problems with the governance indicators used to determine eligibility for MCA funds. The authors discuss the large margins of error that are present in governance data as well as well as the need for supplementing objective indicators with in-depth country analysis. They recognize that aid will be more effective in a better policy and institutional environment, and certainly welcome the attempt to allocate aid in a way that rewards countries that are improving on these margins.

Johnson and Zajonc (2006) have likewise evaluated the claim that an "MCC effect" exists. They estimate that the MCC effect is both present and substantial. The authors use a regression-discontinuity design to find that potential recipients of MCC funds improve in 25% more indicators after the MCC was created than before it existed. While the authors demonstrate that the MCC does change the behavior of potential recipients with regards to institutional reforms, they recognize that the agency has not be around long enough to say with certainty that the agency has had any positive impact on economic growth. As of yet, they find no relationship between MCC funding and economic growth.

While preliminary research shows that this agency may be an improvement over existing bilateral aid agencies, it is still plagued by a number of problems that hampered previous existing aid agencies. The organization of the agency is still such that the superior/subordinate relationship is central to individual performance evaluation, and this dynamic still heavily influences the decision-making of individuals in this agency. It is important to recognize that such an arrangement ultimately places the quality of this political relationship above the quality of an individual's work performance. This renders the act of pleasing the superior the most important criteria of career advancement (Tullock 2005: 15).

Furthermore, since Congress is responsible for approving the MCC's budget request each year, it is unrealistic to allege, as Hook and others do, that the agency is truly insulated from political pressures. Even without direct influence over the exact allocation of the MCC funds, Congress is still able to exert pressure over the agency through the threat of reducing their budget. This pressure is of a "spend it or lose it" nature, and will often result in the approval of programs that fall below agency standards simply to satisfy Congress by ensuring the entire budget is spent.

This thesis offers a critical complement to this burgeoning literature on the MCC by focusing on the MCC's organizational structure and examining the many areas in which the Millennium Challenge Corporation suffers from knowledge and incentive problems. I argue that these problems can be attributed to the constitutional rules set forth by the MCC's founding legislation. The structure of the organization, particularly the structure of the MCC's Board of Directors creates major knowledge and incentive problems at the highest level, and these problems filter through every lower level of the organization.

The highest level of rules, constitutional rules, set forth the broad decision-making structure of the organization. These rules determine the establishment of a Board of Directors, who sits on the Board, the relationship of the Board to the organization and the overall requirements government any aid allocation decisions. The Millennium Challenge Act of 2003, the MCC's founding legislation, sets forth the organizations rule-making environment.

Evaluating the constitutional rules of an organization is crucial because of the nested nature of rules, i.e. once a rule is in place at one level it becomes a part of the framework when making additional rules at other levels. For example, the constitutional rule which requires the MCC to gain approval from the Board of Directors for any country-selection decision has implications for both collective-choice and operational-choice level rules. A decision made by the Board to change current methodology for baseline data collection, or a change in the methodology for project proposal evaluation, will impact the ways in which lower-level employees will perform their jobs.

Rules that determine the structure of the organization affect the agency's ability to accomplish its mission effectively. The structure of the MCC is distinctively different from other bilateral agencies (particularly that of USAID) in that it mimics the structure of a for-profit corporation with a Board of Directors that has the final say in selecting the projects and countries that the agency funds. This Board is composed of a mixture of political and private actors that receive no financial rewards for their services to the agency. As I will show, the political nature of the individuals on the Board combined with the lack of financial incentives to better align their decisions with the performance of the MCC creates potential problems at every decision-making level of the agency. Because of the presence of such knowledge and incentive problems, we should not expect the MCC to be capable of achieving its goals.

The role of a Board of Directors in any organization is to ensure that the organization is operating in a way that is aligned with its mission. In other words, the presence of a Board of Directors in the creation of the MCC is an attempt to increase the level of accountability within the aid organization. Accountability to a Board of Directors is one way to mitigate the principal-agent problem within an organization by creating a context in which a Board that represents that entity's stakeholders evaluates the decisions of lower-level employees of the organization. When there are clear rules in place and the actions of individuals within the organization are evaluated against those rules, one expects the actions of individual agents to contain some aspect of predictability.

In a private corporation, the role of the Board certainly includes ensuring that the operations of the firm are aligned with its mission. This task for the Board of a private corporation, though still difficult, is much easier since members can evaluate the impact of any proposed project by examining whether or not it is going to result in a profitable outcome for the organization. Though private companies often make incorrect management decisions, this constant focus on profitability guides the behavior of the firm in a direction that provides a product or service that is socially desirable. By focusing on profits, the directors of for-profit firms rely on just enough of the relevant information they need to perform efficient economic calculation.

Additionally, Board members of private for-profit corporations usually have a vested interest in the performance of their company through financial incentives such as a paid salary or stock options. As the profitability of a private corporation depends heavily upon the decisions of the Board of Directors, and the compensation of the Board depends heavily upon the profitability of the company, the incentives are such that what is best for the Board of Directors is ultimately what is in the best interest of the organization and its stakeholders. Additionally, a Board of Directors makes decisions affecting the long-term goals of a company thus the incentives that they face must create a situation in which the Board focuses on the long-term.

The MCC is a government owned corporation that places its final decision-making power in the hands of a Board of Directors. The organization's founding legislation clearly defines both the composition of the Board and its governing powers. As will be discussed below, the individuals serving as members of the Board of Directors face many knowledge and incentive problems that affect how well they perform their duties.

The Role of the Board of Directors

It is important to recognize that the structure and the decision-making power of the Board of Directors resonates throughout the entire organization and influences the rules and decisions made at every level. As Gibson et. al. (2005: 24-25)[13] explain, any rules set forth at the constitutional level influence rule formation at both they policy-making (or collective choice) level as well as lowest level, the operational level. Constitutional rules influence who will be responsible for the policy-making decisions and dictate what rules and procedures these individuals will follow. For the MCC, the constitutional rules are outlined in the Millennium Challenge Act of 2003, which stipulates the structure of the organization as well as the specific parties responsible for each type of policy-making decision. It determines the requirements of who can sit on

[13] Gibson, Andersson, Ostrom & Shivakumar. The Samaritan's Dilemma: The Political Economy of Development Aid. Oxford University Press 2005.

the Board of Directors and outlines the procedures that must be followed for filling these positions. It determines who is responsible for the hiring decisions, who is responsible for the country selection decisions, who is responsible for the project selection decisions, and even sets forth restrictions on what types of projects to fund.

The Board of Directors of the MCC, particularly its CEO, has immense control over every major policy-making decision of the agency. The CEO is appointed by the President, and is responsible for making the decisions regarding the hiring of all officers within the organization. These hiring decisions are to be made after consultation with other Board members. Additionally, the Board is responsible for determining what countries are eligible for MCA funds, for both the Compact and Threshold Agreements. Furthermore, the Board is responsible for the selection of projects that the MCC will fund once eligible countries develop proposals that reflect what they consider the most binding constraints on economic growth.

The outcomes of decisions made within the MCC at every level of the organization are held accountable to the Board of Directors. Furthermore, the decisions made and the rules created by the Board are ultimately responsible for the way in which the MCC operates. The everyday decisions of staff members are affected by the rules chosen by the Board each year. The way in which program officers gather their data and perform their duties depends upon the specific methodology chosen by the Board for that fiscal year. It is crucial to recognize that if the knowledge and incentive problems are present and prominent at the Board level these problems will adversely influence the ability of the MCC to achieve its mission.

Knowledge Problems

The MCC's Board is constrained by limited time and resources. Thus, they must base their decisions upon limited amounts of information about potential recipient countries. Because the MCC is not a private corporation and they are providing no goods or services that can be bought or sold on the market, they are not in possession of the quality of information that is contained in market prices, and decisions are not sanctioned by profit and loss mechanisms. The determination of a government agency's usefulness of services rendered is not that a sufficient number of individuals are willing to pay the price asked of them such that operations will result in a profit, as no services are being bought or sold on a market. The management decisions of government owned enterprises must demonstrate usefulness to society using alternate measures of performance. The existence of a deficit is not necessarily indicative of failure for agencies such as the MCC. Management still must base decisions upon some measurable criteria in order for aid recipients to be held accountable for their performance, however, these management criteria must be defined in detail by the government. Mises states that "as the account of profit or loss is not to be considered the criterion of the management's success or failure, the only means to make the manager responsible to the boss, the treasury, is to limit his discretion by rules and regulation" (Mises 2007[1944]: 51). The founding legislation clearly outlines the objective measurement criterion the Board must use to base its decisions.

Determining which countries are eligible for MCC funding is a major function the Board must perform. The MCC Board of Directors bases its determinations of countries' eligibility for MCA assistance on a quantitative indicator methodology, as required by the Millennium Challenge Act of 2003. Additionally, the MCA allows the Board a degree of subjective discretion in making its final selection. In its first two years the MCC used its quantitative indicators and their discretionary authority to select a total of 16 countries as eligible for compact assistance for fiscal years 2004 and 2005. The countries deemed eligible include 13 that met the quantitative indicator criteria and three that did not (Bolivia, Georgia, and Mozambique). Another six countries met the criteria but were not deemed eligible for assistance. The MCC did not provide Congress with its justifications for the six countries that met the indicator criteria but were not deemed eligible to receive funds.[14]

Hayek (1979[1952]) has discussed the mistaken use of objective and scientistic measures as a basis for policy judgments in the social sciences. He states that "the blind transfer of the striving for quantitative measurements to a field in which the specific conditions are not present which give it its basic importance in the natural sciences, is the result of an entirely unfounded prejudice. It is probably responsible for the worst aberrations and absurdities produces by scientism in the social sciences. It not only leads frequently to the selection for study of the most irrelevant aspects of the phenomena because they happen to be measurable, but also to 'measurements' and assignments of numerical values which are absolutely meaningless" (1979[1952]:89-90).

Similar to the warnings of Hayek, the 17 indicators that the MCC uses to determine eligibility have come under criticism for their ability to convey the relevant

[14] GAO Report http://www.gao.gov/new.items/d05625t.pdf

information for this particular use. Mary Shirley (2008) discusses the usefulness of the indices for performing cross-country analysis to observe correlations between various types of institutions and long term economic growth but condemns the use of such indicators when making specific country selection decisions. While errors and biases are present in the indices regardless of their use, it is less problematic to use them for cross-country regressions, as such studies are not concerned with the individual rankings of countries (Shirley 2008:90).

Shirley states that "allocating aid based on the abstract measures of institutions … is ill-advised" (Shirley 2008:87). Even though the MCC criteria are based upon measures that are the result of rigorous academic research and reflect the current progress of where development economics stands in terms of understanding institutions, these measures do not contain all of the knowledge necessary to make accurate aid allocation decisions. There are large margins of error associated with each of these indices that result from serious measurement problems involved in their calculation. This is particularly problematic when selecting eligible countries because if the data points of two countries fall within overlapping confidence intervals, there is no statistically significant difference between them, thus a distinction about which country is performing better cannot be made. As such, the MCC possibly misallocates funds from the outset and it is uncertain whether it will result in improvements in governance.

Though these indices are imperfect and ill suited to the job of selecting which countries are truly adopting productive institutions and should be rewarded for their actions, the Millennium Challenge Act of 2003 stipulates that the decision should largely be based upon such objective criteria. Furthermore, these criteria are the very targets of Threshold Agreements, which are MCC funded programs that work with countries that do not quite meet the 17 criteria required for Compact eligibility in an attempt to improve their performance on indicators that fall below the median. Typically, it is recognized that academics and policy makers are aware of *what* institutions are conducive to economic growth but are not aware of *how* these institutions are created where they do not exist.[15]

This knowledge problem is then complicated by applying these abstract objective measures to the task of identifying the specific aspects of institutions in potential recipient countries that need improvement. Because these indices are essentially aggregates of aggregate information, it is impossible to parse out which specific parts of a country's system is not functioning well and which ones are simply by looking at the final numbers. For example, the MCC uses the Freedom House's Civil Liberties indicator to judge a potential recipient country's policies regarding personal freedom.[16] There are eight categories of personal freedom captured in this one number: (1) independence of the media and the judiciary; (2) freedom of cultural expression, religious institutions and expression, and academia; (3) freedom of assembly and demonstration, of political organization and professional organization and collective bargaining; (4) freedom from economic exploitation; (5) protection from police terror, unjustified imprisonment, exile, and torture; (6) the existence of rule of law, personal property rights, and equal treatment

[15] For a discussion of the gap between know-what and know-how in a reconstruction context see Coyne 2008. His discussion closely parallels a similar problem in the development aid context, as what has come to be recognized as "good" institutions, specifically those founded in private property, are known but how to create these institutions is largely unknown.

[16] http://www.mcc.gov/documents/mcc-fy08-guidetoindicatorsandtheselectionprocess.pdf

under the law; (7) freedom from indoctrination and excessive dependency on the state; and (8) gender equality, equality of opportunity and freedom to travel, reside, work, marry, and determine whether or how many children to have. In order to improve its score on the Civil Liberties indicator, a potential recipient can choose to drastically improve on just one or a few of those factors (most likely the ones that are relatively easy to change) while ignoring the rest of them. Each of the 17 indicators are comprised in a similar way and are subject to similar confusion.

As a result, basing such decisions on these criteria can result in negative outcomes, especially if the underlying cultural norms and informal institutions that are operating within a society are not considered. Champions of the research regarding the importance of institutions (North 1990, 1991; Boettke, Coyne and Leeson 2008; Shirley 2008; Acemoglu and Johnson 2005) repeatedly warn policymakers of the possibility that what is being captured by objective measures might not always reflect the truly important institutions causing a society to function. Acemoglu and Johnson (2005) attempt to examine the relative importance different types of property rights institutions; those which protect citizens from expropriation by the government and those which enable private contracts between members of society. They demonstrate, however, that contracting institutions are of relatively lesser importance because "individuals often find ways of altering the terms of their formal and informal contracts to avoid the adverse effects of weak contracting institutions" (2005:949). In other words, the formalized measures often used to evaluate contracting institutions do not capture the importance of informal institutions that enable personal exchange in the context of a developing nation. Certainly, other forms of informal institutions are neglected by such objective measures.

When looking at the countries that the MCC has selected in just a few years of operations as shown in Table 4, one should note that several of these funding choices have since been modified. Madagascar, Nicaragua and Armenia have had their funding suspended due to increased corruption. This represents a deficiency in the relevant information available to key decision-makers when selecting eligible countries. For example, an objective measure of institutional quality in 2004 was unable to foresee the military coup that occurred in Madagascar early in 2009. It is possible for many other similar mistakes to be made when decisions are based on "objective" measures that do not capture all of the relevant information.

Table 4. MCC Compacts Signed To Date[17]

Compact Country	Grant ($ millions)	Signed On	Entry Into Force
1. Madagascar	$109.8	April 18, 2005	July 27, 2005
2. Honduras	$215.0	June 13, 2005	September 29, 2005
3. Cape Verde	$110.1	July 4, 2005	October 17, 2005
4. Nicaragua	$175.0	July 14, 2005	May 26, 2006
5. Georgia	$295.3	September 12, 2005	April 7, 2006
6. Benin	$307.3	February 22, 2006	October 6, 2006
7. Vanuatu	$65.7	March 2, 2006	April 28, 2006
8. Armenia	$235.7	March 27, 2006	September 29, 2006
9.Ghana	$547.0	August 1, 2006	February 16, 2007
10. Mali	$460.8	November 13, 2006	September 17, 2007
11. El Salvador	$460.9	November 29, 2006	September 20, 2007
12. Mozambique	$506.9	July 13, 2007	September 22, 2008
13. Lesotho	$362.6	July 23, 2007	September 17, 2008
14. Morocco	$697.5	August 31, 2007	September 15, 2008
15. Mongolia	$284.9	October 22, 2007	September 17, 2008
16. Tanzania	$698.1	February 17, 2008	September 15, 2008
17. Burkina Faso	$480.9	July 14, 2008	*projected for 2009*
18. Namibia	$304.5	July 28, 2008	*projected for 2009*

[17] This table was taken from the 2008 Annual Performance and Accountability Report for the MCC.

After eligible countries are selected and approved by the Board, the next major policy decision that directly affects the success of the MCC involves the selection of the specific projects that the organization will fund. While recipient countries are responsible for identifying the areas in which improvements are necessary to facilitate economic growth, the final selection of projects that receive funding lies within the decision-making powers of the Board. These decisions are guided by an Economic Rate of Return (ERR) analysis and informed by subjective information that is attained by implementing partners and staff members who have worked closely with the countries.

An ERR analysis is essentially a cost-benefit analysis where the costs are measured by the amount of the MCA grant, and the benefits are measured by the estimated value-added a proposed project is supposed to create in terms of additional per-capita GNI.[18] The basis for the ERR calculation relies on estimates of possible economic benefit that will be experienced as a result of a particular program weighed against a counterfactual situation in which the project does not take place and the country's current economic conditions are extended into the future.

There is a clear benefit for any firm to perform a cost-benefit analysis before undertaking a major investment, as it determines the profitability of the project. With aid agencies, however, Easterly (2002b:30) shows that "the standard principal-agent problems of adverse selection and moral hazard are likely to be particularly severe with private information available to the agent but not to the principal, bureaucracies will ex ante overstate the benefits of aid programs and underestimate the costs."

[18] See Guidelines for Economic and Beneficiary Analysis of a Compact Proposal

If what Easterly suggests is true, there is a tendency to be overly optimistic about the economic benefit that will be achieved because of undertaking a particular project. An ERR requires making assumptions about the behavioral changes of intended beneficiaries, and the return on investment depends upon individuals acting as MCC agents predict. This is particularly true of the ERR calculations for infrastructure projects because a new road or waterway can be said to improve the lives of a vast portion of a country's population yet it is unclear whether or not this will be the case.[19]

Hayek (1979[1952]) talks about the dangers involved in such estimations of how a centrally planned effort *might* increase social welfare as long as all of the assumptions involved in such a calculation do not change. "The conception of the 'objective' possibilities of production, of the quantity of social output which the physical facts are supposed to make possible, an idea which frequently finds expression in quantitative estimates of the supposed 'productive capacity' of society as a whole. These estimates regularly refer, not to what men can produce by means of any stated organization, but to what in some undefined objective sense 'could' be produced from available resources" (Hayek 1979[1952]:91).

Such calculations, he states, have no applicability to the real world because these calculations assume a number of conditions to go precisely according to the initial estimations. Much effort certainly goes into the collecting of baseline data. The MCC

[19] Furthermore, there are additional incentive problems on the operation level that associated with the act of providing infrastructure aid to developing countries. Gibbons et. al. (2005) Infrastructure aid is a classic example of a Samaritan's Dilemma in which donor are better off by funding the program regardless of the level of effort put forth by the recipient. The recipient, knowing such aid will be provided regardless of whether or not they maintain the infrastructure, will put forth low levels of effort on that front, as it is likely that repairs will be funded via future aid.

considers the input of local stakeholders affected by MCC projects, requests information from private sector entities with experience working in a particular country or sector,[20] consults local NGOs and other governmental aid agencies that have specialized knowledge about conditions in a potential recipient area, and accepts bids from both public and private contractors to estimate the costs of projects. Still, these cost/benefit estimations are an imperfect measure of conditions in the recipient nations, and poor investment decisions are not likely to be recognized because profit is not the ultimate goal.

Such knowledge problems are likely exacerbated when the methodology used to arrive at these objective measures representing economic benefits suffers from major flaws. In April of 2008, the GAO conducted an analysis of the MCC's ERR methodology. They found that the MCC lacked consistency when calculating the ERR for different projects across different countries. Specifically, the MCC used varying time periods when determining whether or not a certain project would reach its minimum required rate of return. This was done despite the MCC's standard procedure that states ERR analysis is to be calculated for a 25 year period.[21] When the GAO recalculated the ERRs at a 25-year timeframe, this did alter their estimated rates of return. In most

---

[20] This is the case for many country cases during the compact proposal phase of attaining MCC aid, though this particular notice is regarding private sector information about the Philippines.
http://frwebgate6.access.gpo.gov/cgi-bin/PDFgate.cgi?WAISdocID=63265640762+3+2+0&WAISaction=retrieve
Though much effort was put into gathering the relevant information regarding how to best allocate aid to the Philippines, the MCC had to suspend funding due to increased corruption in their political process, thus not meeting the MCC's eligibility criteria. This risk of a change in conditions after entering into a compact was not captured by the ERR analysis. No matter how accurate an estimate of project impact may be, objective measures like ERRs do no contain all of the knowledge necessary for policymakers to know what economic and social conditions will be like in the future.

[21] Chapter 28. Guidelines for Economic and Beneficiary Analysis of a Compact Proposal

instances, it did not drop the rate of return below the minimum return required to approve a project, but in two cases, it did. The inconsistency in performing ERR analysis makes it difficult, if not impossible for outsiders without access to supporting documents to determine the viability of selected projects.[22] This reduces the level of transparency in the MCC's reports. Most importantly, inconsistent methodology provides inaccurate information, even by the standards of ERR analysis, which is used by the Board of Directors to determine which are the most fruitful projects.

Furthermore, while the ERR analysis has a long history of use in the calculations of other aid donor agencies,[23] many agencies are moving away from this calculation because there are costs and benefits associated with certain investments that cannot be captured by the ERR. In other words, the ERR analysis does not accurately reflect all of the relevant information necessary for making a sound decision about which projects will provide a greater benefit to a recipient nation. Thus, the MCC's use of ERR analysis has been criticized because such estimates tend to overlook some of benefits provided by certain projects as well as their potential unintended consequences. Additionally ERRs ignore opportunity costs, making it unclear what would be the best use of MCC resources.

[22] In my attempt to understand why the MCC seems to fund a large number of infrastructure projects I searched for ERR analyses of projects that did not receive MCC funds. Unfortunately, this information is not publicly available on their website. After several failed attempts to take advantage of the MCC's commitment to transparency by directly contacting the office of the Chief Economist at the MCC to obtain this information, I contacted the GAO to see if they had any suggestions. My contact at the GAO said I could only obtain such documents either through the cooperation of the MCC, or by filing a FOIA request. I have since filed a FOIA request and am still waiting on the information. Transparency is not as transparent as one would think.

[23] World Bank Operational Manual

A report conducted by the International Housing Coalition, for instance, argues that severe poverty is becoming a predominantly urban phenomenon in many developing countries. They criticize the MCC's use of ERR when evaluating the economic impact of urban investment/reform programs, as the positive externalities and spillover effects cannot be easily captured in such analyses (Kalarickal 2007: 9).

When the MCC's management bases such important decisions on estimates that do not fully reflect all relevant information, these decisions suffer from knowledge problems. The effectiveness of these decisions "depends on whether we are more likely to succeed in putting at the disposal of a single central authority all the knowledge which ought to be used but which is initially dispersed among many different individuals, or in conveying to the individuals such additional knowledge as they need in order to enable them to fit their plans with those of others" (Hayek 1945: 521).

It is clear that the main source of knowledge the Board utilizes in making decisions about which plans are best for a recipient country, the ERR analysis, provides a necessarily incomplete picture of where MCC funds are best allocated. Thus, the knowledge problems faced by the MCC are quite serious.

Incentive Problems

The MCC's Board of Directors is composed of up to nine individuals, all of whom have strong political affiliations. The Secretary of State who serves as the Chairman of the Board; the Secretary of the Treasury; the Administrator of the United States Agency for International Development; the Chief Executive Officer of the

Corporation who is appointed by the President with consent of Senate; and the United States Trade Representative are the five members with direct political affiliations as they are all members of Cabinet. These positions are ex officio, meaning that both Board membership and length of service is determined by virtue of holding another office. The CEO of the MCC is the only member of the Board whose primary role is aligned with the best interest of the corporation, as that particular position depends upon the continued existence of the MCC.

The rationale behind having five cabinet-level officers on the MCC's Board of Directors is that the four additional departments are intended to be utilized as key resources for the MCC. They are thought to have valuable relationships with foreign partners and networks of knowledgeable individuals already familiar with conditions in potential recipient countries. It is an attempt to coordinate the aid efforts of the MCC with the foreign policy efforts of other government departments and to make use of the information the employees of these departments have gained through their experience. It further attempts to build a network of support for the MCC that will allow it to better complete its mission by utilizing the capacity of other departments.

The problem with having cabinet-level government officers on the Board of a development agency is that it is difficult, if not impossible for these individuals to separate their roles as political actors from their roles as decisions-makers for the MCC. There will always be an incentive for ex officio Board members to have in mind the best interest of their primary departments when making decisions that are supposed to be in the best interest of the MCC. One cannot rationally expect the Secretary of State to set aside that role while making key decisions for the MCC, thus the interests of the State Department are likely to play an important role in the decisions made by the chairperson of the MCC's Board. The same follows for the other cabinet members holding Board positions.

Additionally, the Board has a wide degree of discretion when it comes to modifying, terminating and reinstating compact agreements. Board membership by heads of other cabinet departments creates a conflict of interest. The MCC as an organization has the mission of promoting economic growth in a sustainable manner but the interests of the other cabinet departments may be at odds with this goal. That the Board has a level of discretion when determining when to terminate, reinstate, reduce, or to increase funding to a certain country creates many opportunities for political interests to enter into the decision-making process.

One example of where this potential has been put into practice is concerning the MCC's dealings with Georgia. As mentioned previously, Georgia was one of the first set of countries to sign a Compact Agreement. The Board decided to provide assistance to Georgia even though it did not qualify for eligibility as dictated by their "objective" indicator process. Additionally, in September of 2008 the MCC decided to increase its aid to Georgia as a part of a wider U.S. Government effort to provide assistance to Georgia as tension increased between Georgia and Russia during the same time period.[24] The decisions made by the Board of Directors regarding Georgia, combined with little

[24] http://www.mcc.gov/press/releases/documents/stmt-090908-georgia.php

justification of why such decisions were made, suggest that the motivation behind the choice is guided more by politics than by the mission of the MCC.

The potential to make politically driven decisions is particularly problematic when it comes to having the administrator of USAID on the Board of the MCC. USAID and the MCC are both bilateral aid agencies competing for a fixed amount of funds to be allocated by Congress. As both agencies have a similar purpose, one would expect there to be a territorial tension existing between these agencies. The inclusion of the Administrator of USAID on the MCC's Board is the perfect example of misaligned incentives. One can imagine that it might be in the best interest of the head of USAID to ensure that its competitor is not achieving its mission, so that the competition is eliminated. However, the founding legislation also stipulates that in every Compact and Threshold Agreement undertaken by the MCC, there is to be a stated role for USAID somewhere along the process.[25] This stipulation might be enough to align the interests of USAID with that of the MCC by ensuring that the more projects the MCC implements, the larger the role for USAID.

Furthermore, having the head of USAID on the Board of is problematic in terms of monitoring problems. All aspects of the MCC's internal operations are to be evaluated by the Inspector General of USAID, who is to act as the Inspector General of the MCC and is to be compensated by the MCC for any expenses incurred because of performance of this duty.[26] On one hand, the Inspector General could have the incentive to present an overly harsh outlook on the operations of the corporation because doing so would place

[25] Millennium Challenge Act of 2003 Section 615
[26] Millennium Challenge Act of 2003 Section 614(f)

the blame of failed development efforts on the new agency and possibly eliminate the competition. On the other hand, the MCC is providing compensation for the services of the Inspector General for up to $5,000,000, which is no small amount of money, and it could be in the best interest for USAID maintain that funding source. Either way, it is unclear whether the main source of monitoring for the MCC has the necessary incentives to be an unbiased evaluator.

The cabinet-level Board member with arguably the most problematic incentives for advising a corporation with a mission of creating sustainable economic growth in developing countries is that of the United States Trade Representative. The United States Trade Representative acts as the chief trade advisor to the President and is responsible for negotiating trade agreements that are in the best interest of the United States. It seems that this individual's role as the USTR will always be at the forefront of decisions made regarding the efforts of the MCC. Often, what is most conducive to bringing economic development to areas that are at subsistence-levels of production is allowing them "the ability to use their resources to their own best advantage, in particular to choose their employment freely and to have different employers competing for their services" (Bauer 1984: 26). Many times, policies that are in the best interest of those in developing nations are not ones that promise to advance United States trade interests.

There are four other Board positions for individuals who do not directly hold offices in the public sector but do possess relevant international experience.[27] The President, with the advice and consent of the Senate, appoints these positions. Of these

[27] Millennium Challenge Act of 2003 Section 604 (c)(3)(B)(i-iv).

four individuals one should be appointed from a list of individuals submitted by the majority leader of the House of Representatives; one should be appointed from a list of individuals submitted by the minority leader of the House of Representatives; one should be appointed from a list of individuals submitted by the majority leader of the Senate; and one should be appointed from a list of individuals submitted by the minority leader of the Senate. While these private-sector positions are intended to be filled by individuals who possess relevant knowledge about development aid and other aspects of foreign policy but are not political actors, the process by which these individuals are selected remains highly politicized.

Furthermore, out of the four current private sector Board members, two have held political positions in the past. Lorne W. Craner, Board member since 2007, most recently served the public sector as Assistant Secretary for Democracy, Human Rights and Labor for Secretary of State Colin Powell. Prior to that, he served Deputy Assistant Secretary of State for Legislative Affairs under James Baker and held positions as legislative assistant to John McCain, as well as Jim Colbe. Another private-sector Board member William W. Frist has a successful history in politics. This former Senator was appointed to the MCC's Board in 2008 but previously served as Senate Majority leader from 2002-2007 and was thought to be a possible Presidential candidate for Republican Party in 2008. Furthermore, the Board member that Frist was selected to replace was former Governor of New Jersey, Christine Todd Whitman. In theory, these private-sector individuals could be any individual with relevant international experience whether that experience comes from operating a micro-finance firm, managing multinational corporations, orchestrating private non-profit aid efforts or any number of past career experiences that will offer meaningful decision-making advice to the MCC. As three out of the past five private-sector Board members chosen by the President from a list submitted by Congress have had what can only be considered successful political careers, one can conclude that the selection process itself contributes to such an outcome.

By 2006, two years after the MCC was in operation, only half of the private sector Board positions had been filled. Though the corporation's founding legislation allots positions for up to four individuals outside of government, not all four positions were filled until 2007.[28] This created an imbalance between the representatives of the public and private interest within the organization, especially during the corporation's crucial early stages. This was the period that the Board developed many of the official procedures MCC agents must follow. Additionally, as a quorum consists of a simple majority (five out of nine members), the five cabinet positions still constitute a quorum even after every private-sector position is filled.[29] Thus, an official meeting can be called without representation of private-sector actors.

It is not just the case the Board possesses perverse incentives because of their political affiliations. There are additional incentive problems created because the Board lacks a financial interest in the performance of the organization. The members of the Board do not receive any form of monetary compensation for their services to the MCC. The only compensation they are able to receive is a per diem allowance for the days on

[28] The first two private-sector positions were filled in 2004 (see press release http://ftp.info.usaid.gov/mca/Documents/pr_040716.pdf), one in 2006, another in 2007 and one initial member was renewed for 2009 while a new member was added.

[29] However, the rules regarding a quorum have recently been changed to state that a quorum must include at least one private-sector board member.

which they are performing MCC related duties and even that is limited to a maximum of 90 days per year. Since monetary compensation is minimal, the motivation for the private-sector actors to be on the Board must be something other than financially founded.

In the case of private non-profit organizations, members of the Board are individuals who have a strong interest in how well the organization performs. Typically, this is because they either have donated considerable amounts of money to the organization or have spent substantial amounts of time working on projects with a goal similar to that of the non-profit. While private non-profit organizations still suffer from problems of measurement, because Board members are genuinely interested in the success of the organization this to some extent mitigates the incentive problems. They are not involved with the organization because it is a duty required ex officio, it is a purely voluntary process. Additionally, political actors who are not directly involved in with the operations of the MCC select the private-sector positions; they do not understand the nature of the aid industry or possess the knowledge necessary to select individuals who are well suited for such positions. These private-sector members must have some political motivations in order to be on the list in the first place.

As the MCC represents the most conscious effort for political actors to reform the bureaucratic nature of foreign aid, examining the ability of this agency to overcome knowledge and incentive problems is crucial. It is difficult to say with certainty that these problems result in misallocations of resources and other outcomes that are in opposition to its goal of sustainable economic development simply because this agency is still relatively new. Compacts agreements are arranged for five-year periods,[30] none have been completed and few are even close to completion. There exists no present opportunity for ex post evaluation. Only time will allow us to determine whether the efforts of the MCC are development enhancing and provide sustainable change. It is my expectation that because of the extent to which knowledge and incentive problems are prevalent in the key decision-making processes, the outcomes achieved by the MCC will fall short of the high expectations policymakers have placed on them.

---

[30] This is true for all Compact Agreements except the Madagascar Compact, which is a four-year agreement.

CHAPTER 4: Conclusion

This thesis first examines the current state of the foreign aid debate, which recognizes that past decades of aid efforts have been massively disappointing. Billions of dollars have been spent in developing nations over the past 60 years with little to show for the efforts. While much of the academic research examining the effectiveness of foreign aid efforts provides a grim outlook of aid's potential to achieve economic growth, political actors and those within the aid community still hold on to the hope that reforming aid institutions might improve results. Academics such as Bauer (1984, 2000), North (1990, 1991), Easterly (2002a, 2002b, 2006, 2007), Boettke, Coyne and Leeson (2008), and Acemoglu, Johnson & Robinson (2001, 2002) have examined the connection between sound institutions founded in private property and economic development. All have warned of the lack of a "magic bullet" answer to economic growth despite their work's common focus on certain types of institutions (private property institutions) being a prerequisite for economic growth. The policy take-away from these advancements in our understanding about the process of economic development, however, is ultimately a formulaic focus on rewarding countries whose policies match that of an objective set of criterion that vaguely measure institutional quality.

The discussion of the creation of the Millennium Challenge Corporation depicts an effort to improve upon the aid allocation process. It reflects an attempt for political actors to take seriously the advancements in economic development studies. The examination of the MCC's founding legislation points out areas in which clear improvements have been made, such as increased country selectivity as well as and increased role for recipient governments in taking control of their own development programs. However, it also points to areas in which the MCC still suffers from problems common in any bureaucratic institution. Such problems impede the MCC's ability to accomplish its mission of creating sustainable economic development in the world's least developed nations.

The analysis of the MCC's decision-making structure illuminates that the agency's key decision makers, the Board of Directors, suffer from severe knowledge and incentive problems. The knowledge problems are a result of a strong focus on utilizing objective measures, such as the 17 performance indicators and the ERR analysis, to inform country and project selection. These measures do not reflect every relevant institutional arrangement and the resulting decisions are ill informed. Furthermore, incentive problems resulting from the political nature of the individuals holding Board positions create the potential for the MCC to be used to implement political agendas, and otherwise drift from its intended mission. These problems are prevalent at the top-level of decision-making, and since rules and institutions are nested in nature, problems at the top level will flow throughout every aspect of the organization. This analysis casts doubt on the ability for a bureaucratic agency to correct for knowledge and incentive problems through implementing innovative selection processes or the mimicking of private-organizational structures.

Important questions are brought to mind when evaluating the decision making process of the MCC and the effects of its resulting policy decisions. When the selection process relies on objective measure of institutional quality, are the relevant institutions for interpersonal exchange truly being considered? If the answer is no, as I have suggested in this paper, then the MCC may be making poor choices regarding the countries they decide to fund which may have many negative implications. Furthermore, the fact that such objective measures do not capture all relevant institutional arrangements points toward two possible solutions. On one hand, research could focus on developing measurements that capture the cultural constraints and the informal institutions that drive exchange in developing societies. The varying nature of such institutions across different societies renders this effort impossible and any measure that would result from such an endeavor would be meaningless when trying to compare across countries. On the other hand, policy makers and aid workers could constantly make efforts to utilize subjective information to supplement what is gathered from inefficient objective measure. Though this is something that the MCC and other agencies claim to do already, the incentive structure is such that decision-makers are more likely to rely solely on information from the objective measures.

Another essential question to ask, regardless of how effective the MCC model *could* be in a political vacuum, is whether this model is politically viable in the real world? Ideological differences among MCC supporters and those with a higher level of Congressional power have made it difficult for the MCC to receive the type of funding it was intended to receive. Additionally, a close association with the Bush Administration has caused it to lose even more political, and consequently financial, support from Congress. The agency's budget for 2009 was reduced to the extent that the agency is unable to form any new Compact Agreements this year. This severely limits the MCCs ability to entice developing nations to adopt institutional reforms. Additional budget reductions could mark the end of the MCC. Furthermore, Easterly (2002b) talks of the cartel like behavior of international aid agencies, in which the incentives for agencies is to under perform. He predicts that "rogue agencies," i.e. agencies that attempt to improve upon the allocation process or otherwise disrupt the status quo, would be met with much resistance by other agencies that do not want to increase their efforts. This would make it difficult for the MCC to gain support from other agencies in the aid community.

Setting such eligibility requirements is both an example of how the MCC is changing the status quo, as well as the strategic use of incentives to reward countries for growth-enhancing institutions. The "MCC effect," whether or not it truly exists, theoretically demonstrates how these requirements elicit reforms in countries that do not yet meet the objective standards of institutional quality, in hopes that they will be eligible for funds in the future. However, with such a vast number of donor institutions with less stringent donation requirements, it is uncertain that the countries truly in need of such reforms will take the necessary steps to receive MCC funding, or simply look to more lenient donor agencies. If there is to be a true shift in the incentives involved in donor/recipient relationships, more agencies than just the MCC need to adopt such an approach to their giving.

If the bureaucratic and political nature of aid agencies is a major imposition on their ability to meaningfully reform donation practices, the likelihood that aid will ever be a major source of economic growth is minute. Understanding that government-to-government wealth transfers might never result in the desired outcome has a number of implications for foreign policy. Should governments abandon the practice of providing development aid entirely? Many academics suggest that this should be the case. However, understanding the political motivations behind foreign aid allows one to see that few rational politicians will support an agenda to eliminate foreign aid. As P.T. Bauer (2000) noted, the mere practice of calling aid, “aid”, renders the act of criticizing efforts, let alone eliminating them, an unfeasible political notion.

Does this mean we should just accept these bureaucratic inefficiencies as cost of v □□ foreign aid? Should we forget about trying to reform the system? Certainly not. The impact of foreign aid on recipient countries is far too severe to ignore the potential for creating a worse environment than what existed before foreign interference. It is important to address, wherever possible, the areas in which the MCC’s processes can be improved. Furthermore, it would be helpful for other aid agencies to recognize that the MCC is an innovation in the industry. Other aid organizations have much to learn from both the improvements and the mistakes made by the MCC.

Does this mean that aid will never be effective? Due to the political and bureaucratic nature of government sponsored aid programs, it is not likely that any meaningful reforms will result in the allocation of resources that is on par with what the market is capable of achieving. Organizations that rely on taxpayer money to fund their operations are never truly responsive to the parties they are attempting to help. These organizations respond primarily to political incentives. Furthermore, even when such agencies are trying to be innovative in how relevant information is gathered and utilized, they still suffer from massive knowledge problems that affect their ability to implement successful development strategies.

Allowing individuals, especially entrepreneurs, the freedom to locate and fulfill the needs of individuals in their community is a valuable tool for economic development. The knowledge that actors on the ground possess about what is needed and what will work is often overlooked by governments and aid agencies attempting to improve upon their conditions. Unfortunately, it is precisely the information possessed by individuals on the ground that is most useful in understanding why the conditions are what they are and what resources and changes are necessary to improve them.

In the end, Smith was correct to say "little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things."[31] Individuals are not helplessly caught in a poverty trap and are much more creative than are often credited. When individuals are able to decide how to improve upon their lives, without interference from external parties, the result is not always

[31] This quote is attributed to Smith's *Lectures on Jurisprudence* and is contained in the introduction to Smith, Adam [1776] (1976). *An Inquiry into the Nature and Causes of the Wealth of Nations.* Chicago: University of Chicago Press.

immediate economic growth, but is certainly more effective than what outsiders, even if they are innovative aid agencies, are capable of achieving.

REFERENCES

REFERENCES

Acemoglu, D. & Johnson, S. (2005). "Unbundling Institutions." *Journal of Political Economy*. 113(5):949-995.

Acemoglu, D., Johnson, S., & Robinson, J. (2001). "The Colonial Origins of Comparative Development: An Empirical Investigation," *American Economic Review*, 91(5): 1369-1401.

Acemoglu, D., Johnson, S., & Robinson, J. (2002). "Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution," *Quarterly Journal of Economics*, 117(4): 1231-1294.

Bauer, P.T. (1984). *Reality and Rhetoric: Studies in the Economics of Development*. Cambridge: Harvard University Press.

Bauer, P. T. (2000). *From Subsistence to Exchange*, Princeton: Princeton University Press.

Boettke, P., Coyne, C. & Leeson, P. (2008). "Institutional Stickiness and the New Development Economics," *American Journal of Economics and Sociology* 67(2):331-358.

Brautigam, D. & Knack, S. (2004). "Foreign Aid, Institutions and Governance in Sub-Saharan Africa," *Economic Development and Cultural Change*. 52(2):255-285.

Burnside, C. & Dollar, D. (2000). "Aid, Policies and Growth," *American Economic Review*, 94(4): 847-868.

Burnside, C. & Dollar, D. (2004). "Aid Policies, and Growth: Revisiting the Evidence." *World Bank Policy Research Working Paper 3251*.

Coyne, C. J. (2008). *After War: The Political Economy of Exporting Democracy*. Stanford: Stanford University Press.

Easterly, W. (2002a). *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*. Cambridge: The MIT Press.

Easterly, W. (2002b). “The Cartel of Good Intentions: The Problem of Bureaucracy in Foreign Aid.” *Center for Global Development Working Paper 4.*

Easterly, W. (2003). “Can Foreign Aid Buy Growth?” *Journal of Economic Perspectives* 17(3) 23-48.

Easterly, W., Levine, R. & Roodman, D. (2004). “Aid, Policies and Growth: Comment,’” *American Economic Review*, 94(3): 774-780.

Easterly, W. (2006). *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good*. New York: The Penguin Press.

Easterly, W. (2007). “Are Aid Agencies Improving?” *Economic Policy*, 22(52): 633-678.

Frye, T. & Shleifer, A. (1997). “The Invisible Hand and the Grabbing Hand,” *American Economic Review*, 87(2): 354-358.

Gibson, C. C., Andersson, K, Ostrom, E. & Shivakumar, S. (2005). *The Samaritan’s Dilemma: the Political Economy of Development Aid*. New York: Oxford University Press.

Glaeser, E. & Shleifer, A. (2002). “Legal Origins,” *Quarterly Journal of Economics*,117(4): 1193-1229.

Government Accountability Office Reports:
- GAO-08-730 “MILLENNIUM CHALLENGE CORPORATION: Independent Reviews and Consistent Approaches will Strengthen Projections of Program Impact” June 2008
- GAO-08-577R MCC Compact Assistance, April 2008
- GAO-07-909 “MILLENNIUM CHALLENGE CORPORATION: Vanautu Compact Overstates Projected Program Impact” July 2007

Gwartney, J., Holcombe, R. & Lawson, R. (1999). “Economic Freedom and the Environment for Economic Growth,” *Journal of Institutional and Theoretical Economics.* 155(4): 1-21.

Hayek, F.A. (1945). “The Use of Knowledge in Society,” *American Economic Review*, 35(4):519-530.

Hayek, F.A. (1979[1952]). *The Counter-Revolution of Science*. Indiana: Liberty Fund

Hook, S. W. (2008). “Ideas and Change in U.S. Foreign Aid: Inventing the Millennium Challenge Corporation.” *Foreign Policy Analysis* 4: 147-167

Johnson, D. & Zajonc, T. (2006). "Can Foreign Aid Create an Incentive for Good Governance? Evidence from the Millennium Challenge Corporation." *CID Graduate Student and Postdoctoral Fellow Working Paper No. 11.*

Kaufmann, D. & Kraay, A. (2002). "Governance Indicators, Aid Allocation, and the Millennium Challenge Account." *World Bank Working Paper Series.*

La Porta, R., Lopez-de-Silanes, F., Pop-Eleches, C. & Shleifer, A. (2004). "Judicial Checks and Balances," *Journal of Political Economy*, 112(2): 445-470.

La Porta, R., Lopez-de-Silanes, F., & Shleifer, A. (2008). "The Economic Consequences of Legal Origins," *Journal of Economic Literature* 46(2): 285-332.

Kalarickal, J. (2007). Urban Investments and Rates of Return: Assessing MCC's Approach to Project Evaluation. *International Housing Coalition Working Paper*.

Knack, S. & Keefer, P. (1999). "Institutions and Economic Performance: Cross-country Tests using Alternative Institutional Measures" *Economics and Politics* 7(3):202-227.

Knack, S.(2001). "Aid Dependence and the Quality of Governance: a Cross Country Empirical Test," *Southern Economic Journal*. 68(2):310-329.

Knack, S. (2004). "Does Foreign Aid Promote Democracy?" *International Studies Quarterly*. 48: 251-266.

Martens, B. (2005). "Why Do Aid Agencies Exist?" *Development Policy Review*. 23(6): 643-663.

Millennium Challenge Corporation Official Website Documents

- Millennium Challenge Act of 2003 Available Online: http://www.mcc.gov/about/reports/mca_legislation.pdf
- Millennium Challenge Corporation. 2007. "Chapter 28. Guidelines for Economic and Beneficiary Analysis of a Compact Proposal" Available Online: http://www.mcc.gov/countrytools/compact/fy07guidance/english/28-guidelinesforeconandbeneanalysis.pdf
- MCC Effect Avaliable Online: http://www.mcc.gov/documents/mcc-102108-mcceffect.pdf
- Guide to the MCC Indicators and the Selection Process, Fiscal Year 2008 Available Online: http://www.mcc.gov/documents/mcc-fy08-guidetoindicatorsandtheselectionprocess.pdf

Mises, L. (2007 [1944]). *Bureaucracy*. Indianapolis: Liberty Fund.

Murphy, K., Shleifer, A. & Vishny,R. (1991). "The Allocation of Talent:

Implications for Growth," *Quarterly Journal of Economics*, 106(2): 503-530.

North, D. C. (1991). "Institutions," *Journal of Economic Perspectives*, 5(1): 97-112.

North, D. C. (1990). *Institutions, Institutional Change and Economic Performance,* Cambridge: Cambridge University Press. Chps. 1-4, 11-12.

Prud'homme, Daniel G. (2007). "Assessing the Millennium Challenge Account as a Model of Foreign Assistance." *MPRA Paper No. 9795*.

Radelet, S. (2004). "The Millennium Challenge Account: Transforming US Foreign Assistance Policy?" *Agenda,* 11(1): 53-69

Radelet, S. (2006). A Primer on Foreign Aid. *Center for Global Development Working Paper* (92).

Reinikka, R. & Svensson, J. (2004). "Local Capture: Evidence From a Central Government Transfer Program in Uganda." *Quarterly Journal of Economics*. 119:679-705.

Riddle, R. C. (2007). *Does Foreign Aid Really Work?* New York: Oxford University Press.

Rieffel, L. & Fox, J. W. (2008). The Millennium Challenge Corporation, An Opportunity for the Next President. *The Brookings Global Economy and Development Working Paper* (30).

Rodrik, D. (2006). "Goodbye Washington Consensus, Hello Washington Confusion?," *Journal of Economic Literature*, 44(4): 973-987.

Sachs, J. D. (2004). *The End of Poverty: Economic Possibilities for Our Time*. New York: The Penguin Press.

Sachs, J.D. (2001). "Topical Underdevelopment," NBER Working Paper No. 8119.

Sachs, J.D. (2003). "Institutions Don't Rule: Direct Effects of Geography on Per Capita Income," NBER Working Paper No. 9490.

Sachs, J.D. & Warner, A (2001). "The Curse of Natural Resources," *European Economic Review*, 45(4-6): 827-838.

Sautet, F., McKenzie, K., & Rothschild, D. (2008). "The MCC at Five: Continuing Toward a Growth-Based Poverty Reduction Policy." *Mercatus Center Policy* Comment Available Online: http://www.mcc.gov/documents/comment-selection-fy08-mercatus.pdf

Shirley, M. M. (2008). *Institutions and Development*. Massachusetts: Edward Elgar Publishing, Inc.

Smith, A. [1776] (1976). *An Inquiry into the Nature and Causes of the Wealth of Nations*. Chicago: University of Chicago Press.

Svensson, J. (2000). "Foreign Aid and Rent-Seeking," *Journal of International Economics.* 51:437-461.

Svensson, J. (2006). "Institutional Economics of Foreign Aid." *Swedish Economic Policy Review*. 13:115-137.

Tullock, G. (2005). *The Selected Works of Gordon Tullock Volume 6: Bureaucracy*. Indiana: Liberty Fund.

CURRICULUM VITAE

Rosemarie Fike was born on March 18, 1984, in Sewickley, Pennsylvania, and is an American citizen. She graduated as Valedictorian from Hopewell High School, Aliquippa, Pennsylvania, in 2002. She received her Bachelor of Arts in Business Administration from Duquesne University in Pittsburgh, Pennsylvania in 2007. She was employed as a Graduate Student Fellow at the Mercatus Center at George Mason University where she worked as a research assistant during the two years she was completing her Master of Arts in Economics from George Mason University.