Should the MCC Provide Financing Through Recipient Country's Budgets?
An Issues and Options Paper

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Introduction

The Millennium Challenge Corporation (MCC) began operations in 2004 with the aim of supporting well-governed, low-income countries in their efforts to achieve sustained economic growth and poverty reduction. The MCC operates through a set of operating principles that distinguish it from many other aid agencies: country ownership, stronger partnerships, robust policies and institutions, performance-based allocation of aid, and a heavy emphasis on results.

The MCC strives to be both innovative in its approaches and transformative in its impact in recipient countries. It is too early to judge the extent to which the MCC will be transformative, but it clearly has been innovative in some of its initial operations. It pioneered a transparent and highly selective methodology for choosing countries to be eligible to apply for MCC funding, based on publicly available data. It asks countries to develop their own proposals for funding, taking the idea of country ownership much more seriously than most other aid agencies. Its five-year agreements provide longer-term, more predictable financing than many other agencies. And it is willing to cut off funding to countries performing poorly.

But in one important area, the MCC has been decidedly un-innovative: it provides its funding as traditional project finance through an institution called an "accountable entity" in the recipient country that is specially designed and created for the MCC. The accountable entity is quasi-independent of the recipient government, formally outside the Ministry of Finance, but none-the-less authorized to receive and disburse MCC funds on behalf of the government. This structure is designed to give the MCC greater confidence in the fiduciary oversight and control over the funds and in ensuring that the funds are allocated to their intended use. This approach is anything but new: it has been used for many years, most commonly by the World Bank and other multilateral banks through their "project management units" (PMUs). Of course, just because PMUs are not new does not mean they are a bad idea. But this approach has been criticized on a number of fronts, particularly for setting up new bureaucracies and undermining institutional development in recipient countries by establishing parallel structures to, and drawing time and talent away from, government financial institutions. The World Bank and other

agencies have begun to move away from this approach and toward providing finances directly through government budget institutions, at least in countries with strong development policies that have relatively decent mechanisms for financial oversight. It is important to recognize that the approach of providing financing directly through budgets is used primarily in countries with a strong established track record, and therefore is broadly consistent with the countries eligible for funding from the MCC.

The debate between those who support providing aid through budget systems and those who oppose it has become stale. Those who support the approach emphasize the gains from greater efficiency and coordination, while those who oppose it focus on fiduciary risks of providing assistance through weak government systems. We propose a different approach that could be pioneered by the MCC and potentially influence aid agencies around the world: the MCC should provide an initially small share of its assistance through budgetary channels to a subset of countries that surpass minimum standards of fiduciary and financial oversight and control, *and increase that share as countries improve and strengthen their operations*. The idea is to tie the share of funding provided through the budget to performance on fiduciary and financial management standards, and to create an incentive for countries to continue strengthening these standards. Only a subset of MCC countries would receive assistance in this way, and even those countries would receive only a share of their funding through the budget, at least initially. The goal is to move away from the either-or debate and provide the incentives and structures to actually improve and transform the government's key financial institutions over time rather than abandoning them and undermining their long-term development.

Types of Donor Budget Support

Aid agencies provide financing through budgets in two broadly different ways. First, *general* budget support provides financing to support a broad medium-term development program with agreed-upon general budget priorities and expenditures. That is, it supports a country's broad development strategy and approach, rather than specific activities. The funds are provided directly to a recipient country's budget using the country's own financial management systems (including procurement and accounting), institutions and budget procedures. Disbursements are typically annual, sequenced with the country's budget cycle, and based on an agreed set of performance measures. Performance measures can be policy reforms (e.g., implementing planned tariff reductions), outputs (building specified roads), or outcomes (achieving a lower infant mortality rate).

Second, *sector* support provides funding through the budget aimed at supporting a strategy and particular activities within a specified sector, typically either health or education. This support often is provided as part of a "Sector-Wide Approach," or SWAp, and often involves several donors contributing to a "basket" of funding. The narrower focus on one sector allows for greater specificity in goals within the sector that donors are particularly interested in supporting (e.g., child survival and health) while allowing for building systems and institutions within a sector. It also allows for more intensive oversight of expenditures and procurement within the sector than might be

feasible for the entire government budget, sometimes with the aid of outside institutions such as accounting firms.

Trends Toward Budget Support in International Assistance

Several trends in global development assistance have increased the emphasis on providing financing through budget systems during the last several years. Stefan Koeberle and Zoran Stavreski of the World Bank sum them up:[1]

- ***The shift away from traditional project support***, given concerns about the proliferation of parallel structures outside the government's budget framework, that attract away good staff and weaken existing systems; low disbursement rates; and limited impact.
- ***The shift from conditionality to a partnership approach*** that places a premium on prior agreement between donor and recipient, on a reform agenda, and clear accountability measures.
- ***Greater emphasis on country ownership, systems and capacity,*** recognizing that countries reform when and how they want to, and achieve bigger and more sustained gains when assistance supports countrywide priorities based on country-specific policy programs and institutions (of which, the budget process itself is perhaps the most important in terms of effective use of resources).
- ***Shift from short-term to medium-term reforms,*** reflecting the fact that most developing countries have tackled most macroeconomic reforms and today face the more complex policy and institutional reforms necessary for sustained growth and poverty reduction.
- ***Recognition of the disruptive role of volatile and unpredictable aid.***
- ***Greater selectivity in favor of good performers,*** reflecting the view that aid can achieve results in good policy environments. In this context, budget support is seen as suitable for countries with strong ownership, commitment and capacity to allocate resources effectively and in accordance with their development priorities.
- ***Enhanced focus on results.***
- ***Scaling up assistance, contingent on recipient countries' demonstrated good performance.***

Benefits and Risks of Budget Support

Advocates of budget support argue that it makes aid more effective by:

- Enhancing country ownership and the reform process, since financing directly supports the government's priorities and activities;
- Reducing transaction costs and loss of government talent, by avoiding proliferation of parallel (off-government) project and reporting structures;

[1]Stefan Koeberle, Jan Walliser and Zoran Stavreski, "Budget Support as More Effective Aid? Recent Experiences and Emerging Lessons," The World Bank., March, 2006, Available at: http://publications.worldbank.org/ecommerce/catalog/product?item_id=5287702.

- Strengthening government budget and fiduciary/accounting mechanisms, instead of working around them and weakening them;
- Moving the focus to country-driven, medium-term results instead of donor-driven priorities and project-specific outputs with little effect on policy;
- Enhancing the efficiency and transparency of budget spending through consolidation of disparate accounts and conditionality on published budget and expenditure accounts; and
- Increasing the predictability of aid.

Those concerned with budget support worry that it:

- Increases the fungibility of aid and makes it impossible to account precisely for how the money was spent;
- Is too risky in countries with weak fiduciary and financial systems; and
- Increases transaction costs in the short term, particularly to donors as they re-orient their systems.

The dilemma facing the donor community is that poor countries most in need of budget support, particularly in terms of reducing aid volatility and consolidating fragmented budget and aid management systems, are typically the countries with the weakest financial management capacity and fiduciary standards. Waste (intended or an unintentional outcome of weak capacity) and abuse can be significant problems. Yet even in some of weakest cases—Afghanistan, East Timor and Sierra Leone—budget support has been used effectively while simultaneously strengthening financial management capacity.

The biggest concern revolves around weak financial systems and donors' inability to track the flow of money. This concern is legitimate in many, perhaps even most, developing countries, and in these countries it would be inappropriate to provide budget support. But there are three considerations that begin to at least partially counter this concern.

First, the fact that most developing countries do not have sufficiently robust financial systems does not mean that all countries do not have these systems. The capability of recipient governments to track and oversee funds varies widely by country, and in many countries these systems have strengthened significantly in recent years. This suggests that a one-size-fits-all approach of never providing funds to the budget under the assumption that no system can be trusted in any county is extreme.

Second, in donor programs that are performance-based, the focus of attention should primarily be on whether or not a country achieves its specified results, rather than on tracking every dollar in the input process. This does not mean that no oversight mechanisms or safeguards are needed, but in true performance-based systems the bulk of attention should be focused on whether or not the recipient achieved the intended results.

Third, while it may be expedient in the short run for each donor to set up its own parallel system to track finances, in the long run it can undermine the very budget and financial

systems that need to be strengthened. Donors want to hire the best people for their own projects, so they hire skilled people from the Ministry of Finance and other agencies. As a result, local budget authorities are left with weaker staffs, and government budgets receive much less scrutiny because donor funds go elsewhere, perpetuating the cycle of low donor confidence in these systems. An interesting model by David Roodman of the Center for Global Development concludes that a donor can raise project-level governance above the baseline national level by requiring oversight activities of the recipient, but that the benefits from doing so are less when national level governance is already high.[2] In addition, the multiplicity of donor systems makes it much more difficult to track overall resource flows and manage programs and strategies.

The need for strong financial oversight in the short run needs to be balanced with the need to strengthen critical financial systems in the long run. The appropriate balance differs across countries. Budget support is certainly not the right approach for all countries at all times, or perhaps even for most countries. So where should it be provided? And how can it be provided in such a way that it creates incentives to continually strengthen financial systems and institutions in the recipient country?

Bridging the Benefits and Risks: When Might Budget Support be Appropriate?

Judging whether budget support is appropriate depends mainly on two separate assessments:

- ***The strength of the government's commitment to sound development policies.*** Does the country have a good track record of pursuing sound development policies? Is the government engaging its citizens in setting priorities, and building strong governance and accountability systems? Is there agreement between the donor and the recipient country on policy and budget priorities, and on programs that can support sustained development and poverty reduction?
- ***The strength of the government's financial management and fiduciary systems.*** Can the recipient country appropriately use and account for development resources (its own and donors' alike)? Does it have reasonable standards for accounting, auditing, procurement and transparency of its budget resources?

The first assessment is at the core of the MCA, and is essentially identical to the standards required for countries to become eligible. MCA countries must show a demonstrated commitment to sound development policies, and once they are eligible, they must reach agreement with the MCC on a set of priority projects aimed at stimulating economic growth and poverty reduction.

The second assessment has received less attention by development agencies, including the MCC. It recognizes that just because a country is chosen as eligible for the MCC does not mean that it has strong fiduciary and financial systems in place. Something more is needed that is not fully captured by the MCA's 16 eligibility requirements that focuses on

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[2] David Roodman, "Competitive Proliferation of Aid Projects: A Model," Working Paper 89, Center for Global Development, June 2006. Available at: http://www.cgdev.org/content/publications/detail/8488.

accounting, auditing, procurement, transparency and other financial system issues. Beyond the MCC indicators, there are a growing number of assessment tools available that focus on these issues (discussed below), and evidence suggests that many countries are in the process of strengthening their financial systems.

A key challenge, then, is to go beyond the 16 MCA indicators and create the incentives to encourage countries to further strengthen fiduciary and financial systems so that they can eventually meet the standards necessary to provide the confidence that they are prepared to receive greater financing through their budgets and use it effectively.

A Proposal for Innovative Leadership by the MCC

The MCC has the opportunity to break new ground with an innovative approach that both provides appropriate oversight of its funds and creates the incentives for governments to strengthen their fiduciary and financial management systems.

The MCC should provide a limited portion of its financial flows through the budget in a subset of MCC-eligible countries that meet a specified standard on a measurable assessment of fiduciary and financial management systems. It should increase the share of its funds provided in this way as recipient countries strengthen these systems over time.

The MCC should start with a subset of countries with the strongest capacity—those that not only have good governance generally but specifically meet established minimal standards for accounting, auditing and transparency in their fiscal activities, as measured by one of the assessment tools described below. In addition, the MCC could require that government accounts be audited regularly by a certified international accounting firm. In countries that meet these minimum standards, the MCC could initially provide a small share of its funding through the budget—perhaps 10 percent. Benchmarks and targets should be established to guide continued improvement in financial management over time within the compact. As a country's financial system improves, a larger share of funding could go through the budget, up to 25 or 50 percent of the funds provided each year, or even more. This criterion would not necessarily affect the total amount of assistance the MCC gives to a country, but rather the proportion provided through the host government's budget.

This support would only be provided to a small number of countries with the best financial oversight and performance evaluation systems, giving greater assurance that funds would be used properly. Many MCA countries already receive budget support from other donors, so the MCC could take advantage of some of the tracking systems that are already in place.

Most importantly, this structure would provide very clear incentives for countries to improve their critical fiduciary systems to better manage their own development. Properly designed and incentive-based, this approach would help strengthen the recipient government's budget, evaluation and supporting financial institutions (rather than weaken

them as with current practices) and help establish the budget in its proper place as the key mechanism to determine national priorities and allocate scarce resources among competing goals. Since recipient governments typically prefer to receive funding through their budgets rather than through a separate unit, the system would create the internal incentives for countries with weaker systems to meet the minimal standards, and for countries meeting the minimal standards to strengthen their systems over time. Ideally, several years down the road when countries negotiate new compacts, their financial systems will have strengthened sufficiently that an even larger share of MCC funds can go through the budget. They key point is to use the MCC structures to create the internal incentives for countries to strengthen their own fiduciary and management systems, rather than simply concluding that the systems are no good and working around them.

A structure for delivering a share of MCA resources through government budgets does not require a change in compact performance targets (although including fiduciary strengthening targets is sensible regardless of the financing instrument). Compacts could continue to have the same targets and goals as they now have, but more attention—by recipient country and MCC alike—would shift from measuring attribution and tracking dollars to measuring outcomes and results. The focus of measuring the effectiveness of U.S. development assistance should be on the change in living standards of people and growth potential of countries around the world. For example, if the MCC provides $10 million to the Tanzanian budget to construct roads, it can still measure whether or not those roads were built, and where the $10 million was spent, just as well as if the money had been allocated through a separate "accountable entity."

The impact could be substantial and would go well beyond MCC funds. It would help build transparency, accountability and strong fiduciary practices, reduce malfeasance and corruption in the budget, and strengthen complementary parliamentary and civil society mechanisms for oversight. This approach could significantly leverage the impact of MCA funds by making government budgetary funds much more effective in fighting poverty and stimulating development.

Diagnostic Tools

How would the MCC assess the quality of government fiduciary and financial systems? There are several diagnostic tools and standards currently used by various international institutions to assess such risk. These tools generally are relatively new and are in various stages of their development: coverage varies, they are not all public, just two are scored at this point, and some are just good-practice standards. Of course, as with the MCA eligibility indicators, the MCC could provide strong motivation for further strengthening and refinement of these tools over time. The current tools include:

- ***Public Expenditure Review (PER***): Prepared by the World Bank, the PER is a qualitative assessment of the efficiency and efficacy of resource allocation and public institutions.

- ***Country Financial and Accountability Assessment (CFAA***): Prepared by the World Bank, the CFAA identifies the strengths and weaknesses of accountability arrangements in the public sector and the risks that these may pose to the use of development funds and the achievement of development objectives.
- ***Country Procurement Assessment Report (CPAR)***: Prepared by the World Bank, the CPAR assesses the efficiency, transparency and integrity of a country's entire procurement system and the risk it may pose to the use of development funds.
- ***Country Policy and Institutional Assessment (CPIA***)[3]: Prepared by the World Bank, the CPIA assesses IDA-eligible countries' policy and institutional performance in economic management, structural policies, policies for social inclusion/equity and public sector management and institutions. Countries are then ranked by quintiles according to overall performance as well as by each of the four clusters. The public sector management and institutions cluster, which captures quality of budgetary and financial management, efficiency of revenue mobilization and transparency, accountability and corruption in the public sector is a particularly relevant cluster with regards to assessing fiduciary risk.
- ***Reports on the Observance of Standards and Codes (ROSC***) [4]: Prepared by the IMF and World Bank at the request of countries, ROSCs summarize the extent to which countries observe certain internationally recognized standards and codes in 12 areas. Of relevance to assessing fiduciary risk are two—Auditing & Accounting, and Fiscal Transparency.
- ***Code of Good Practices on Fiscal Transparency***[5]: Prepared by the IMF, the Code represents a standard of fiscal transparency that is judged appropriate to provide assurances to the public and to capital markets that a sufficiently complete picture of the structure and finances of government is available to allow the soundness of a country's fiscal position to be reliably assessed. It is therefore a standard that most countries should seek to meet.
- ***HIPC Public Expenditure Management (PEM) Assessments***[6]: Prepared by the IMF and World Bank, reports on the progress of HIPCs to track public spending in the context of the enhanced debt relief initiative and on the status of action plans agreed with country authorities to strengthen their PEM systems. It grades 26 HIPC countries on 16 PEM indicators.
- ***The Public Financial Management Performance Measurement Framework (PFM), prepared by the Public Expenditure and Financial Accountability (PEFA)***[7]: PEFA is a multi-agency partnership that includes the World Bank, IMF,

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[3]For more information see the IDA allocation landing page: http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/IDA/0,,contentMDK:20052347~menuPK:116699~pagePK:51236175~piPK:437394~theSitePK:73154,00.html.

[4]For more information see the IMF ROSC landing page: http://www.imf.org/external/np/rosc/rosc.asp.

[5] See: http://www.imf.org/external/np/fad/trans/manual/intro.htm.

[6] For more information see the World Bank HIPC landing page: http://www1.worldbank.org/publicsector/pe/HIPC/HIPCBoardPaperApril2005.pdf.

[7] For more information, see the PEFA homepage: http://www.pefa.org/PEFA%20Website%20--%20CURRENT%204-9-03/www.pefa.org%20WEBSITE/PFM%20PMF%20Final%20June%2013%20with%20corrections%20Oct,%202005.pdf.

European Commission, DFID, French Ministry of Foreign Affairs, Norwegian Ministry of Foreign Affairs, Swiss State Secretariat for Economic Affairs, and the Strategic Partnership with Africa. The Performance Measurement Framework (PFM) assesses and develops essential systems by providing a common pool of information for measurement and monitoring of PFM performance progress, and a common platform for dialogue. It includes a PFM performance report, and a set of indicators which draw on the HIPC PEM assessment benchmarks, the IMF Fiscal Transparency Code and other international standards. It aims to support PFM reform, emphasizing country-led reform, donor harmonization and alignment around the country strategy, and a focus on monitoring and results. This approach seeks to mainstream the better practices that are already being applied in some countries. After considerable testing, the finalized framework and report card template was just made public. It has yet to be applied to any country.

The diagnostic tools above serve as useful guidance in determining both eligibility for budget support as well as benchmarks to include either as *ex ante* conditions for effectiveness or as outcomes. Unfortunately, none of them—so far—- provides ratings for all aid recipient countries in a publicly accessible form. We have not attempted in this short piece to derive our own composite, but there is great promise in the use of the PEMA PFM tool.

Table 1 serves as a starting point for assessing the financial management and fiduciary capacity of 2006 MCA eligible countries. It shows the scores for the two ratings that are scoreable (HIPC PEM and CPIA ratings) and the dates of financial management and fiduciary diagnostics for this group of countries. (It does not include PFM ratings since this tool has not yet been applied to any country). On the scoreable diagnostics, Mali and Tanzania stand out as strong performers. Both received an “A” score on the HIPC PEM, and both are in the top quintile of CPIA scores, both on the overall CPIA and the public sector management component. Benin and Burkina Faso also score fairly well. The table shows that diagnostics have been done for most of the other eligible countries, providing information upon which the MCC could begin to think about a rating system. Of particular note is the timely release of the PEMA PFM Report Card which appears to offer great potential for use by the MCC.

These tools show great promise, although they would need further development and strengthening to be used fully by the MCC. The fact that they are still under development provides an opportunity for the MCC to influence their design and spur their development. There is little question that serious attention by the MCC could strongly influence the development of these tools, just as MCC attention has significantly influenced the further development and refinement of the 16 eligibility indicators.

Conclusion

The MCC has the opportunity to be truly innovative in the way it provides its finances and create the incentives for recipient countries to significantly strengthen their public fiduciary, financial and resource management institutions. Unfortunately its current

practice of using “accountable entities” for resource flows is likely to further weaken government fiduciary systems rather than strengthen them. The MCC could turn this around by providing a share of its financing directly to the budget in MCA-eligible countries that meet a specified standard of fiduciary controls and financial oversight.

There is an array of financing options available for delivering assistance. The appropriate choice of instrument depends largely on a country’s budget and policy priorities and institutional capacity to both implement the program and account for the use of resources. The appropriate choice of instrument also depends on the donors’ (and their Parliaments’) ability to focus more on achieving development results than on controlling the flow and exact expenditure of their investment. A graduated approach to the choice of instruments is sensible—one that incrementally builds implementation and fiduciary capacity in countries and builds confidence in donors.

The key is for the MCC to directly link the share of funds it provides to the budget with the measured quality of the recipient’s public financial systems on accounting, auditing, procurement and transparency. Countries with poor systems would receive nothing through the budget. Those meeting the baseline standard would receive a small initial share of funding (say 10 percent). As the quality of the institutions improved, the MCC would provide more of its funds directly to the budget.

This approach would have a substantial impact well beyond the MCC itself. It would help strengthen public financial management systems more broadly, helping to ensure more effective use of all public finances in supporting sustained economic growth, poverty reduction and development.

Table 1
Financial management and fiduciary capacity of 2006 MCA eligible countries

2005 Eligibles	IMF/WB PEM System Grade/1	CFAA	CPAR	PER	CPIA Quintile/2	CPIA Cluster D (Pub Sector Mngt)/2	IMF ROSC Audit/Acct	IMF ROSC Fisc. Transp
Armenia	N/A		FY03	FY02	1	1		2004
Benin	B	FY02	FY99		2	2		2002
Bolivia	C	FY99	FY01		2	3		
Burkina Faso	B	FY02	FY01		1	2		2002
Cape Verde	N/A	FY03			1	1		
East Timor	N/A	FY02	FY03		N/A	N/A		
El Salvador	N/A				N/A	N/A		2005
The Gambia	C	FY03	FY99		4	4		
Georgia	N/A	FY03	FY01	FY02	2	2		2003
Ghana	C	FY01	FY03		2	1		2004
Honduras	C	FY03	FY99	FY01	1	2		2002
Lesotho	N/A				2	2		2005
Madagascar	C	FY03	FY03	FY99	2	2		
Mali	A	FY03			1	1		2002
Mongolia	N/A	FY03	FY03	FY02	3	3		2005
Morocco	N/A				N/A	N/A	2002	2005
Mozambique	C	FY02	FY02	FY03	3	3		2004
Namibia	N/A				N/A	N/A		
Nicaragua	C	FY03	FY03	FY02	1	2		2004
Senegal	C	FY03	FY03	FY99	1	1	2005	
Sri Lanka	N/A	FY03	FY03		2	2		2005
Tanzania	A	FY01	FY03	FY03	1	1	2005	2002
Vanuatu	N/A				4	4		

1) http://www.imf.org/external/np/pp/eng/2005/041205a.pdf
2) http://siteresources.worldbank.org/IDA/Resources/2004CPIAweb1.pdf

*PEM/A + CPIA/D1 = lowest risk = Mali, Tanzania
**PEM/B + CPIA/D2 = moderate risk = Benin, Burkina Faso