

July 2006

MILLENNIUM  
CHALLENGE  
CORPORATION

Compact  
Implementation  
Structures Are Being  
Established;  
Framework for  
Measuring Results  
Needs Improvement



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-06-805](#), a report to the Chairman, Committee on Foreign Relations, U.S. Senate

# MILLENNIUM CHALLENGE CORPORATION

## Compact Implementation Structures Are Being Established; Framework for Measuring Results Needs Improvement

### Why GAO Did This Study

In January 2004, Congress established the Millennium Challenge Corporation (MCC) to administer the Millennium Challenge Account. MCC's mission is to reduce poverty by supporting sustainable, transformative economic growth in developing countries that create and maintain sound policy environments. MCC has received more than \$4.2 billion in appropriations, and, as of May 2006, it had disbursed \$22.4 million to four countries whose signed MCC compacts have entered into force. For the first three countries with compact entry into force—Madagascar, Cape Verde, and Honduras—GAO was requested to examine (1) key aspects that MCC reviewed, and the criteria it used, in its due diligence assessments; and (2) the structures that have been established for implementing the compacts.

### What GAO Recommends

GAO recommends that the Chief Executive Officer of MCC (1) ensure that economic analyses of compact proposals better reflect country conditions and involve country participation and (2) improve monitoring and evaluation by obtaining more reliable baseline data, ensuring a clear linkage to economic analyses, developing criteria for establishing and adjusting targets, and ensuring timely development of evaluation designs. MCC generally agreed with GAO's recommendations; State commented that some of GAO's findings reflect transitory problems.

[www.gao.gov/cgi-bin/getrpt?GAO-06-805](http://www.gao.gov/cgi-bin/getrpt?GAO-06-805).

To view the full product, including the scope and methodology, click on the link above. For more information, contact David Gootnick at (202) 512-3149 or [gootnickd@gao.gov](mailto:gootnickd@gao.gov).

### What GAO Found

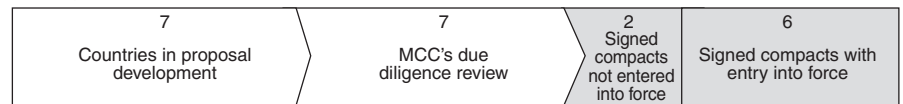
MCC undertook a wide range of activities in its due diligence, including five key aspects of the Madagascar, Cape Verde, and Honduras proposals: (1) countries' consultation with local groups in developing compact proposals, (2) projects' coherence with compact goals, (3) environmental and social impacts, (4) institutional and financial sustainability, and (5) impact on economic growth and poverty reduction. MCC based its assessments on an evolving set of criteria: early, general guidance to the countries followed by later, more specific guidance. MCC's analyses of the projects' economic impact were limited in that some of the assumptions and data used may not reflect country conditions. As a result, the projects selected on the basis of the analyses may not achieve compact goals. In the two countries we visited, Madagascar and Cape Verde, MCC conducted the analyses with limited country participation, which resulted in countries' having little understanding of the process.

MCC and the three countries have made progress in establishing compact country structures for oversight and management, procurement, fiscal accountability, and monitoring and evaluation, although some of these structures are not yet complete. The oversight structures allow for country management with MCC review, but some organizations were not fully staffed for months after the compacts entered into force. Madagascar and Cape Verde have implemented fiscal accountability structures for MCC-funded projects, and established procurement structures with effective characteristics; however, these structures are still largely untested and some are still under development. Finally, MCC and the countries have established monitoring and evaluation frameworks to track and account for program results. However, limitations in the baseline data collected, linkage to economic analyses, methods of addressing uncertainty associated with program results, and the timely design of randomized controlled trials may constrain MCC's ability to monitor and evaluate program results.

#### Status of MCC Compact Development and Appropriations

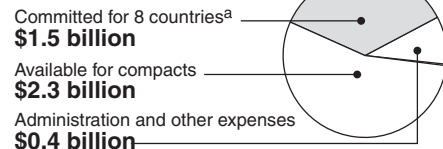
##### Compact development and implementation status

Total eligible countries: 22



##### MCC budget allocation and disbursement status

Total appropriations: \$4.2 billion



Source: GAO analysis of MCC information.

<sup>a</sup>\$22.4 million of the committed amount has been disbursed to begin compact implementation.

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## Abbreviations

CEO	Chief Executive Officer
ERR	economic rate of return
FAP	Fiscal Accountability Plan
FISMA	Federal Information Security Management Act of 2002
FMFIA	Federal Managers Financial Integrity Act of 1982
GDP	gross domestic product
GPRA	Government Performance and Results Act of 1993
IG	Inspector General
MCA	Millennium Challenge Account
MCC	Millennium Challenge Corporation
NBC	National Business Center
NGO	nongovernmental organization
OMB	Office of Management and Budget
PIU	Program Implementation Unit
SAS 70	Statement on Auditing Standards No. 70
USAID	U.S. Agency for International Development

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**Contents**

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United States Government Accountability Office  
Washington, D.C. 20548

July 28, 2006

The Honorable Richard G. Lugar  
Chairman  
Committee on Foreign Relations  
United States Senate

Dear Mr. Chairman:

In January 2004, Congress established the Millennium Challenge Corporation (MCC) to administer the Millennium Challenge Account (MCA) for foreign assistance.<sup>1</sup> MCC's mission is to reduce poverty by supporting sustainable, transformative economic growth in partnership with developing countries that create and maintain sound policy environments. MCC carries out its mission by funding projects or activities in developing countries that demonstrate a commitment to MCA objectives. MCC expects to raise incomes and lift thousands out of poverty in countries receiving MCC assistance. MCC has received appropriations for fiscal years 2004 to 2006 totaling more than \$4.2 billion, about \$3.8 billion of which has been set aside for compact assistance; as of May 2006, it had committed \$1.5 billion and disbursed \$22.4 million in compact assistance.<sup>2</sup> The President has requested an additional \$3 billion in MCC funding for fiscal year 2007.

In April 2005, we reported on MCC's first year of operations, focusing on its process for determining country eligibility, progress in developing compacts, coordination with stakeholders, and progress in establishing management and accountability structures.<sup>3</sup> We made several recommendations to the Chief Executive Officer (CEO) of MCC and to the

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<sup>1</sup>Millennium Challenge Act of 2003, Public Law 108-199, Division D, Title VI of the Consolidated Appropriations Act, 2004. Title II, Division D of this act established MCA for MCC appropriations.

<sup>2</sup>About \$400 million has been set aside for MCC's administrative expenses, due diligence, monitoring and evaluation, threshold country program—which provides funding to candidate countries to help them become eligible for MCA assistance, and other costs. An MCC compact is an agreement between the U.S. government, acting through MCC, and the government of a country eligible for MCC assistance. Compacts have a maximum duration of 5 years.

<sup>3</sup>GAO, *Millennium Challenge Corporation: Progress Made on Key Challenges in First Year of Operations*, [GAO-05-455T](#) (Washington, D.C.: Apr. 26, 2005) and [GAO-05-625T](#) (Washington, D.C.: Apr. 27, 2005).

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Secretary of State, in her capacity as board chair, on ways to improve MCC's strategic planning, internal controls, and human capital and corporate governance policies. At that time, MCC's assessment—"due diligence"—of eligible countries' compact proposals<sup>4</sup> had resulted in its signing one compact for \$110 million with Madagascar; by the end of May 2006, MCC had signed compacts with seven more countries.<sup>5</sup> As of the end of May 2006, six compact countries—Madagascar, Cape Verde, Honduras, Georgia, Vanuatu, and Nicaragua—had signed the supplemental agreements that MCC requires before compacts can "enter into force," when MCC begins to disburse funds for compact implementation. MCC has disbursed funds to four of these six countries—Madagascar, Cape Verde, Honduras, and Georgia—to begin implementing their compacts.

At your request, we examine in this report MCC's procedures and structures for developing and implementing compacts. We focused our work on the first three countries to sign compacts: Madagascar, Cape Verde, and Honduras. Specifically, we reviewed

- the key areas that MCC examined in its due diligence assessments of the three countries' compact proposals and the criteria that MCC used in these assessments and
- the implementation structures that MCC and the three countries have established for oversight and management, fiscal accountability, procurement, and monitoring and evaluation of compacts.

We also report on MCC's response to our April 2005 recommendations (see app. I). In conducting our work, we analyzed MCC's process for evaluating eligible country proposals, including MCC's guidance documents for eligible countries, policies and procedures, economic analysis, and documentation of its assessment of proposals submitted by Madagascar, Cape Verde, and Honduras. In addition, we reviewed MCC's compacts with the three countries and the supplemental agreements required for those

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<sup>4</sup>A compact proposal outlines, among other things, program objectives, related projects, project funding, and a program implementation framework.

<sup>5</sup>Between April 2005 and May 2006, MCC signed compacts with Honduras, Cape Verde, Nicaragua, Georgia, Benin, Vanuatu, and Armenia.



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compacts to enter into force.<sup>6</sup> We also reviewed the countries' implementation plans, such as those for monitoring and evaluation. We supplemented our evaluation of due diligence and implementation documents with interviews with MCC officials and site visits to Madagascar and Cape Verde, in January and February 2006. We selected these two countries because they had advanced further than Honduras in filling key positions and beginning compact implementation. These site visits provided us with a firsthand perspective of the status of the program and the challenges these countries faced in developing their compacts and in beginning to implement their programs. Furthermore, we examined MCC's planning documents, policies, and procedures and interviewed senior MCC officials. We conducted our review from June 2005 through May 2006 in accordance with generally accepted government auditing standards. (See app. II for additional details of our scope and methodology.)

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## Results in Brief

MCC undertook a wide range of activities in its due diligence of the Madagascar, Cape Verde, and Honduras proposals, while at the same time developing guidance on key aspects of the countries' proposals. In conducting its assessments, MCC applied criteria from general guidance issued in 2004, which was shortly before the countries began developing their proposals, and from more specific guidance issued in 2005 and 2006. MCC's analyses of the projects' economic impact had limitations in their use of assumptions and data and degree of country involvement. We focused on MCC's assessment of five key aspects: the consultative process during proposal development, project coherence, environmental impact, institutional and financial sustainability, and economic analyses of the projects' impact on economic growth and poverty reduction:

- *Consultative process.* MCC obtained the views of government, civil society, and private sector officials to determine whether the countries' consultative process had been timely, participatory, and meaningful. MCC officials told us that, on the basis of these assessments, they had returned proposals that were not sufficiently founded on the consultative process. However, in assessing the proposals, MCC used criteria contained in guidance issued after or shortly before the countries submitted their proposals.

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<sup>6</sup>MCC's compacts with Georgia, Vanuatu, and Nicaragua entered into force, respectively, on April 7, May 11, and May 26, 2006. However, because these compacts entered into force late in our review, we did not focus our analysis on these countries.

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- *Project coherence.* MCC assessed whether the countries' proposed projects were linked to their compact goals and whether the projects addressed key impediments to achieving those goals. MCC's initial published guidance to the countries did not inform them that projects should be linked to compact goals. When MCC issued more specific guidance, in November 2005, it had already signed compacts with all three countries. Generally, projects were linked to compact goals in the three countries that we reviewed.
  - *Environmental and social impact.* MCC reviewed the probable environmental and social impact of proposed projects. For projects that MCC deemed likely to have a negative impact, it required further assessment as well as an impact management plan. In conducting its assessments, MCC used criteria in guidelines issued in March 2005.
  - *Project sustainability.* MCC assessed whether projects could be sustained institutionally and financially after the compacts expired. MCC reviewed (1) the countries' commitment to sustaining the projects by making policy changes and providing financial resources, (2) the countries' institutional capacity to achieve project objectives, and (3) the projects' likelihood of being financially self-sustaining based on MCC's economic analysis.
  - *Economic analyses.* To predict the projects' impact on economic growth, MCC calculated their economic rate of return—that is, for each dollar that it spent, the dollar benefit the country is likely to receive. MCC used an economic model that included data and assumptions about project beneficiaries' expected behaviors. However, the data and assumptions used in some of MCC's economic analyses may not accurately reflect the countries' socioeconomic conditions. As a result, MCC cannot be assured that it has selected projects that will achieve the compacts' goals. In the two countries we visited, Madagascar and Cape Verde, country representatives were not closely involved in MCC's economic analyses. This limited involvement in the process resulted in countries' having little understanding of the underlying economic framework on which the compacts were based.

MCC and the countries have made progress in implementing structures for oversight and management, fiscal accountability, and procurement for Madagascar, Cape Verde, and Honduras, but some of these structures are not yet complete. In addition, although MCC has established monitoring

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and evaluation frameworks, the frameworks have weaknesses that could affect MCC's ability to ensure accountability for results.

- *Oversight and management.* MCC and the countries have established structures that allow for country management with MCC review. MCC maintains a small staff in each country, which refers matters requiring approval to MCC headquarters in Washington, D.C. Country management structures include the following: a steering committee, a stakeholder committee, and a management unit. Staffing for all three country organizations remained incomplete for months after the compacts entered into force. This incomplete staffing at entry into force limits the ability of the countries to achieve their compact objectives within the fixed time period of the compact.
- *Fiscal accountability.* MCC has established a framework of internal controls to incorporate fiscal accountability into MCC-funded projects. In Madagascar, we found that underlying accountability systems, policies and procedures, and internal controls are less fully developed than those in Cape Verde, which built on existing government structures and systems. Because the accountability systems in both countries are still under development, both countries face risks in their key financial processes and activities. In January 2006, the MCC Inspector General (IG) issued guidelines for the countries' financial audits, and Madagascar and Cape Verde are preparing for these audits.
- *Procurement.* In each of the three countries, the MCC-approved systems have characteristics that typify effective procurement systems—for example, integrity, openness, and accountability. These systems are still largely untested, and some MCC and country staff and procedures are not yet in place.
- *Monitoring and evaluation.* Compact countries are required to prepare and implement a monitoring and evaluation framework, including plans that document the necessary data collection, data quality reviews, analysis, and interim and final reporting of results. MCC has conditioned some disbursements on the countries' achieving performance targets. However, MCC's ability to track and account for results may be limited by weaknesses in the frameworks related to the availability and quality of baseline data, ensuring linkage between the economic models and the monitoring and evaluation plans, and accounting for uncertainty in setting targets and measuring progress. In addition, although MCC has retained five U.S. research organizations to independently analyze the

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results of MCC compacts, MCC has not completed the research designs needed to use its preferred methodology of randomized controlled trials prior to project implementation. Not completing the designs prior to project implementation potentially limits MCC's ability to perform randomized controlled trials.

We are recommending that the CEO of MCC (1) adopt procedures that ensure greater involvement of compact country stakeholders in developing the economic model used to assess projects' likely impact and (2) to the extent practical and cost-effective, improve MCC's monitoring and evaluation capabilities by obtaining more accurate and reliable baseline data, ensuring a clear linkage between MCC's economic analyses and monitoring and evaluation frameworks, better accounting for uncertainty in setting targets and achieving outcomes, and ensuring the timely development of the needed research designs for randomized controlled trials prior to project implementation.

In commenting on a draft of this report, MCC generally agreed with our findings, conclusions, and recommendations. The Department of State commented that it considered some of the findings of our report as reflecting minor or transitory problems, and that the report should note the improvements that MCC made during and since the period it covers. Throughout this report, we have described MCC and compact progress through May 2006. We have reprinted MCC's and State's comments, with our responses, in appendixes V and VI. We also incorporated technical comments from MCC in our report where appropriate.

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## Background

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### MCC Principles

In pursuit of its mission to reduce poverty by supporting economic growth, MCC has identified and defined the following three key principles to guide its actions:<sup>7</sup>

- *Reward good policy.* "Using objective indicators, countries are selected to receive assistance based on their performance in governing justly, investing in their citizens, and encouraging economic freedom."

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<sup>7</sup>MCC, 2005 Annual Report.

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- *Operate in partnership.* “Countries that receive MCA assistance are responsible for identifying the greatest barriers to their own development, ensuring civil society participation, and developing a multi-year MCC compact.”
  - *Focus on results.* “MCA assistance goes to those countries that have developed well-designed programs with clear objectives, benchmarks to measure expected results, procedures to ensure fiscal accountability for the use of MCA assistance, and a plan for effective monitoring and objective evaluation of results. Programs are designed so that recipient countries can sustain progress after the funding under the compact has ended.”

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## MCC Structure

MCC is a government corporation that is managed by a CEO appointed by the President with the advice and consent of the Senate and is overseen by a Board of Directors (MCC Board). The Secretary of State serves as board chair, and the Secretary of the Treasury serves as vice-chair. Other board members are the U.S. Trade Representative, the Administrator of the U.S. Agency for International Development (USAID), the CEO of MCC, and up to four Senate-confirmed public members who are appointed by the President from lists of individuals submitted by congressional leadership.

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## Eligibility for MCC Assistance

The Millennium Challenge Act of 2003 requires MCC to select countries as eligible for MCA assistance each fiscal year. Countries with per capita income at or below a set threshold may be selected as eligible for assistance if they pass MCC indicator criteria and are not statutorily barred from receiving U.S. assistance. MCC uses 16 indicators divided into three categories: Ruling Justly, Encouraging Economic Freedom, and Investing in People.<sup>8</sup> To be eligible for MCA assistance, countries must score above the

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<sup>8</sup>These indicators are as follows: *Ruling Justly*: (1) political rights, (2) civil liberties, (3) voice and accountability, (4) government effectiveness, (5) rule of law, and (6) control of corruption. *Encouraging Economic Freedom*: (1) cost of starting a business, (2) 1-year consumer price inflation, (3) fiscal policy, (4) trade policy, (5) regulatory quality, and (6) days to start a business. *Investing in People*: (1) public expenditures on health as a percentage of the gross domestic product (GDP), (2) immunization rates for DPT3 and measles, (3) public primary education spending as a percentage of the GDP, and (4) girls' primary education completion rate. See MCC, *Report on Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 06* (Sept. 8, 2005).

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median relative to their peers on at least half of the indicators in each category and above the median on the indicator for combating corruption. MCC used these quantitative indicators, as well as the discretion implicit in the Millennium Challenge Act, to select 17 countries as eligible to apply for MCA compact assistance for fiscal years 2004 and 2005. For fiscal year 2006, MCC identified 23 countries<sup>9</sup> as eligible for assistance—the 17 previously selected and 6 additional countries, which included lower-middle-income countries eligible for the first time in fiscal year 2006.<sup>10</sup>

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## MCC's Compact Development

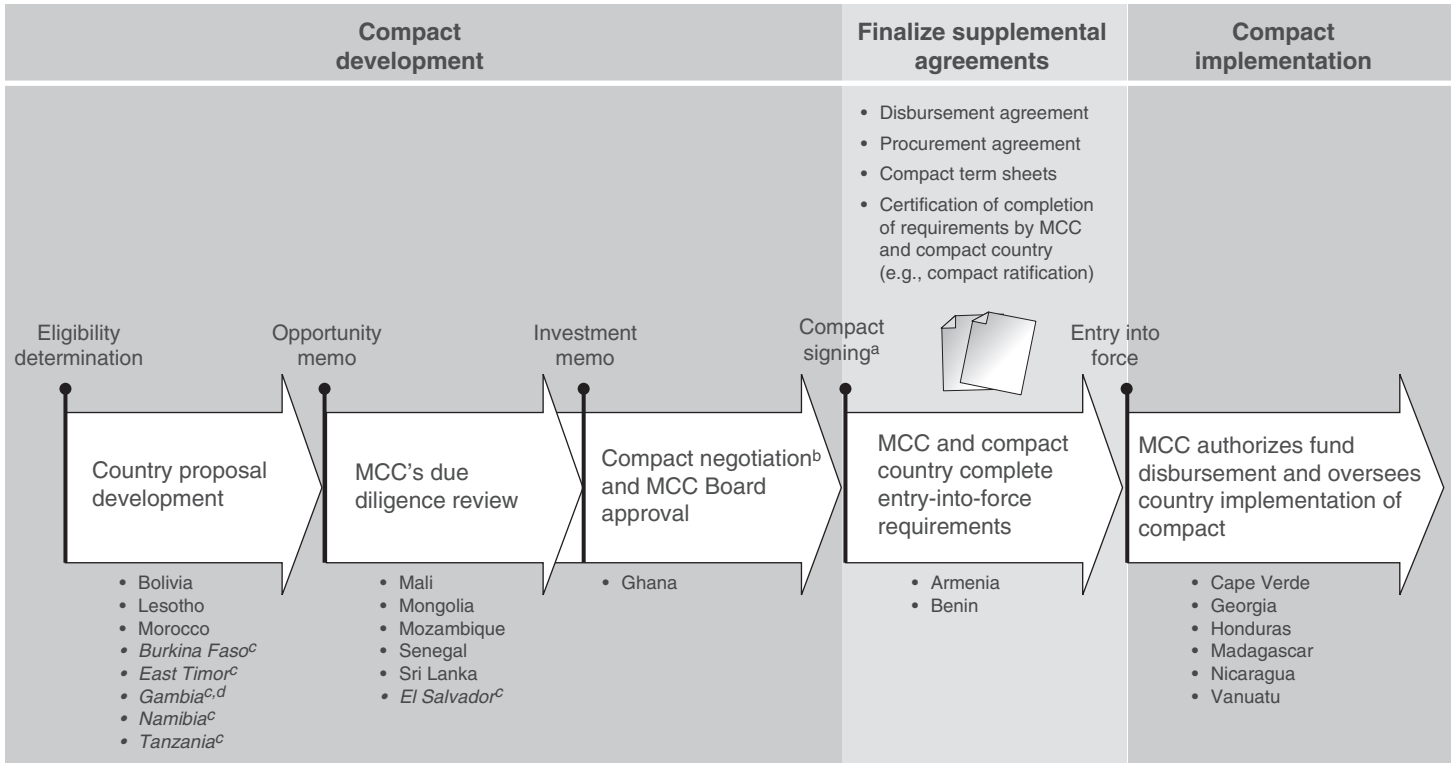
After MCC selects eligible countries, they may begin a four-phase process that can lead to the entry into force of compacts (see fig. 1). Each phase of this process is discussed after figure 1.

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<sup>9</sup>The MCC Board suspended Gambia's eligibility for assistance on June 16, 2006, citing a pattern of actions inconsistent with MCC's selection criteria.

<sup>10</sup>The annual per capita income threshold for MCA assistance was \$1,415 in fiscal year 2004 and \$1,465 in 2005. In fiscal year 2006, the threshold was \$1,575 for low-income countries and \$1,575 to \$3,255 for lower-middle-income countries. In fiscal year 2006, MCC selected Cape Verde, El Salvador, and Namibia from its list of lower-middle-income countries.

**Figure 1: Summary of the MCC Compact Development and Implementation Process and Status of Countries Eligible to Apply for Compacts, as of June 2006**



Source: GAO analysis of MCC data.

<sup>a</sup>MCC must notify congressional appropriations committees 15 days prior to obligating funds.

<sup>b</sup>Compact negotiations begin after the MCC investment committee approves a Consultation Memorandum prepared by the MCC transaction team. The memorandum is based on the transaction team's determination that the country proposal has sufficient information to justify entering into negotiations with the country. MCC must consult with and report to the appropriate congressional committees 15 days prior to the start of compact negotiations.

<sup>c</sup>The names of newly eligible countries in fiscal year 2006 are italicized.

<sup>d</sup>The MCC Board suspended Gambia's eligibility on June 16, 2006.

- 
1. *Country proposal 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 nongovernmental organizations (NGO). The eligible country also identifies an “accountable entity” to manage the programs funded by MCC.<sup>11</sup> Eligible countries submitting proposals are not guaranteed funding; instead, MCC assesses proposals through its due diligence review. As of May 2006, 14 of the 17 countries selected as eligible in fiscal year 2004 or 2005, and 1 of the 6 countries selected as eligible for the first time in fiscal year 2006, had submitted proposals accepted by MCC for due diligence review.
  2. *MCC’s due diligence review.* MCC determines whether the proposal that an eligible country has submitted meets MCC criteria to ensure that proposed programs will be effective and funds will be well-used. Due diligence primarily occurs between MCC’s acceptances of an “opportunity memo” and an “investment memo.” MCC assembles a transaction team of MCC staff, personnel from other U.S. agencies, and consultants to conduct a preliminary assessment of a country’s proposal and reports the team’s findings in an opportunity memo to the MCC investment committee. The MCC investment committee consists of MCC’s CEO, vice presidents, and other senior officials. If the opportunity memo is approved, the transaction team launches a detailed due diligence review. The team assesses the country proposal, reports its findings, and makes recommendations based on its assessment in an investment memo to the MCC investment committee. As of May 2006, MCC was conducting due diligence analyses of seven eligible country proposals.
  3. *Compact negotiation and MCC Board approval.* MCC may enter into compact negotiations with the eligible country before the investment memo is completed. If compact negotiations are successful, MCC staff formally submit the compact for MCC Board approval. Once the board approves the compact, MCC and the eligible country may sign it. As of March 2006, MCC had signed compacts with 8 of the 17 countries determined eligible in fiscal years 2004 and 2005. (See fig. 2.) MCC commits the full amount of the compact funding at signing but obligates and begins to disburse funds to implement projects only after

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<sup>11</sup>MCC refers to the accountable entity by combining “MCA” and the country’s name—for example, “MCA-Madagascar.”



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the compact has entered into force. Under the Millennium Challenge Act, compacts may remain in force no longer than 5 years. The compacts stipulate that, with limited exceptions, all funds must be spent during that time.

4. *MCC and compact country complete entry-into-force requirements.* MCC's compact with each country identifies the following supplemental agreements that MCC and the country's accountable entity must complete before the compact can enter into force.<sup>12</sup>
  - The *disbursement agreement* sets out the "conditions precedent"<sup>13</sup> and other requirements for disbursements from MCC and redissembments to any person or entity. These conditions include performance targets for projects outlined in the compact.
  - The *procurement agreement* sets forth guidelines for all procurements of goods, works, and services financed with MCC funding.
  - Compact term sheets for supplemental agreements, which vary by country, and include documents such as a *governance agreement*, *fiscal agent agreement*, *form of implementing entity agreement*, and *form of bank agreement*.

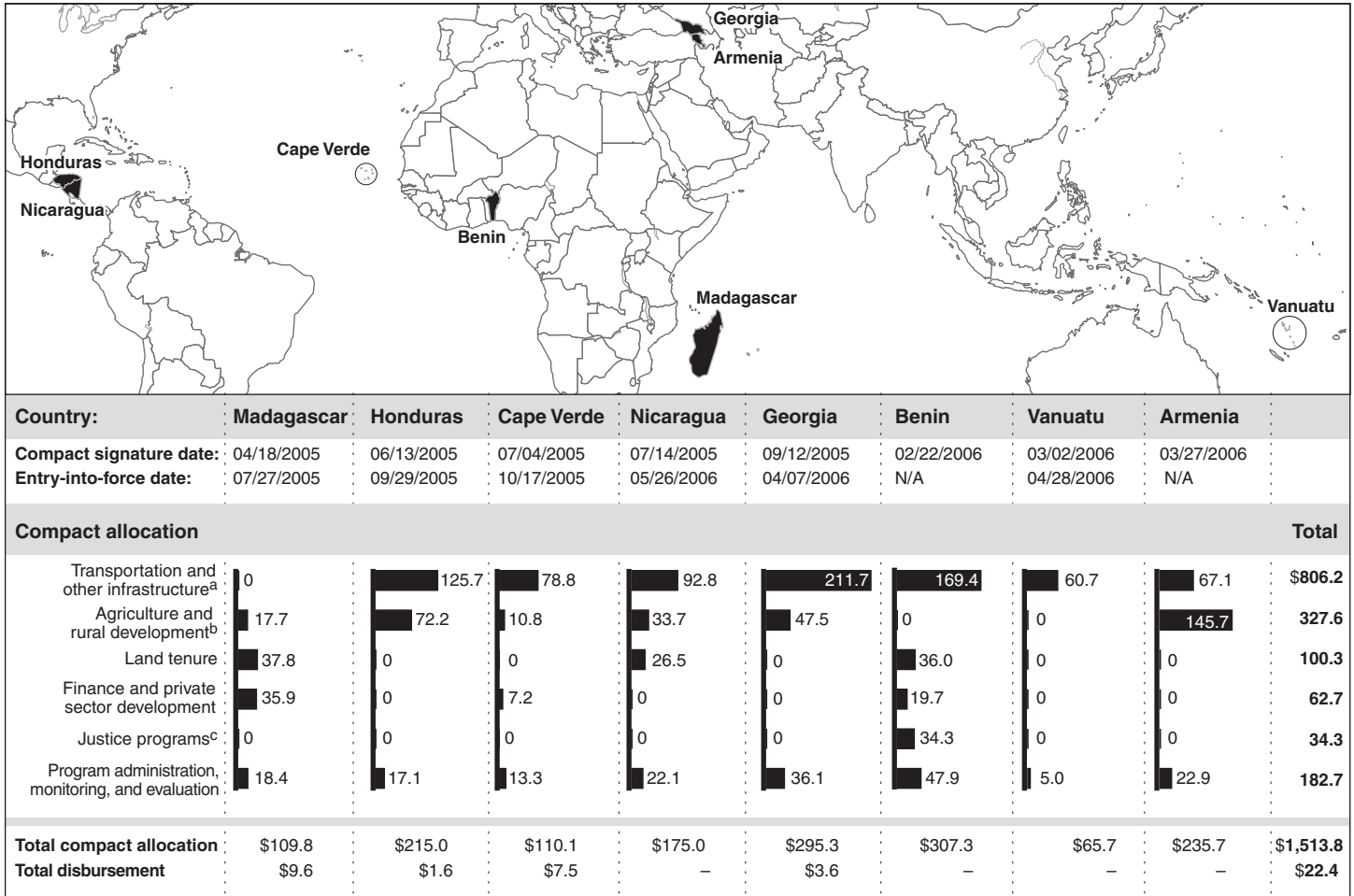
After compacts enter into force, MCC may begin the disbursement of funds and countries may begin implementing projects. In the first eight compacts, approximately 53 percent of funding went to transportation and other infrastructure projects; 22 percent went to agriculture and rural development; 13 percent went to other project types; and 12 percent went to program management, monitoring, and evaluation. (See fig. 2.)

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<sup>12</sup>In addition, MCC and the compact country must certify the completion of these requirements for entry into force and provide statements of the incumbency of their representatives with specimen signatures.

<sup>13</sup>"Conditions precedent" are specific steps that must be completed by the compact country prior to MCC's providing a disbursement.

**Figure 2: MCC-Eligible Countries with Signed Compacts, as of May 2006**  
U.S. dollars in millions



Sources: GAO analysis of MCC data and Map Resources (map).

Note: Numbers may not add due to rounding of source data. See appendix III for photographs of projects we visited in Cape Verde and Madagascar.

<sup>a</sup>The Access to Markets Project in Benin is a major construction project at the Port of Cotonou and includes associated studies and institutional strengthening.

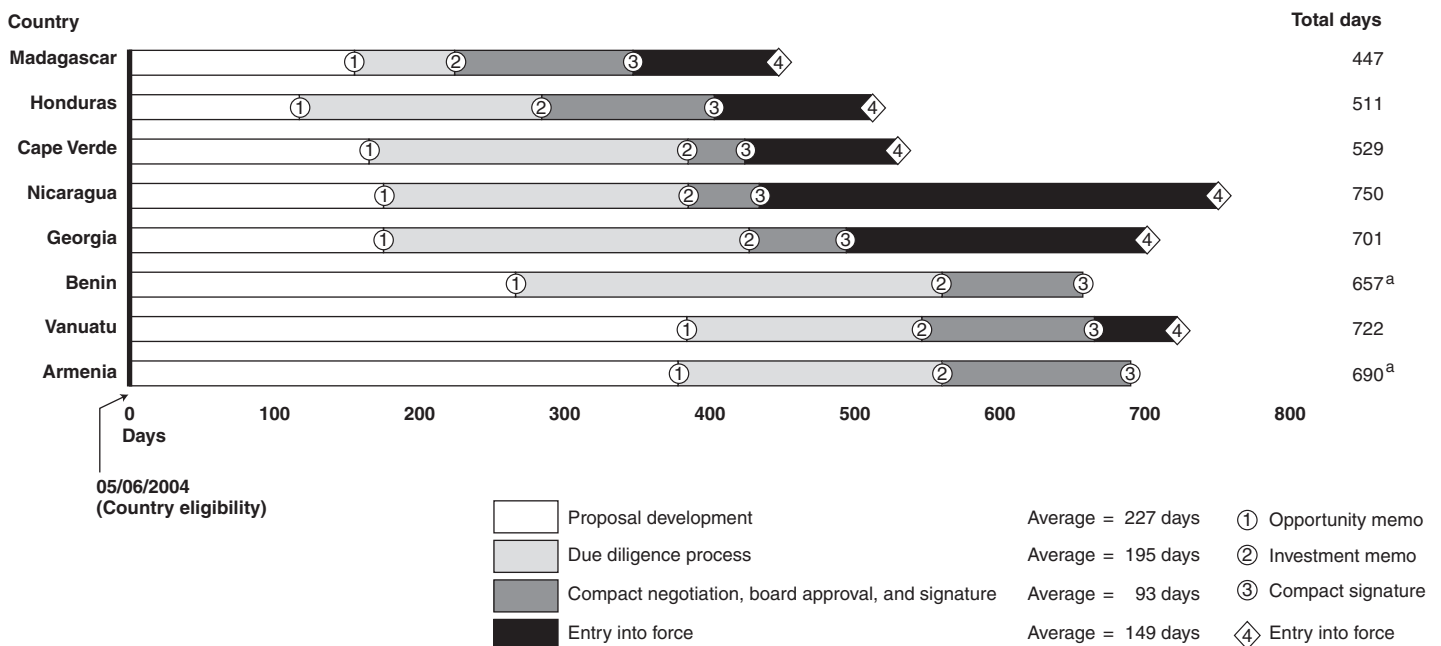
<sup>b</sup>The Irrigated Agriculture Project in Armenia includes the repair of irrigation infrastructure.

<sup>c</sup>The Justice Program in Benin includes institutional strengthening and infrastructure components (construction of new courthouses).

## Compact Signature and Entry-into-Force Time Frames

The length of time from country eligibility selection to compact signature has varied, with proposal development and due diligence generally requiring the most time (see fig. 3). For the six countries whose compacts had entered into force as of the end of May 2006, completing the steps necessary for entry into force after compact signing took approximately 3 to 4 months for Madagascar, Cape Verde, and Honduras; approximately 7 months for Georgia; 2 months for Vanuatu; and about 10½ months for Nicaragua. For the two countries whose compacts had not entered into force as of the end of May 2006, 3 months had elapsed since compact signature for Benin, and 2 months had elapsed for Armenia (see fig. 3).

**Figure 3: Number of Days Elapsed from Eligibility to Compact Signature or Entry into Force, as of May 2006**

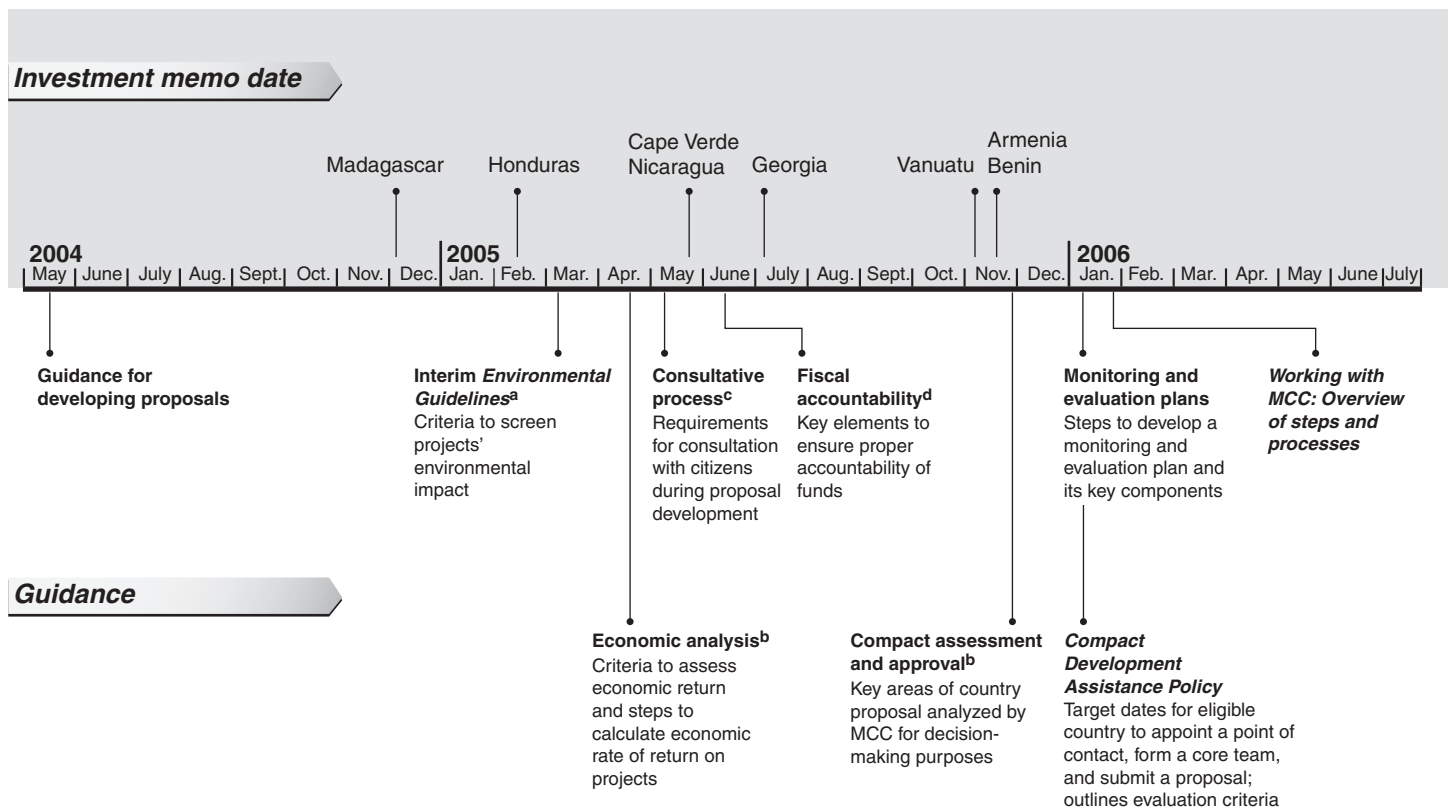


## MCC Guidance

MCC has issued guidance and policies for its compact development process in several stages. Before publishing its initial guidance in May 2004, MCC provided countries with preliminary guidance addressing fiscal accountability and monitoring and evaluation. Figure 4 shows the evolution

of MCC's published guidance relative to the end of the due diligence process with the investment memo.

**Figure 4: Timeline of MCC Guidance Issuance and Investment Memo Dates**



Source: GAO analysis of MCC data.

<sup>a</sup>MCC issued interim *Environmental Guidelines* on March 4, 2005, and final *Environmental Guidelines* on January 23, 2006.

<sup>b</sup>Economic analysis guidelines and compact assessment and approval guidelines were reissued on January 23, 2006.

<sup>c</sup>Consultative process guidance was reissued on January 6, 2006.

<sup>d</sup>According to MCC officials, MCC provided an initial 2-page guidance to eligible countries in December 2004, but it did not publish the guidance on the MCC Web site. MCC issued an updated version of the guidance on January 6, 2006.

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## MCC Assessed Five Key Aspects of Proposals While Developing Guidance, but Limitations Affected the Accuracy of Economic Analyses

MCC undertook a wide range of activities in its due diligence of the Madagascar, Cape Verde, and Honduras proposals, while at the same time developing guidance on key aspects of the countries' proposals.<sup>14</sup> During due diligence, MCC primarily considered criteria related to the proposals' consultative process, project coherence, environmental impact, institutional and financial sustainability, and economic analyses.<sup>15</sup> MCC generally approved proposals that were based on a consultative process and returned proposals that lacked adequate consultations; however, MCC did not publish detailed criteria for the consultative process until 1 year after selecting the countries as eligible for MCC assistance. In assessing project coherence, MCC approved projects that were linked to the overall proposal objectives and rejected projects that were not, although its assessments used criteria that it had not yet published in its guidance. Additionally, MCC screened projects for likely environmental impacts and considered factors important for institutional and financial sustainability. Finally, MCC conducted economic analyses to assess the projects' likely impact on economic growth. However, limitations in assumptions and data may have affected the analyses' accuracy and led MCC to select projects that would not achieve its goals. Also, a lack of country involvement in the analyses does not reflect the MCC principle of working in partnership with countries and may have limited the countries' understanding of the process.

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## MCC Assessed the Consultative Process as Guidance Evolved

MCC's due diligence for Madagascar, Cape Verde, and Honduras assessed whether the countries had consulted with public and private sector and civil society stakeholders during proposal development. MCC officials told us that before beginning due diligence for the three countries, they assessed the consultative process in proposal drafts and, on the basis of this review, returned proposals that were not sufficiently founded on a consultative process. For example, according to the officials, MCC did not accept one country's proposal because, although the country had consulted

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<sup>14</sup>In January 2006, MCC issued new guidance to better prepare countries at the start of the proposal development process by providing estimates of personnel and funds required for proposal development. According to MCC officials, MCC is engaging with countries earlier in the compact development process to ensure that countries develop better proposals.

<sup>15</sup>In addition to assessing aspects related to project selection, MCC also assessed program oversight and management, fiscal accountability, procurement, and monitoring and evaluation structures to ensure the proper oversight and use of MCC funding. These structures are discussed later in this report in the context of compact implementation.

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with stakeholders, its proposal did not reflect the priorities identified during the consultative process.

**MCC Definition of an Adequate Consultative Process**

1. **Timely:** Includes wide initial discussions, on-going feedback on decisions, and project-level consultations with potential beneficiaries.
2. **Participatory:** Takes into account a broad range of views, including representatives from the government, nongovernmental organizations, the private sector, and urban and rural organizations.
3. **Meaningful:** Allowing genuine input by ensuring timely distribution of materials, reflecting input from consultations in the proposal, and providing feedback.

Source: MCC.

MCC documents indicate that during its due diligence for two of the three countries, MCC obtained the views of government, civil society, and private sector officials on how the governments conducted the consultative process. In addition, MCC assessed any previous experience the country had had with a consultative process<sup>16</sup> For all three countries, MCC also reviewed factors such as the date, frequency, and locations of the process. MCC's documentation of these assessments in Madagascar, Cape Verde, and Honduras indicated that key stakeholders had generally agreed on the proposed compact priorities. However, the MCC assessments noted some weaknesses in the Madagascar and Honduras governments' management of the process:

- In Madagascar, some groups expressed concern to MCC that the government had provided short notice (less than 10 days) for consultative meetings, and that this might have limited rural groups' participation. Additionally, the government did not communicate to participants its rationale for accepting or rejecting projects. However, despite these shortcomings, MCC noted "widespread agreement and enthusiasm for the...primary components of [the] proposal" among the business community, local and international NGOs, civil society, and donors.
- In Honduras, MCC found, on the basis of discussions with local civil society organizations and international NGOs, that weaknesses—such as the large size of meetings—had limited effective participation in the consultative process for the poverty reduction strategy, which formed the basis of Honduras's MCC proposal. MCC's assessment also indicated that the government had not directly asked the consulted groups to identify obstacles to growth. However, MCC found that these groups concurred with the priorities identified in the country proposal. According to MCC officials, they followed up with the Honduran government to address the weakness noted by MCC in Honduras's consultative process. As a result, according to MCC documentation, the

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<sup>16</sup>For example, Madagascar and Honduras participated in a World Bank-initiated poverty reduction strategy initiative that required countries to involve stakeholders in identifying national development priorities through a consultative process.

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Honduran government conducted additional consultative sessions with civil society organizations and donors.

MCC's due diligence of the countries also noted requirements for additional consultations during project implementation. For example, in some cases, countries were to undertake consultations with local stakeholders to identify project sites and conduct environmental assessments.

Our discussions with representatives of civil society groups and donors in Madagascar and Cape Verde indicated that they generally concurred with the compact proposals.<sup>17</sup> In Madagascar, a representative from a key civil society organization noted weaknesses in the government's conduct of the consultative process similar to those recorded by MCC. Nevertheless, stakeholders on the Madagascar advisory council, which includes various civil society and other organizations, said that the compact proposal generally accounted for their views, especially in comparison with other donor programs.

As a relatively new organization, MCC conducted due diligence reviews while it was developing consultative process guidance:

- *Evolving guidance.* While developing their proposals, the countries had access to general criteria in MCC's 2004 guidance; however, in assessing the proposals, MCC applied the more specific criteria contained in its detailed 2005 guidance. As figure 5 shows, the 2005 guidance was issued 1 year after MCC announced the eligibility of Madagascar, Honduras, and Cape Verde. According to MCC's *Guidance for Developing Proposals for MCA Assistance in FY 2004*, "...each proposal is expected to reflect the results of an open consultative process, integrating governmental interests with those of the private sector and civil society." The 2004 guidance required that proposals include a description of the consultative process, such as how the proposal takes into account local-level perspectives of the country's rural and urban poor, including women, and of private and voluntary organizations and the business community. Additionally, the guidance required the country

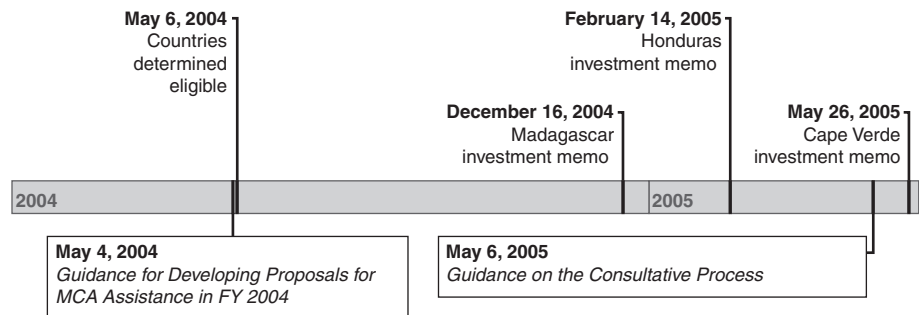
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<sup>17</sup>We did not conduct in-depth interviews into the nature of these representatives' participation in the consultative process. Also, due to the limited number of people interviewed, this result is not representative of the entire set of consultative process participants in these countries.

to list all key participants, such as government and nongovernmental officials, who played a significant role in developing the proposal.

MCC's 2005 *Guidance on the Consultative Process* more specifically requires eligible country governments to involve their citizens in identifying obstacles to economic growth and developing and prioritizing the development strategies and programs that will be included in the compact proposal. The 2005 guidance further states that an adequate consultative process should be timely, participatory, and meaningful. MCC's guidance also took into account the country's experience in using a consultative process to develop other national or poverty reduction strategies. If the compact was built on these consultations, MCC required some additional consultations to provide justification of country priorities in the MCA proposal.

**Figure 5: Issuance of Key MCC Criteria for the Consultative Process Relative to Completion of Due Diligence for Madagascar, Honduras, and Cape Verde**



Source: GAO analysis of MCC data.

- Incomplete documentation.* MCC's documentation of its due diligence for the three countries presents summary findings, rather than an analysis of the extent to which the countries consulted with the rural and urban poor. For example, MCC's due diligence documentation indicates that the countries' governments included women's groups and rural sector groups in their consultative process; however, the documentation does not indicate the extent to which these groups represented the poor. Additionally, in Madagascar and Honduras, MCC's documentation does not indicate how MCC assessed the extent to which the consulted groups informed compact proposal priorities.



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## MCC Assessed Project Coherence While Developing Specific Guidance

In keeping with MCC's emphasis on results, due diligence for the three countries also assessed whether proposed projects were linked to one or more of the country's compact goals, and whether the projects addressed key impediments or constraints to achieving these goals. On the basis of its due diligence assessment, MCC rejected projects that were not linked to key constraints in two of the three countries we reviewed. Specifically, MCC rejected tourism and preschool education projects proposed by Honduras because they were not linked to the impediments to growth that emerged from the consultative process.<sup>18</sup> MCC also rejected projects to construct feeder roads, which connect some watershed areas to the markets, and provide access to electricity in the rural areas of Cape Verde, because MCC's due diligence did not indicate that these projects addressed key constraints in Cape Verde.<sup>19</sup>

### MCC Considered Other Donor Projects and Resources during Due Diligence

The Millennium Challenge Act of 2003 requires that MCC-funded activities be coordinated with other donors' activities to the "maximum extent feasible." Accordingly, during due diligence, MCC considered projects' relationship to other donors' efforts. For example, MCC used existing donor assessments and studies for technical and environmental assessment of projects in Madagascar, Cape Verde, and Honduras. In addition, MCC conducted due diligence on projects that would complement or expand on other donor projects. For example, in Cape Verde, MCC will fund upgrading 5 of 11 roads for which the World Bank has completed economic analyses, feasibility studies, and environmental impact assessments. In addition, MCC will use the existing World Bank management unit for oversight and management of this project. The photograph below shows one of these roads, which connects a remote fishing town to a larger road network on the island of Santiago, in Cape Verde.



Source: GAO.

In reviewing MCC's due diligence for the three countries, we found that MCC did not issue guidance stating that proposed projects should be linked to the compact goal until after it had concluded its due diligence assessments. MCC's 2004 guidelines for proposal development broadly instruct eligible countries to identify priority areas, such as health or education, and their expected goals for each priority area over the term of the proposed compact. The guidance also asks the countries to show how these strategic goals are related to the economic growth and poverty reduction of the country. MCC's November 2005 *MCC Compact Assessment and Approval Guidelines* more specifically indicates that MCC will assess how the project addresses compact goals. However, MCC issued the

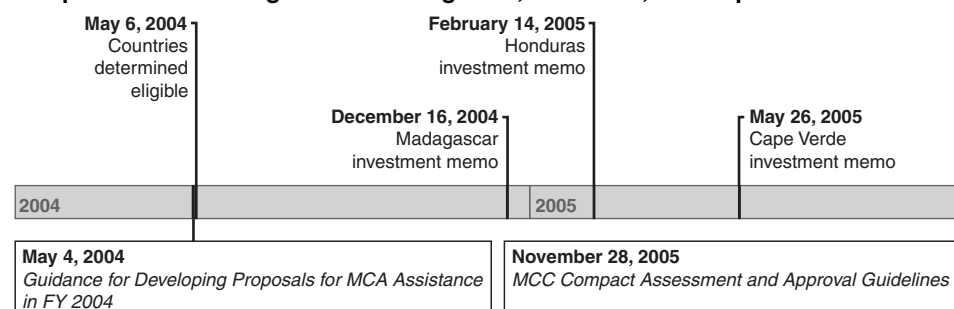
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<sup>18</sup>MCC also had various concerns about these projects, including who would likely benefit from them. MCC considered these projects appropriate for private sector funding. MCC also stated that some Honduran government officials had conflicts of interest related to these projects. For example, the then President of Honduras was the founder of a preschool foundation, and a cabinet minister had financial interests in the Tela Bay project.

<sup>19</sup>Additionally, according to MCC officials, MCC chose not to work on electricity in Cape Verde because of problems stemming from the privatization effort that had taken place in the electricity sector. MCC had asked the Cape Verde government to address these problems related to the privatization.

November 2005 guidance after completing its due diligence for the three countries.<sup>20</sup> (See fig. 6.)

**Figure 6: Issuance of Key MCC Criteria for Project Coherence Relative to Completion of Due Diligence for Madagascar, Honduras, and Cape Verde**



Source: GAO analysis of MCC data.

## MCC Screened Projects for Environmental and Social Impact, Conditioning Funding on Detailed Assessment

MCC's due diligence for the three countries included a review of the probable environmental and social impact of projects that met its economic analysis and other criteria.<sup>21</sup> For projects that it deemed likely to cause adverse environmental and social impact, MCC required impact assessments or environmental analyses, including an impact management plan.

On the basis of its assessment, MCC assigned each project to category A, B, or C during due diligence to reflect its likely impact and assessments

<sup>20</sup>MCC's April 2005 *Guidelines for Economic Analysis* states MCC's intention to "assess a project's logic and potential impact on economic growth and poverty reduction [and] to test claims of the necessity and sufficiency of project components in achieving the overall objective and to examine critical linkages and dependencies." However, this guidance was issued after MCC finished due diligence for Madagascar and Honduras and 1 month before it completed due diligence for Cape Verde.

<sup>21</sup>In its interim *Environmental Guidelines*, issued in March 2005, MCC defines "environmental impact" as the effects of a project on the surrounding natural environment and on the humans reliant on that environment, including the effects on cultural property, indigenous peoples, and involuntary resettlement, as well as impact on human health and safety. In its January 2006 *Environmental Guidelines*, MCC provides the same definition for "environmental and social impact." MCC added that environmental impact may also include significant induced, indirect, and cumulative impact and reasonably foreseeable effects that may be associated with, or ancillary to the project.

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### MCC's Environmental Impact Categories

In its interim *Environmental Guidelines*, MCC assigned the following categories to projects on the basis of their potential environmental impact:

**Category A** projects are likely to cause significant adverse environmental impacts that affect broad or sensitive areas. MCC requires an Environmental Impact Assessment to evaluate potential environmental risks and impacts for such a project.

**Category B** projects are likely to cause environmental impacts that are site-specific, less likely to be irreversible, and for which mitigation measures are more readily available. MCC may require specific environmental analyses, if needed. The scope of such work will be narrower than for category A projects.

**Category C** projects are unlikely to have adverse environmental impacts; however, MCC may require environmental analyses, if needed.

Source: MCC.

required.<sup>22</sup> For example, MCC assigned all projects in the Madagascar proposal to category C, because MCC determined that these projects were not likely to have adverse environmental and social impact. In contrast, MCC assigned infrastructure projects in Cape Verde's and Honduras's proposals to category A or B. For example, the highway expansion project in Honduras was assigned category A, because it involves the clearing of rights-of-way that will require compensation for more than 200 affected people. The port expansion project in the Cape Verde proposal was also assigned to category A, because it entails dredging and construction in and around an existing port.

Additionally, MCC assessed whether environmental impact assessments had been conducted for category A or B projects. For projects lacking environmental impact assessments, MCC conditioned project funding on the completion of such assessments as well as on the development of mitigation plans in consultation with affected groups. For projects that other organizations had assessed for environmental impact, MCC used a U.S. agency or a contractor to evaluate the assessment and determine its adequacy. For example, in Honduras, another donor had already conducted the environmental impact assessment for the highway segments proposed for MCC funding. As part of MCC due diligence, the U.S. Army Corps of Engineers reviewed these assessments and made recommendations that were incorporated in the existing assessments. However, in Cape Verde, the MCC contractor conducting due diligence found another organization's assessment of the port project's environmental impact to be inadequate. As a result, MCC required a new environmental assessment, along with plans to manage adverse impact, as a precondition for funding the project. MCC has allocated funds for this analysis in the compact budget for Cape Verde.

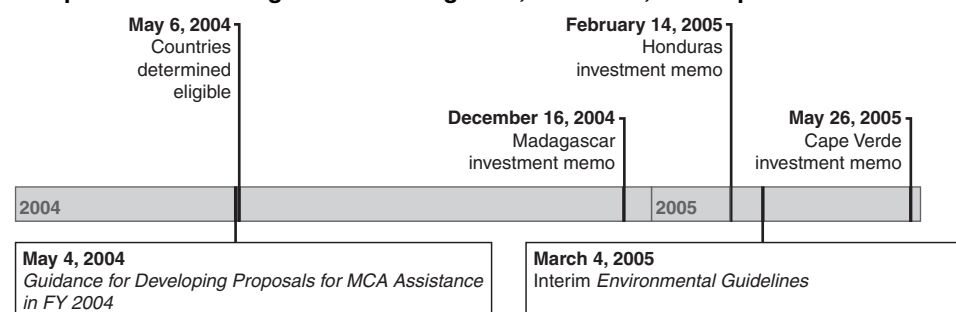
MCC's 2004 proposal development guidelines do not address projects' environmental and social impact. In assessing environmental impact, MCC applied criteria from the Millennium Challenge Act of 2003, which prohibits MCC from funding projects that are "likely to cause a significant environmental, health, or safety hazard." MCC also used criteria laid out in its March 2005 interim *Environmental Guidelines*, which state that MCC will not fund projects that lack the appropriate screening or analysis for

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<sup>22</sup>MCC's 2006 *Environmental Guidelines* assign proposed projects to category D if they involve an intermediate facility, such as a grant fund, that will be used later to finance activities that may have adverse environmental and social impact.

environmental impact.<sup>23</sup> The guidance also states that the country has primary responsibility for conducting and monitoring environmental assessments. (See fig. 7.)

**Figure 7: Issuance of Key MCC Criteria for Environmental Impact Relative to Completion of Due Diligence for Madagascar, Honduras, and Cape Verde**



Source: GAO analysis of MCC data.

### MCC Evaluated Country Commitment and Capacity and Estimated Project Impact to Assess Sustainability

In keeping with its emphasis on sustainable progress, MCC’s due diligence examined whether the three countries’ proposed projects could be sustained after their compacts expired. In assessing project sustainability, MCC reviewed each country’s policy and regulatory environment and commitment to reforms and financing of future maintenance costs; it also reviewed expected results from MCC-funded projects. In addition, MCC considered the countries’ institutional capacity to sustain proposed projects as well as other donors’ roles in strengthening countries’ capacity.

- Country commitment.** For specific projects in Madagascar, Honduras, and Cape Verde, MCC reviewed policy or regulatory reforms, and host country financial commitment, and required some changes or commitment as a precondition to funding. For example, MCC determined that agricultural projects proposed by Cape Verde and Honduras would not be sustainable without the governments’ commitment to policy reform. To ensure adequate operations and maintenance of proposed irrigation systems, MCC required that the Cape Verde government implement fees that reflect the costs of scarce water resources and recommended that the Honduran government also

<sup>23</sup>The final *Environmental Guidelines* were issued in January 2006.

#### USAID- and MCC-Funded Business Centers



Source: GAO.

USAID- and MCC-funded business centers are colocated in Antsirabe, Madagascar.

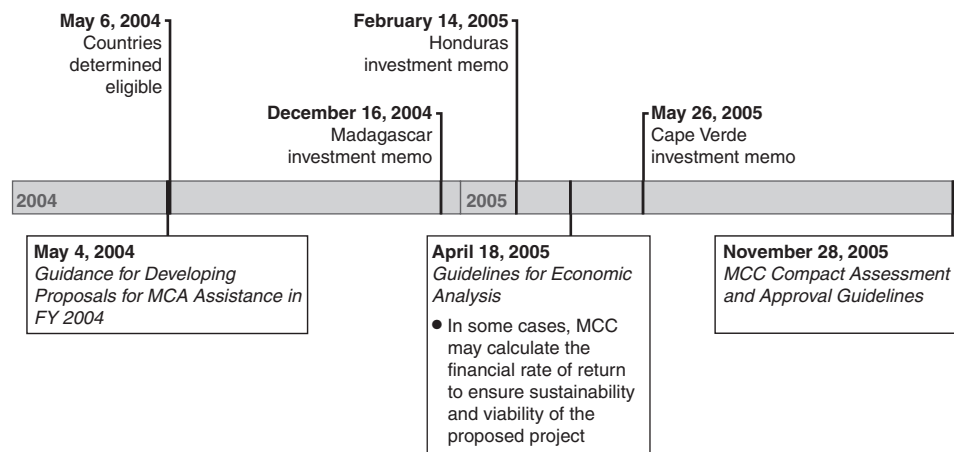
The USAID-funded program supports farmers' access to markets and provides linkages to large businesses. The MCC-funded program will focus on technical assistance to farmers and make them creditworthy. These farmers may seek help from the USAID project later. The USAID project is expected to share its existing client list with and introduce these clients to the MCC program. Although USAID and MCC projects are considered complementary, there is a perception that MCC is replacing USAID. This perception is strengthened by the fact that USAID is losing about one-third of its employees in Madagascar, according to U.S. officials with whom we spoke.

institute such reforms. In the case of Madagascar, MCC reviewed policy reforms in land management and financial sectors that would benefit MCC-funded activities.

- *Country capacity.* In Madagascar, MCC determined that the government had limited institutional capacity to achieve the project objectives of increasing land security and promoting financial intermediation to increase rural savings and extension of credit. To build the government's capacity, MCC budgeted funding for (1) staff recruitment and training at Madagascar's land management department to support the land security project and (2) finance, management, and production training for rural producers and microfinance institutions to support the financial intermediation project. In addition, MCC considered the role of other donors in strengthening the countries' institutional capacity. For example, while assessing road projects, MCC considered the World Bank's road sector initiative, which includes institutional capacity-building in Cape Verde. In Honduras, MCC considered World Bank-funded and Inter-American Development Bank-funded programs intended to develop the transportation ministry's management capacity and maintenance contracting capacity.
- *Project impact.* MCC also relied on the assumptions used in its analysis of projects' economic impact to determine the sustainability of agricultural sector projects for all three countries we reviewed. For example, MCC expects that as a result of MCC-funded technical assistance or credit to farmers and rural entrepreneurs, recipients will be able to generate enough income to afford these services by paying fees to providers. In cases where sustainability depends on achieving MCC's projected impact, the soundness of MCC's economic analysis, discussed in the next section of this report, will also be an important factor.

In its sustainability assessments, MCC generally adhered to guidance issued in 2005, rather than to guidance from 2004. MCC's May 2004 proposal development guidance included a general requirement for a strategy to sustain progress after the compact's expiration. MCC's November 2005 *MCC Compact Assessment and Approval Guidelines* did not require such a strategy, but the guidelines required identification of factors contributing to institutional and financial sustainability for each project. (See fig. 8.)

**Figure 8: Issuance of Key MCC Criteria for Project Sustainability Relative to Completion of Due Diligence for Madagascar, Honduras, and Cape Verde**



Source: GAO analysis of MCC data.

### Limitations in Assumptions and Data, as Well as Country Involvement, Affected the Accuracy of Economic Analyses

During its due diligence reviews for Madagascar, Cape Verde, and Honduras, MCC analyzed proposed projects' probable impact on the country's economic growth and poverty reduction.<sup>24</sup> This analysis was intended both to assess whether these projects would achieve MCC's goals and to provide a basis for monitoring their progress and evaluating their impact.

To predict each project's impact on economic growth, MCC calculated an economic rate of return (ERR)—that is, the expected annual average return to the country's firms, individuals, or sectors for each dollar that

<sup>24</sup>MCC regards the promotion of economic growth as being closely linked to the reduction of poverty, its other key objective. MCC cites, as one source that investigates the two objectives' relation, *Pro-Poor Growth in the 1990s: Lessons and Insights from 14 Countries*, a study coauthored by Agence Française de Développement, Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung, U.K. Department for International Development and the World Bank (available at [http://siteresources.worldbank.org/INTPGI/Resources/342674-1119450037681/Pro-poor\\_growth\\_in\\_the\\_1990s.pdf](http://siteresources.worldbank.org/INTPGI/Resources/342674-1119450037681/Pro-poor_growth_in_the_1990s.pdf)).

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MCC spends on the project.<sup>25</sup> In calculating projects' ERRs,<sup>26</sup> MCC used an economic model that includes the following elements (see fig. 9):

- MCC's annual expenditures for the project,
- the project's annual benefits to the country,
- predicted net benefits<sup>27</sup> of the project, and
- the projected ERR.

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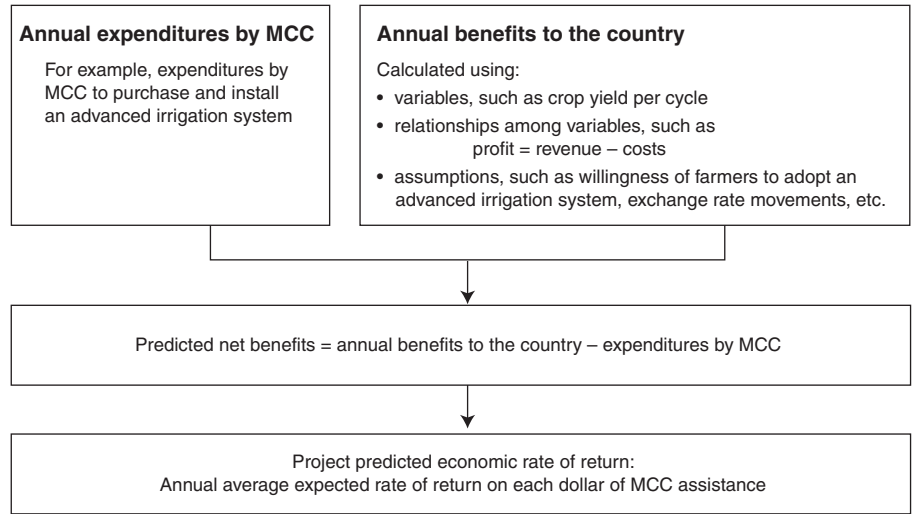
<sup>25</sup>The following is a simplified example of how an ERR is calculated: If MCC spent \$100,000 on a project in year 1 and expected that the project would yield net benefits of \$120,000 in year 2, the project's ERR for year 1 would be  $(120,000-100,000)/100,000=0.2$ , or 20 percent. Technically, the ERR of a project is the discount rate (interest rate) at which the present value of the cost stream is equal to the present value of the benefit stream. If ERR computations are not appropriate for a project—such as policy reform at the national level—MCC guidelines describe other methods that can be used to determine project impact. For example, impact on growth can be estimated with statistical analysis using data from other countries or with simulations.

<sup>26</sup>In the case of Madagascar, MCC performed an economic analysis for two out of the three projects, but calculated only a compact-level ERR.

<sup>27</sup>Net benefits include not only net income but also imputed benefits, such as spillovers.



**Figure 9: Illustration of MCC's Methodology for Calculating an Economic Rate of Return: Advanced Crop Irrigation Project**



Source: GAO analysis of MCC data.

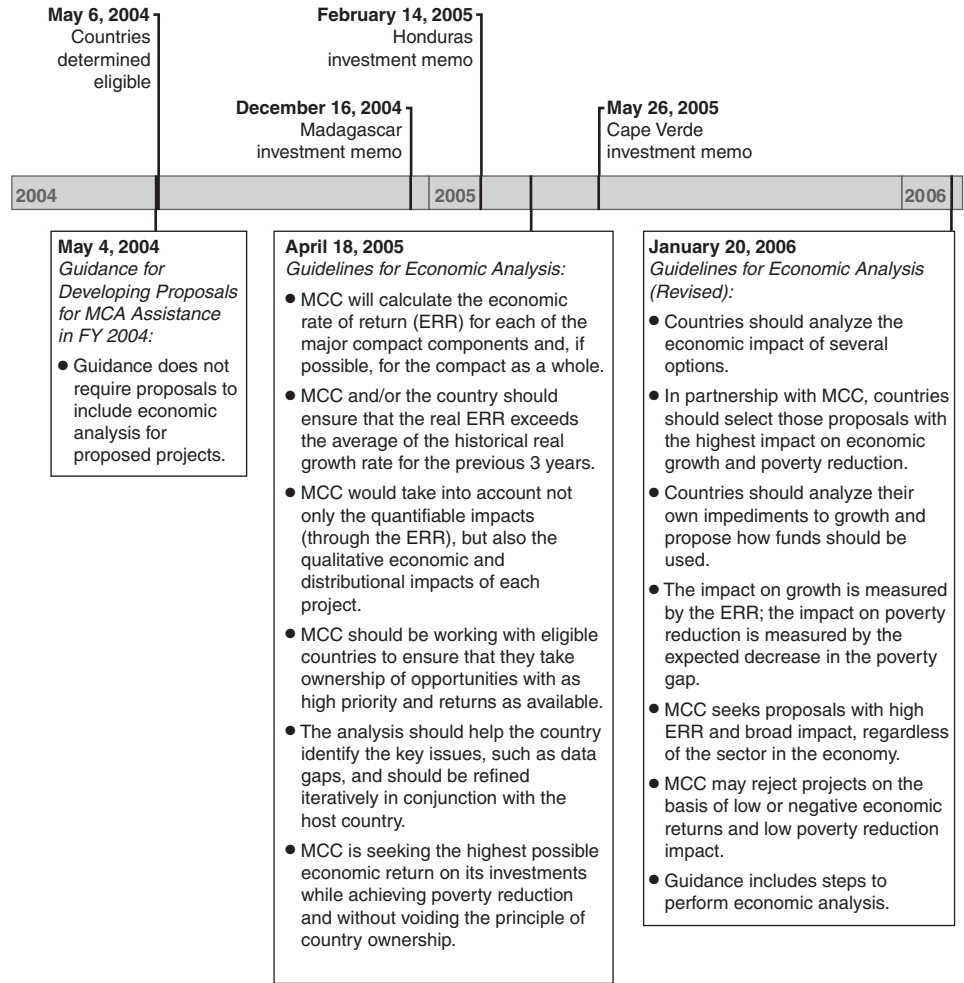
ERRs for the proposed projects in Madagascar, Cape Verde, and Honduras varied considerably, ranging from 116 percent for Madagascar's land titling project to 10 percent for a watershed management and agriculture support project in Cape Verde;<sup>28</sup> the median ERR for projects in the three countries was 14 percent. However, because MCC analyzed the Madagascar and Honduras proposals before publishing its first set of economic analysis guidelines, the ERRs did not significantly affect those countries' overall choice of projects. (See fig. 10.)<sup>29</sup> MCC's finding of a low ERR for part of Cape Verde's watershed management and agriculture support project resulted in the country's dropping an irrigation activity on one island.

<sup>28</sup>Economic analyses of similar projects in two countries may have both common and country-specific elements. For instance, the analyses of transportation projects in Cape Verde and Honduras share some common elements—reduction in vehicle operating costs and increase in annual daily traffic. However, because the Cape Verde project was also aimed at alleviating bottlenecks caused by the absence of all-weather crossings, income loss from the transportation blockage, which would be eliminated with the new bridges, was included in a broader measure of net benefits.

<sup>29</sup>According to MCC officials, the ERR for all activities that were assessed during due diligence was above the threshold set in the guidelines.



**Figure 10: Issuance of Key MCC Criteria for Economic Analysis Relative to Completion of Due Diligence for Madagascar, Honduras, and Cape Verde**



Source: GAO analysis of MCC data.

Note: The 2006 guidance states that because of economic analyses' confirmed tendency to be overly optimistic about project benefits, MCC prefers that evidence about project impact be based on evaluations of similar, completed projects. For a discussion of the accuracy of such economic analyses, see Gerhard Pohl and Dubravko Mihaljek, "Project Evaluation and Uncertainty in Practice: A Statistical Analysis of Rate-of-Return Divergences of 1015 World Bank Projects," *World Bank Economic Review*, Volume 6 (1992): 255-277. With respect to poverty reduction, the guidelines state that poverty reduction should be measured by the expected decrease in the poverty gap, defined simply as the amount of money that, when transferred to poor people, brings everyone's income up to the poverty line.

We found limitations in the assumptions and data that MCC used in its analyses as well as in the countries' involvement in the analyses. These

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limitations may negatively affect the accuracy of the analyses and the countries' understanding of the analysis process, respectively.

- *Assumptions and data.* Some of the assumptions and data that MCC used in its analyses do not fully reflect the countries' socioeconomic environment. As a result, MCC cannot be assured that the projects it approved, partly on the basis of these analyses, will achieve the compacts' goals. For example, in calculating the ERR for the Madagascar land titling project, MCC assumed that local small farmers would use newly titled land as collateral for loans, invest the borrowed funds in agricultural activities, and benefit from the increased income from those activities. We discussed this assumption with focus group participants in Madagascar, including MCA and U.S. government officials, senior Madagascar government officials representing ministries affected by the compact, and bank representatives. Our discussions suggested that MCC's analysis may have been overly optimistic in assuming that small farmers would mortgage 40 percent of their newly titled land in Madagascar's uncertain market, which does not offer insurance.<sup>30</sup> While MCC assumed that 40 percent of the newly titled land will be collateralized, focus group participants believed this was overly optimistic. As a result, MCC may have calculated an unrealistically high ERR for the land titling project. Furthermore, the project may be more likely to benefit farmers with large, secure

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<sup>30</sup>In Madagascar, where prevailing land tenure practices do not provide the titles needed for mortgage transactions, 80 percent of the households own 20 percent of rural cultivated land, and 48 percent of the population is illiterate. In 1999, the poverty rate for individuals owning 0.001 to 0.09 hectares of land was 91.7 percent. The richest families own 3.7 times more agricultural rural land than the poorer families. Furthermore, interest rates are high; for example, in December 2004, the Central Bank charged a base rate of 14 percent to 18 percent.

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landholdings and investors from outside the farming community, rather than the local small farmers it was intended to help.<sup>31</sup>

Similarly, MCC's economic model for a part of Madagascar's finance project, the modernization of the National Savings Institution, may not accurately reflect the institution's financial condition. MCC's model for the institution's modernization uses the institution's April 2003 net profits (1.4 billion Malagasy francs) as a baseline for estimating the benefits of computerizing the bank. However, according to institution officials, 2003 is not a representative year for the bank, and it experienced unusually large net losses (13 billion Malagasy francs) after an economic crisis in 2002. As a result, MCC may have inaccurately estimated the project's likely impact on the banking system.

- *Country involvement.* In the two countries we visited, country representatives were not closely involved in MCC's economic analyses of the proposed projects. This constrained the contribution of the analysis process to enhancing country partnership, and stakeholders' understanding of MCC's economic analysis—including the data analyzed, assumptions used in the analysis, and the expected outcomes. According to country officials in Madagascar and Cape Verde, MCC developed the economic models and selected data with little assistance from country representatives. According to the Cape Verde proposal team, they provided some data but did not participate in the actual analysis and did not have a clear understanding of the process and the criteria MCC used to assess proposed projects. We discussed these issues with MCC officials, who told us that the countries' degree of involvement depended on the capability and willingness of the

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<sup>31</sup>Several studies suggest that, given a real threat of foreclosure and land loss and an uncertain environment without insurance markets, the impact of land titles on individual investment incentives and productivity is likely to be greater for the wealthy farmers whose landholdings and other assets will enable them to benefit from capital markets. In addition, customary land tenure most often provides security of tenure. However, major threats to such security often come from outside investors seeking land with the backing of the state. Thus, land titling, if misused, may become a tool for land grabbing by official elites. See Jolyne Melmed-Sanjak and Susana Lastarria-Cornhiel, "Land access, off-farm income and capital access in relation to the reduction of rural poverty," *Land Reform*, Volume 1 (1998): 4-18 (available at <http://www.fao.org/sd/LTdirect/LTan0023.htm>); M. Carter, K. Weibe, and B. Blarel, "Tenure security for whom? Differential impacts of land policy in Kenya," Research Paper No. 106 (Madison, WI: University of Wisconsin (1991)); and John W. Bruce and Shem Migot-Adholla, eds. *Searching for Land Tenure Security in Africa* (Dubuque, IA: Kendal/Hunt Publishing Company (1994)).

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countries' proposal development team to actively participate in the analyses.

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**MCC-Approved Compact Implementation Structures Are Not Yet Complete; Weaknesses in Monitoring and Evaluation Framework May Limit Measurement of Results**

MCC gave Madagascar, Cape Verde, and Honduras authority to propose and develop the implementation structures that they will use to manage compacts, although MCC retains authority over a number of management decisions. To govern their programs, the countries have created management units under the direction of a steering committee, but they have had difficulty in filling key positions. The countries also have established structures for ensuring fiscal accountability and for managing procurements that appear to be effective; however, implementation is still at a very early stage, and some required elements of these structures are not yet in place. Finally, the countries have established frameworks for monitoring and evaluating the performance of MCC projects. However, the frameworks have weaknesses related to the inadequacy of baseline data, linkage of monitoring plans with economic models, methods of addressing uncertainty in achieving stated targets, and the timeliness of research designs for randomized controlled trials. These weaknesses may limit MCC's ability to track and account for program results.

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**Countries Manage Projects with MCC Review, but Have Faced Delays in Staffing Oversight and Management Structures**

MCC has established a limited presence in Madagascar, Cape Verde, and Honduras and has approved oversight and management structures that allow the countries to direct their compact programs, subject to MCC review. However, these structures were not fully staffed until months after the countries' compacts entered into force. According to MCC officials, the delay in staffing has shortened the available time in which to achieve compact goals. MCC has adopted a policy that implements its authority to provide funding to hire officials prior to compact signature, which may reduce delays in hiring in the future.

**MCC Has Oversight Staff in Each Country, while Countries Retain Management Responsibility**

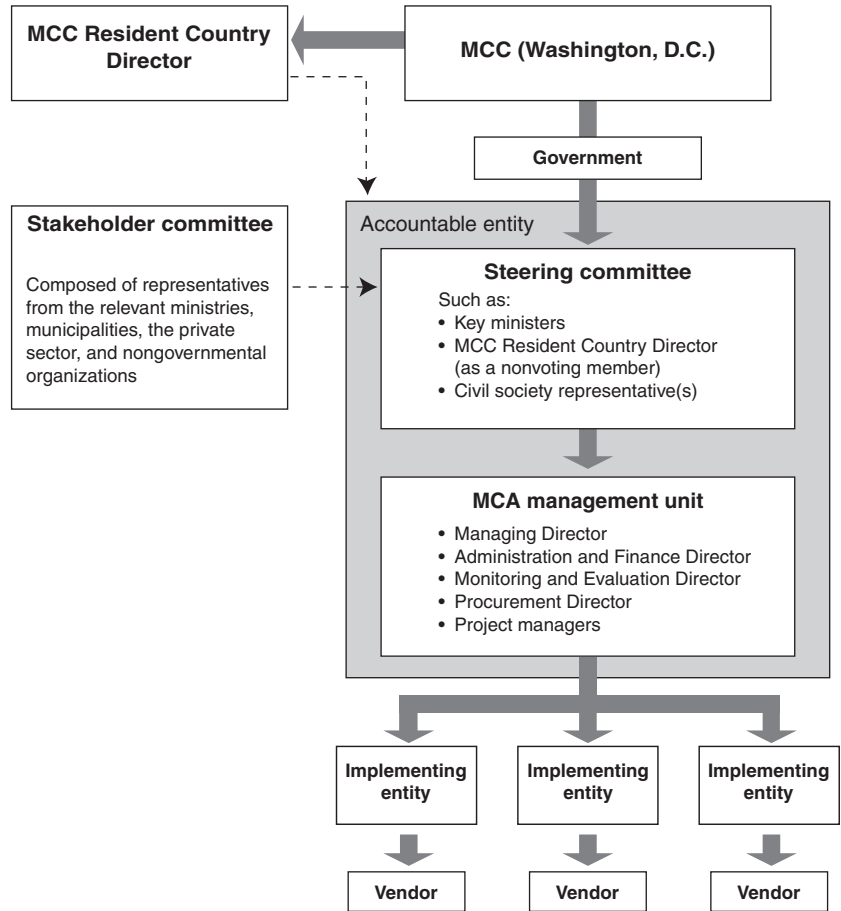
Although MCC maintains a limited presence in each country and retains some review and approval authorities, the countries have authority to manage and oversee the compact program using MCC funds. In each country, MCC has directly hired a resident country director and a small staff. The director serves as MCC's public face and manages its relationship with the compact country, guiding and overseeing the country's efforts to complete needed plans and reports, implement accountability mechanisms, and make appropriate use of resources. The director also supervises management of the MCC office and staff, site visits by MCC staff and

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technical teams, and engagement with MCC headquarters. MCC retains authority and approval over several key elements, including quarterly disbursements, plans such as those for monitoring and evaluation, procurements above certain thresholds, and the hiring of key employees. According to MCC officials, resident country directors review matters that require MCC approval, sometimes making a recommendation, before forwarding the matters to MCC headquarters.

Each of the three countries has established structures to provide oversight and management of their compact programs and to ensure stakeholder input (see fig. 11). Although these structures have most elements in common, the countries have the flexibility to design these structures to fit their needs.

**Figure 11: Compact Country Oversight and Management Structure**



--> Feedback/Advice

➔ Oversight

Source: GAO analysis of MCC data.

Note: This figure represents a composite of the Madagascar, Cape Verde, and Honduras oversight and management structures. However, in Honduras, stakeholder input is obtained through representatives on the steering committee, rather than through a stakeholder committee.

The three countries have generally included the following three key oversight and management entities in their structures:

- The *steering committee* represents the country government and interfaces directly with MCC. The committee is ultimately responsible

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for the oversight and results of the MCC compact, oversees management unit employees, and approves and signs off on key decisions and reporting to MCC. Steering committee members vary by country but have included government executives, such as representatives of the Prime Minister's office; representatives of key ministries affected by compact projects; and representatives of stakeholder groups, such as civil society and the private sector. The MCC resident country director serves as a nonvoting member of the steering committee. According to MCC guidelines, MCC must approve the individual members of the steering committee.

- In Madagascar and Cape Verde, a *stakeholder committee* meets periodically to advise and inform the steering committee regarding compact implementation and to serve as the official liaison between interested parties and the steering committee. Stakeholder committee members include representatives of civil society, the private sector, and NGOs. MCC approves the type of organization that should be represented on the committee (e.g., civil society) but does not approve the specific individuals. MCC reserves the right to approve all changes in the committee's membership.
- The *management unit* is directed by the steering committee and has principal responsibility for overall compact management and implementation.<sup>32</sup> The compact lists key management positions responsible for daily program operations. The steering committee hires

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<sup>32</sup>Several papers written by members of the development community have identified limitations to capacity development resulting from the use of project implementation units (PIU), which are similar to MCC's management units. While PIUs seem to benefit from short-term efficiency in service delivery, the model does not fare well when it comes to building long-term capacity in developing countries. Critics view PIUs as parallel and insular structures that do not promote skills transfers to host governments. The skills and abilities that staff develop on one PIU-managed project tend to be lost to the host government when the staff accept positions with the next donor-funded project. See John Lawrence, Sarah Renner, and Jan Vandemoortele, *The PIU Dilemma: How to Address Project Implementation Units*, UN Development Program (September 2003); UN Development Program, *Background Note on Preparation of Guidelines on Strengthening Country Capacity for Financing, Implementing, and Managing Development Programs* (Feb. 7, 2005); and World Bank, *Guidance Note for Project Management: Strengthening Institutional Capacity during Project Implementation* (October 2005).

employees for these positions, but MCC retains the authority to approve the country's choices.<sup>33</sup>

**Oversight and Management Entities Have Faced Staffing Delays**

In each of the three countries, key compact management positions have remained unfilled after the compacts have entered into force. Madagascar and Cape Verde did not hire key officials until several months after their compacts' entry into force in July and October 2005, respectively. As of April 2006, Honduras's hiring of key officials was not yet complete, although the compact entered into force in September 2005. (See table 1.) This incomplete staffing at entry into force limits the ability of the countries to achieve their compact objectives within the fixed time period of the compacts.

**Table 1: Hiring Dates for Key Positions Identified in Madagascar, Cape Verde, and Honduras Compacts, as of April 2006**

Key position	Hiring date		
	Madagascar (entry into force July 27, 2005)	Cape Verde <sup>a</sup> (entry into force Oct. 17, 2005)	Honduras (entry into force Sept. 29, 2005)
Managing director: Responsible for the overall operation of the management unit, including all communications with third-parties and the public, including other donors. Certifies all quarterly financial and performance reports, budgets, and any other documents presented to the steering committee.	Incumbent participated in compact development and served as interim director prior to being confirmed on November 22, 2005.	January 1, 2006	The first person to hold this position, from November 2005 to March 2006, left after the change in ruling party from the January elections. The current managing director was hired March 6, 2006.
Manager of administration and finance: Responsible for ensuring that reporting is prepared, and that all accounting records are maintained in a form acceptable to MCC.	November 22, 2005	March 1, 2006	April 10, 2006
Manager of procurement: <sup>b</sup> Serves as a liaison with the procurement agent and for the preparation of periodic reporting to the steering committee regarding procurement activities.	November 22, 2005 <sup>c</sup>	January 1, 2006	Selection in progress.

<sup>33</sup>To date, MCC has objected only once to a country's choice, during the hiring of an environmental and social assessment manager for one of the countries.



(Continued From Previous Page)

Key position	Hiring date		
	Madagascar (entry into force July 27, 2005)	Cape Verde <sup>a</sup> (entry into force Oct. 17, 2005)	Honduras (entry into force Sept. 29, 2005)
Manager of monitoring and evaluation: Responsible for setting up the data collection, analysis, and reporting systems for the overall program, and, in turn, for training and assisting project managers in their implementation project monitoring systems for each project.	January 19, 2006	January 1, 2006	Selection in progress.
Manager of environmental and social assessment: Ensures that environmental and social mitigation measures are followed for all activities of the program, in accordance with the provisions set in the compact and other documents.	Position does not exist at MCA-Madagascar.	March 1, 2006	April 1, 2006
Managers of individual compact projects: Project managers should have sectoral expertise relevant for their respective projects. Project managers are responsible for the day-to-day oversight and management of implementing entities. <sup>d</sup>	Land Tenure: Incumbent participated in compact development and served as interim manager prior to being confirmed on November 22, 2005.  Finance: November 22, 2005  Agricultural Business Investment: November 22, 2005. A new manager took over this position on January 19, 2006.	Watershed Management and Agricultural Support: January 1, 2006  Infrastructure: January 1, 2006  Private Sector Development: January 1, 2006	Rural Development: Selection in progress.  Transportation: April 1, 2006

Source: MCC compacts and hiring data.

<sup>a</sup>According to MCC, in Cape Verde, some of the key staff “became engaged” shortly after Compact signature—though the hiring process was not complete. These positions, including the senior economist, project managers, and monitoring and evaluation manager, were retained through a provisional employment contractual arrangement made with the Ministry of Finance.

<sup>b</sup>This position is referred to as the “procurement specialist” in Honduras.

<sup>c</sup>Incumbent serves as manager of procurement and of administration and finance.

<sup>d</sup>The Cape Verde compact, for example, defines an “implementing entity” as a government affiliate, nongovernmental organization, or other public or private sector entity or persons to which MCA-Cape Verde may provide funding, directly or indirectly, to implement or carry out the projects or any other activities in furtherance of the compact.

The apparent reasons for these difficulties in hiring key personnel vary by country. For example:

- In Madagascar, according to U.S., MCC, and country officials, finding technically qualified candidates for key positions has presented a challenge compounded by competition for their availability. According

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to the Managing Director of MCA-Madagascar, hiring her MCA team was difficult because “all the good people in Madagascar are taken.”

- In Honduras, a postelection change in government has delayed staffing the program management unit. After a recent national election, the director of the management unit resigned to allow the new administration to appoint a director. According to MCC, all other management unit staff appointed under the previous government have been retained.
- In Honduras, the monitoring and evaluation director position and one of the project director (Rural Development) positions have been difficult to fill. MCA-Honduras recompetes both of these positions because the first attempt did not produce suitable candidates.

In October 2005, after the signature of its first six compacts, MCC adopted a policy implementing the authority given it by section 609(g) of the Millennium Challenge Act of 2003 to make grants to facilitate the development and implementation of compacts. MCC’s policy includes a provision where, if certain conditions are met, it may fund an eligible country’s request for “management support payments” for salaries, rent, and equipment for the country’s MCA technical team prior to compact signature. MCC has used this authority in four countries. Experienced officials may therefore be hired and in place prior to compact signature and the delays in hiring may be reduced in the future.

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### MCC Has Made Progress in Ensuring Fiscal Accountability, Although Countries’ Systems Are Still Being Developed

MCC has established a framework of internal controls to incorporate fiscal accountability into compacts between MCC and recipient countries. The MCC fiscal accountability framework includes an accountable entity (MCA), which is responsible for internal control and at least an annual audit of the program’s financial and procurement transactions, with semiannual audits initially expected for countries starting implementation.<sup>34</sup> MCA-Madagascar and MCA-Cape Verde both have made

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<sup>34</sup>As defined for MCC programs, “fiscal accountability” is the assurance that funds are managed properly and procurements are undertaken in a fair, open, and transparent manner. “Internal control” is an integral component of an organization’s management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with laws and regulations. See GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

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significant progress in implementing the framework's internal controls.<sup>35</sup> However, MCA-Madagascar's newly formed system is somewhat less mature than that established by MCA-Cape Verde. While MCA-Madagascar has established internal control processes, some processes that are routinely practiced are not formally documented, and it has not yet converted to a fully automated financial management system. MCA-Cape Verde was established partly within the country's Ministry of Finance, and it continues to develop internal controls, put in place key finance and administration personnel, and make use of existing information system platforms with the characteristics of advanced and integrated systems. Neither country has yet had an MCA unit in operation long enough to require an annual audit, but officials at both MCAs told us that they expected their first audits to be completed within the period established by the MCC IG.

#### MCC Has Made Progress in Fiscal Accountability at the Compact Level

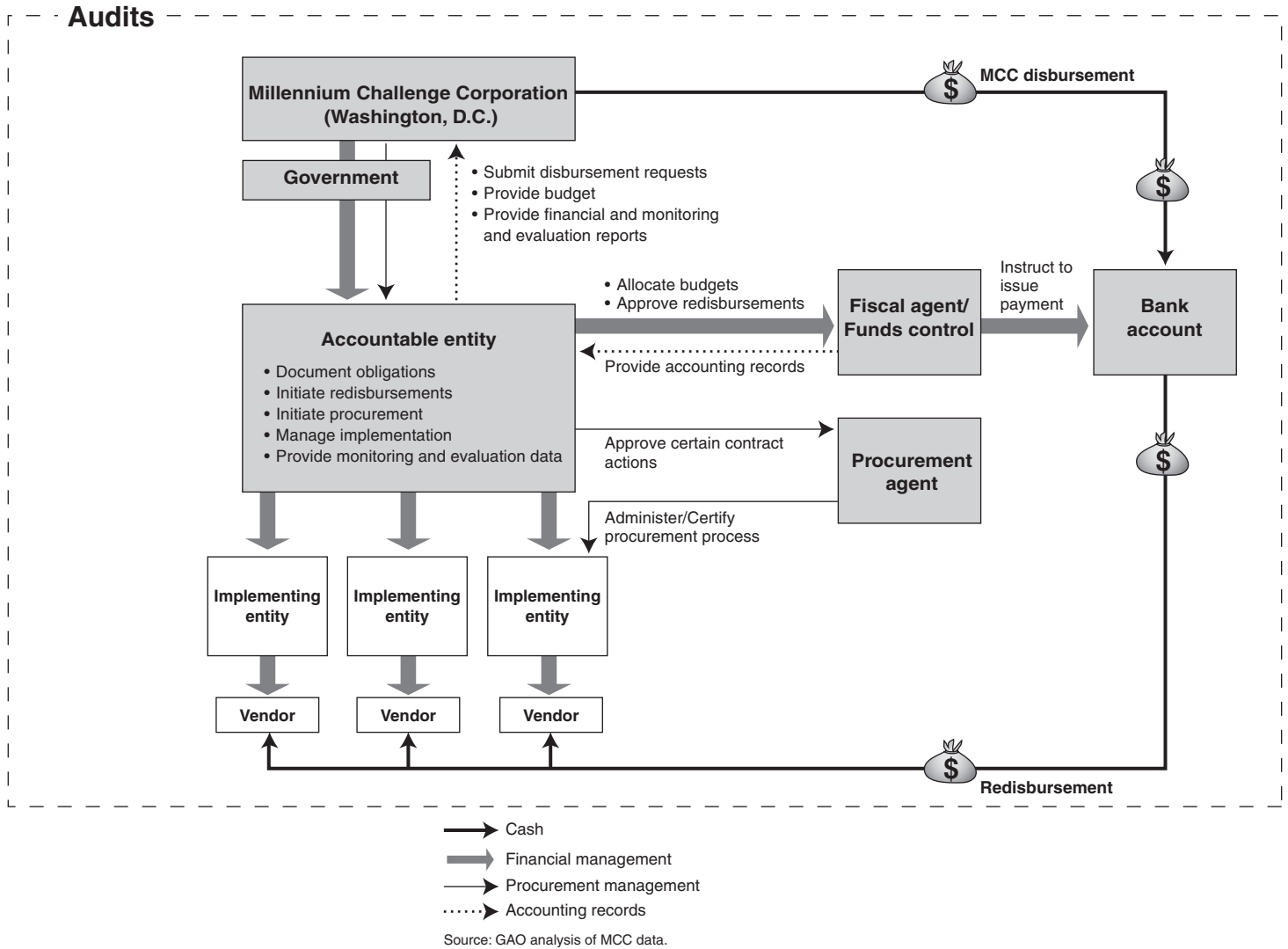
MCC has made progress in defining the mechanisms and processes of internal control that provide reasonable assurance of fiscal accountability at the compact level. MCC incorporated these internal controls into a fiscal accountability framework for the compacts between MCC and recipient countries. To help countries implement this framework, MCC also developed guidance<sup>36</sup> and a series of charts that identify the characteristics of each element of the framework, responsibilities of key personnel, and examples of alternative methods of achieving fiscal accountability. Figure 12, which is based on these charts, provides an overall view of the framework.

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<sup>35</sup>We did not evaluate Honduras's implementation of fiscal accountability.

<sup>36</sup>MCC, *MCC Fiscal Accountability Guidelines* (June 14, 2005).

**Figure 12: Elements of the MCC Fiscal Accountability Framework**



Although MCC identifies the country’s government as ultimately responsible for meeting its fiscal accountability requirements, the country’s accountable entity is responsible for ensuring that basic internal control functions—such as funds control and documentation, cash management, disbursement controls, and timely and meaningful reporting—are

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established as specified in the country's compact.<sup>37</sup> The fiscal accountability framework also requires that the accountable entity obtain at least an annual audit of financial and procurement transactions.

Each country's compact requires the accountable entity to develop its own fiscal accountability plan (FAP), which typically includes a transparent process for ensuring that open, fair, and competitive procedures will be used to administer grants or cooperative agreements and procurement. Required elements of the FAP include funds control, internal controls, accounting standards and systems, reporting, public availability of financial information, cash management, procurement and contracting, the role of independent auditors, and the roles of fiscal and procurement agents.

**MCA-Madagascar and MCA-Cape Verde Have Implemented Internal Controls for Fiscal Accountability, but Their Systems Are Not Yet Fully Developed**

MCA-Madagascar and MCA-Cape Verde have made significant progress in implementing internal controls for fiscal accountability, although their systems are not yet mature or fully developed. In line with their compacts and supplemental agreements with MCC, both countries have put in place such elements of the fiscal accountability framework as bank agreements, fiscal agents, procurement agents, and financial reporting mechanisms; however, controls called for in the framework, such as proper and consistent accounting and authorization of transactions, are still in development. Because the controls are not yet fully operational, we focused on those that have been put in place in relation to an internal control maturity model that provides a scale of development.<sup>38</sup> We found that both MCAs differ in the maturity of their internal controls. Madagascar is using a newly formed entity; therefore, the maturity of MCA-Madagascar's internal control is still at a developing stage. MCA-Cape Verde used an existing government institution with established processes and systems as the accountable entity and, therefore, represents a higher level of internal control maturity. Neither country has yet been required to provide any financial statement audits, but officials at both MCAs told us that they expected their audits to be completed within the period specified in their compacts.

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<sup>37</sup>*MCC Fiscal Accountability Guidelines.*

<sup>38</sup>The internal control maturity continuum developed by the independent risk consulting company, Protiviti, Inc., provides a scale for evaluating the sufficiency of an entity's internal controls. The scale describes the attributes of controls at five levels: initial, repeatable, defined, managed, and optimizing. See *Guide to the Sarbanes-Oxley Act: Internal Control Reporting Requirements*, 3<sup>rd</sup> ed. (2004): 84 ([www.protiviti.com](http://www.protiviti.com)).

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## MCA-Madagascar

Although MCA-Madagascar has established important internal control processes, some have not been formally documented, and processes in several areas are in the early stages of development. (See table 2.) The government of Madagascar proposed, and MCC agreed, to establish MCA-Madagascar as a new unit of government with the sole purpose of managing implementation of the MCC compact. The MCA has established finance and administrative operations based on the MCC fiscal accountability framework, with segregation of duties<sup>39</sup> over such functions as work-order approval, vendor selection, and authorization to disburse funds. Standard operating procedures for these processes are outlined in the MCA's FAP, which was approved by MCC in January 2006. However, the FAP includes limited detail on asset management, and sections in the management of tax exemption, information technology management, communications, and audits serve mainly as placeholders with information "to follow." Although MCA-Madagascar acquired and is testing an automated accounting system, current use of a manually based system leaves operations vulnerable to human omission and error. The FAP makes reference to MCC's procurement agreement guidelines but does not formally incorporate procurement processes.

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<sup>39</sup>Key duties and responsibilities of financial operations need to be divided, or segregated, among different members of the staff to reduce the risk of error or fraud. This should include separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling any related aspects. No one individual should control all key aspects of a transaction or event. See [GAO/AIMD-00-21.3.1](#).

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**Table 2: Status of MCA-Madagascar Internal Controls, as of February 2006**

<b>Internal control</b>	<b>Status</b>
Key capability attributes	<ul style="list-style-type: none"><li>• Overall, a fiscal accountability framework is in place and functioning.</li><li>• The FAP was approved by MCC in January 2006.</li><li>• Duties are segregated, with oversight of fiscal and procurement agent activities performed by MCA-Madagascar officials.</li><li>• Bank agreements have been established.</li><li>• Expenditure process is in place.</li><li>• MCC conducts quarterly visits to review fiscal activities.</li><li>• Staff has been hired.</li></ul>
Control efforts under way	<ul style="list-style-type: none"><li>• Formal documentation that covers the internal control structure for all significant transactions and events (i.e., standard operating procedures) is being developed on the basis of existing documents and practice.</li><li>• Procurement has not yet been formally incorporated into the FAP. At the time of our review, the procurement manual was considered to be an annex to the FAP.</li></ul>
Potential residual risks	<ul style="list-style-type: none"><li>• Accounting system carries the inherent risks of a manually based system.</li><li>• The MCC IG risk assessment of the MCA-Madagascar's financial operations identified high vulnerabilities in several critical areas—procurement, cash management, and disbursements—that may adversely impact financial operations.</li><li>• Lack of a disaster recovery or back-up plan could result in the loss of critical data.</li><li>• Inadequately addressed data security could result in fraud, waste, and abuse.</li></ul>

Source: GAO analysis of MCA-Madagascar systems and documents.

Although internal controls with and without formal documentation were in operation in MCA-Madagascar at the time of our review in February 2006, a risk assessment performed by the MCC IG in December 2005 found vulnerabilities in high-risk areas that could affect the MCA's financial operations. The assessment was performed during MCA-Madagascar's implementation phase to detect early-on any vulnerabilities that could prevent the MCA from establishing effective financial operations. The IG reported that the MCA had high vulnerabilities in several critical areas—including procurement, cash management, and disbursements—that may adversely impact its financial operations, and that it had not implemented

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all of the key controls described in its compact with MCC.<sup>40</sup> The IG also reported that the MCA's FAP was interim and not comprehensive in establishing the internal controls needed to effectively manage the funds provided by MCC.

MCA-Madagascar's internal controls are in development. It is putting in place a control framework defined in MCC's fiscal accountability framework, but the MCA currently has basic internal control policies and processes that are not fully documented or implemented. Due to the developmental stage of MCA-Madagascar's internal controls, residual risks currently exist in its key financial processes and activities.

#### MCA-Cape Verde

MCA-Cape Verde is developing its internal controls on the basis of the Cape Verde government's existing structure and information system platforms, which have the characteristics of advanced and integrated systems (see table 3). The MCA was established in the Ministry of Finance, and management is focused on implementing its interim FAP, which was approved by MCC in December 2005. The MCA is using ministry staff, and most key finance and administration personnel are in place. To support the financial processing requirements set out in Cape Verde's compact, the MCA is also using the ministry's financial management information system and the basic accounting system that the Cape Verde government has used for several years. Cape Verde's fiscal agent, which is responsible for the MCA's financial processing, consists of Ministry of Finance staff with experience in the budget, treasury, and financial processes and in the use of the accounting system. The MCA's expense transaction flows are documented, and key duties and responsibilities are segregated.

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<sup>40</sup>USAID, Office of Inspector General for the Millennium Challenge Corporation, *Risk Assessment of Millennium Challenge Corporation's MCA Madagascar Financial Operations*, Audit Report No. M-000-06-003-F (Washington, D.C.: Mar. 28, 2006).



**Table 3: Status of MCA-Cape Verde Internal Controls, as of February 2006**

Internal control	Status
Key capabilities	<ul style="list-style-type: none"> <li>• Fiscal agent and key finance and administration personnel are mostly in place.</li> <li>• Basic accounting system appears to be fully operational.</li> <li>• The interim FAP is in place.</li> <li>• Transparency of operations is enhanced by Cape Verde’s Web site and management oversight.</li> <li>• Information system platform was preexisting in the Ministry of Finance and is fully operational.</li> <li>• Expenditure flows for MCA office transactions are documented.</li> <li>• Procurement and payment authorizations are segregated.</li> </ul>
Control efforts under way	<ul style="list-style-type: none"> <li>• Currency conversion capability for accounting system is being implemented.</li> <li>• Conversion to commitment-based budgeting system is under way.</li> <li>• Accounting policies and procedures manuals are being formalized.</li> <li>• Outside audit entity is yet to be contracted.</li> <li>• The FAP is being updated and finalized.</li> <li>• Enhanced transparency initiative is to be completed, which includes management tools.</li> </ul>
Potential residual risks	<ul style="list-style-type: none"> <li>• Currency conversion calculations and some conversion schedules are being done manually, which could lead to potential errors or omissions.</li> <li>• Complications may result from converting to an enterprisewide and commitment-based budgeting system.</li> <li>• Potential conflicts of interest could arise due to the different ministries that currently have operational responsibilities and may also participate in the oversight of the effectiveness and efficiency of MCA-Cape Verde’s operations.<sup>a</sup></li> <li>• Lack of a disaster recovery plan could result in the loss of critical data.</li> </ul>

Source: GAO analysis of MCA-Cape Verde systems and documents.

<sup>a</sup>MCC officials have stated that they believe this risk is mitigated through clearly defined roles and responsibilities, autonomy of the ministries, and specific controls over procurement approvals.

MCA-Cape Verde had internal controls across the entity, documented transaction flows, sources of risk identified, and risk-mitigating control processes that were mostly documented at the time of our review. MCA-Cape Verde also had several internal control efforts under way, including the development of policies and procedures manuals. As these efforts continue, the MCA continues to have some residual risks that are related to specific processes.

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Financial Audits for MCA-Madagascar and MCA-Cape Verde

MCA-Madagascar and MCA-Cape Verde are preparing for financial statement audits as required in their compacts. In January 2006, the MCC IG issued guidelines for MCA financial audits and a standard statement of work for the MCAs to use in their financial audits and posted lists of MCC-approved audit firms for Madagascar and Cape Verde.<sup>41</sup> According to MCC IG revised guidance issued in January 2006, compacts are to have an audit completed no later than 90 days after the first anniversary of the entry into force of the compact or such other periods as parties may agree in writing. The MCC IG recently informed us that the audits for MCA-Madagascar and MCA-Cape Verde are to be completed by September 30, 2006, for the period from entry into force until June 30, 2006. The MCC IG also told us that it waived the first audit to be completed for MCA-Madagascar as stipulated in the compact documents because the MCA did not have any financial activity for the period to be audited.

Although we were able to assess the countries' progress in establishing a system of internal controls to provide the financial accountability required by MCC, it is too early to assess the effectiveness of those controls over the funding provided to them. Each country has made progress, but they are at different stages of maturity in their underlying accountability systems, policies and procedures, and internal controls. Oversight mechanisms that support program effectiveness as compact projects disburse funds throughout multiple countries and promote the segregation of procurement and payment processes will be critical for the continual monitoring of progress, the development of key accountability mechanisms that function as intended, and the mitigation of risks to acceptable levels.

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MCC-Approved Country Procurement Systems Have Effective Characteristics, but Are Early in Their Implementation

Consistent with MCC guidance, each of the three countries—Madagascar, Cape Verde, and Honduras—proposed its own procurement system, subject to MCC review and approval during due diligence. Although the approved systems have characteristics that we have found typical of effective procurement systems, their effectiveness has not yet been tested by many procurements. In addition, some of the staff and procedures needed to implement the systems are not yet in place at MCC headquarters or in compact countries.

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<sup>41</sup>MCC IG, *Guidelines for Financial Audits Contracted by MCA* (revised January 2006); "Standard Statement of Work for Financial Audits of Accountable Entities" (revised January 2006); and "Standard Statement of Work for Financial Audits of Covered Providers" (revised January 2006).

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MCC Allowed Countries to Propose Procurement Agents and Systems, but Retained Approval Rights

To capitalize on existing country knowledge and experience, MCC has given the countries flexibility to choose their procurement agents and standards, with the choice subject to MCC approval during due diligence. Madagascar and Cape Verde are using private and public sector procurement agents, respectively, and Honduras is using a combination of public and private sector agents.<sup>42</sup> (See app. IV.) In contrast to donors such as the World Bank, MCC also allowed the countries to propose their own standards for managing procurements.<sup>43</sup> (See app. IV for details of the countries' procurement agents and standards.) MCC required the countries to adhere to "procurement principles" that include equal access to procurements, competition for awards, and transparency of the process.<sup>44</sup> Madagascar, Cape Verde, and Honduras have used either existing World Bank standards or their own laws to govern MCC procurements. In its procurement agreement with each country, MCC included modifications to the country's selected standards to reconcile them with U.S. law and MCC principles. For example, MCC required that countries not include preferences for domestic suppliers in solicitations paid for with MCC funds.

Although MCC's agreements with the three countries give the countries a number of authorities over procurements, MCC retains certain approval rights. MCC's fiscal accountability framework describes procurement as one of the highest-risk areas of fiscal accountability. MCC's compact, disbursement agreement, and procurement agreement with each of the countries describe the relationship, roles, and authority of MCC, the procurement agent, and the compact country (see app. IV for details). Although these agreements have some common elements, each agreement is unique to the individual country. To determine when MCC approval of individual actions is appropriate, MCC included review thresholds in the procurement agreements keyed to procurement size and methods. Above cost thresholds, which vary among countries, MCC must approve items

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<sup>42</sup>Within the MCC fiscal accountability framework, the procurement agent is responsible for impartially administering and/or certifying a process for procurement, up to the point of selection, that adheres to a defined set of procurement standards.

<sup>43</sup>Procurement standards define technical language, provide instructions to participating vendors, and communicate the terms and conditions for vendor selection and process performance.

<sup>44</sup>The Millennium Challenge Act of 2003 requires MCC to ensure that open, fair, and competitive procedures are used in a transparent manner in the procurement of goods and services under the compact.

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such as the procurement method, terms of reference, and selection. Below thresholds, the compact country may conduct procurements in keeping with the procurement plan without additional MCC oversight. These thresholds are a risk management tool that maximizes MCC control for larger transactions but leaves discretion to the compact country for smaller transactions.<sup>45</sup>

### Countries' Procurement Systems Have Strengths, but MCC and Country Systems Are Not Fully Established

Although the three countries' procurement systems vary, each has characteristics that we have previously identified as typical of effective international procurement systems.<sup>46</sup> These characteristics are similar to the principles, such as equal access, competition, and transparency, that MCC applies in its review of the systems during due diligence. However, MCA officials in Madagascar and Cape Verde told us that they had completed few procurements that would test the systems in practice. Furthermore, MCC headquarters has not yet finished hiring its procurement staff, and procurement systems in Madagascar and Cape Verde are not yet fully established.

- *Incomplete staffing.* As of May 2006, MCC headquarters had hired its senior director of procurement but had not yet hired five director-level procurement staff in its Accountability Department. According to MCC officials, the function of these vacant positions is currently being filled by six intermittent personal service contractors, and MCC has offered one of these contractors a full-time position.<sup>47</sup> During our site visits in January and February 2006, staff in Madagascar and Cape Verde reported that the time frames for MCC review of procurements had been satisfactory. However, if MCC staffing does not increase as the countries

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<sup>45</sup>According to MCC officials, Madagascar's procurement law did not identify review thresholds. They stated that, because of the lack of thresholds in Malagasy law, MCC developed them in consultation with Madagascar representatives prior to compact signing. Although MCC officials stated that the thresholds were based on the best available knowledge of local practices, the thresholds had not yet been tested in practice prior to their adoption by MCC.

<sup>46</sup>These characteristics include integrity, openness, accountability, professional workforce, competition, and value. See GAO, *United Nations: Progress of Procurement Reforms*, [GAO-NSIAD-99-71](#) (Washington, D.C.: Apr. 15, 1999); and *United Nations: Preliminary Observations on Internal Oversight and Procurement Practices*, [GAO-06-226T](#) (Washington, D.C.: Oct. 31, 2005).

<sup>47</sup>MCC officials also stated that they have entered into blanket purchase agreements with other firms to supplement their procurement staff.

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submit more procurement decisions for approval, MCC may have difficulty in conducting timely reviews of these decisions.

- *Incomplete systems.* During our site visits, we found that some elements of the procurement systems documented in MCC's agreements with Madagascar and Cape Verde were not yet in place or had not functioned smoothly.
- Neither country had yet established the procurement bid protest body required by MCC or put in place automated systems for procurement tracking and management, although both reported plans to do so in 2006. Madagascar also had not established a process for reviewing contractor change order requests.
- During our visit to Madagascar, a senior MCC official discovered that the country's procurement plan for months 2 through 4 did not reflect current project work plans. As a result, the procurement agent was preparing for procurements that were no longer needed. Members of the Madagascar management team told us that they would establish new procedures to coordinate future work plan changes with the procurement agent.<sup>48</sup>
- In Cape Verde, the procurement review commission lacked office space and was concerned about being able to handle the number of reviews required of it once procurements begin in earnest. The commission is comprised of members who are fully employed elsewhere and are not permitted to delegate their work. The members have worked nights and weekends or have negotiated with their supervisors to be released from their other jobs to perform the commission's work. According to MCC, subsequent to our site visit,

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<sup>48</sup>The MCC IG identified additional weaknesses in management practices in its *Risk Assessment of Millennium Challenge Corporation's MCA-Madagascar Financial Operations* (Washington, D.C.: Mar. 28, 2006). The MCC IG found that MCA-Madagascar had not implemented procedures for validating the receipt of goods and services, recording goods in an inventory system, and tracking time and attendance. Furthermore, the MCC IG found that MCA-Madagascar was in the process of purchasing vehicles for MCA employees' work-related and personal use. MCA-Madagascar canceled the procurement after this finding. MCC noted in its response to the audit that the provision of vehicles for personal use was an accepted practice in many parts of the world; but MCC adopted a policy reinforcing the compact provision against the personal use of MCC assets. On the basis of its findings, the MCC IG recommended that MCC establish and distribute a set of policies and procedures for managing assets purchased with MCC funds. MCC agreed with this recommendation.

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Cape Verde has taken actions to mitigate the risks to the efficient operation of the commission.<sup>49</sup>

- Both Madagascar and Cape Verde reported difficulties with an MCC requirement that documents be in both English and the local language. Cape Verdean procurement review commission members are not required to speak English but are expected to review documents prepared in English. Cape Verde was considering hiring a full-time translator to address this need.<sup>50</sup> In Madagascar, the translation of a French document prepared by the implementer of the finance project and requested by MCC delayed the approval of needed project procurement.

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### MCC Has Established Country Monitoring and Evaluation Frameworks, but Weaknesses May Limit Measurement of Results

Each of the three countries' (Madagascar, Cape Verde, and Honduras) programs includes a monitoring and evaluation framework that includes plans for data collection, data quality reviews, analysis, and interim and final reporting of results. We found several weaknesses in the monitoring and evaluation frameworks that could affect MCC's ability to track and account for program results.

### Countries' Programs Include Monitoring and Evaluation Frameworks

Each of the three countries' programs includes detailed plans for monitoring and evaluating program results. MCC approved Madagascar's and Cape Verde's plans in November 2005 and April 2006, respectively, while Honduras's plan existed in April as a detailed draft but had not yet been approved. According to MCC officials, Honduras's plan is not final pending the staffing of the monitoring and evaluation director position to ensure country understanding and buy-in. In accordance with MCC

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<sup>49</sup>These actions include working with the Ministry of Finance to provide adequate permanent facilities, changing the review process to reduce the number of actions required of the commission, developing a training plan for the members of the commission, and receiving additional technical assistance from MCC.

<sup>50</sup>According to MCC officials, MCA-Cape Verde subsequently hired a full-time translator to serve the procurement review commission and MCA-Cape Verde.

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guidance, the countries' plans include separate components for monitoring and evaluation:<sup>51</sup>

- The *monitoring component* includes, among other things, key indicators that are linked as closely as possible to the variables identified in the economic analysis of the country's proposed projects. These indicators are to be used throughout implementation to assess whether the program is likely to achieve the desired results. The monitoring component also identifies baseline and target values for each indicator and includes plans for periodic performance reports and data quality reviews. MCC guidelines state that monitoring can be on select indicators to minimize reporting requirements.<sup>52</sup>
- The *evaluation component* identifies, among other things, the methodology that will be used to assess the program's impact, such as randomized controlled trials, and describes plans for collecting baseline, interim, and final data on program results.

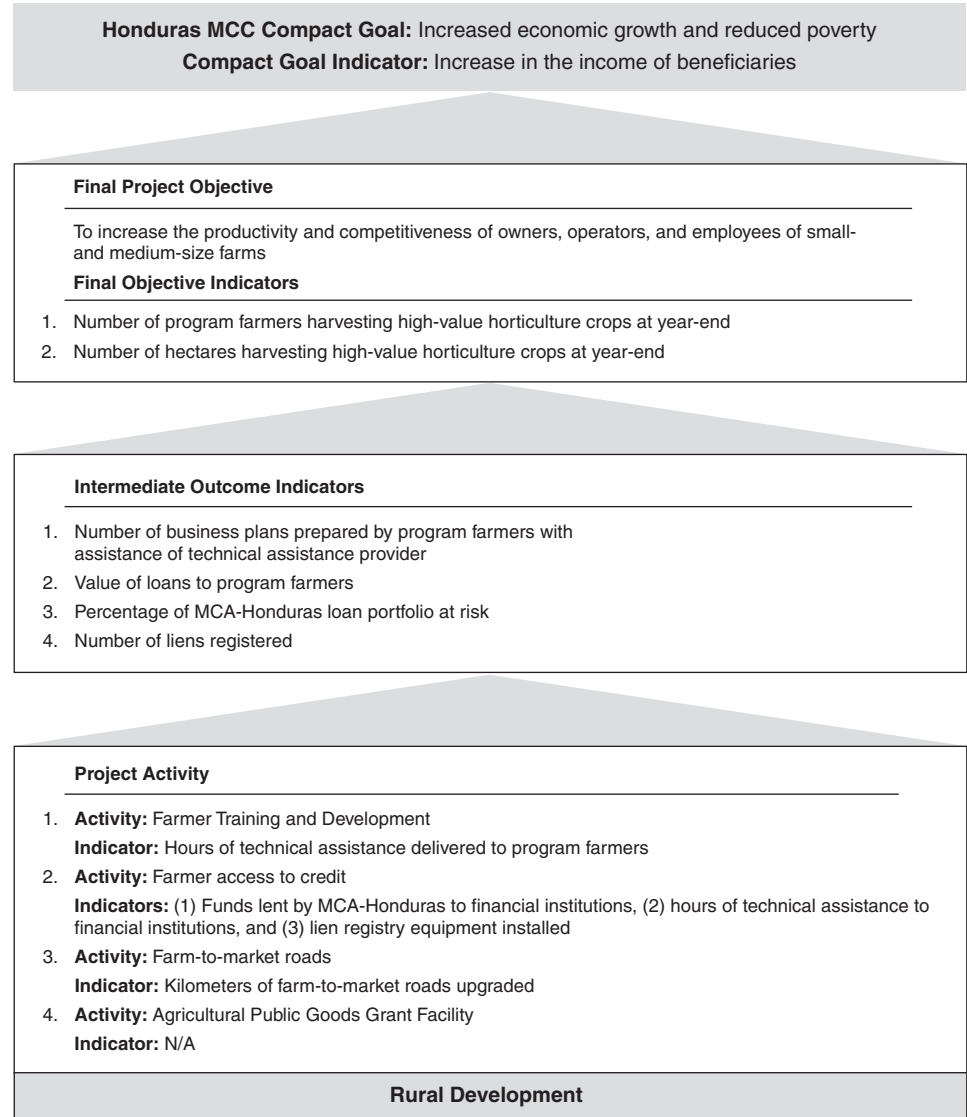
Countries' monitoring and evaluation plans use, to varying degrees, the economic analysis of the proposed projects to identify indicators for monitoring progress toward project objectives, calculate targets for each indicator, and evaluate the achievement of compact goals. The economic relationships specified in the models, such as the relationship between improved infrastructure and farm output, provide a basis for tracking project success. The monitoring framework also includes setting target values for indicators. Figure 13 illustrates indicators at various levels for a rural development project in Honduras.

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<sup>51</sup>According to MCC's January 2006 *Guidelines for Monitoring and Evaluation Plans*, each plan is to include separate components for monitoring and evaluation as well as summarize the compact program and objectives, identify program beneficiaries, document assumptions and risks, identify country staff responsibilities for managing and implementing the plan, and provide a detailed annual monitoring and evaluation budget. Compact Disbursement Agreements also condition MCC's periodic disbursement of compact funds on a country's demonstrating that it is meeting the performance requirements outlined in its plan. Prior to January 2006, MCC provided very limited guidance to eligible countries for developing monitoring and evaluation plans. For instance, its *Guidance for Developing Proposals for MCA Assistance in FY 2004* described the need for measurable goals and accountability for results. In addition, an attachment to the 2004 guidance required that a country's proposal describe a plan, including progress indicators and baseline data, for monitoring progress toward compact goals. This guidance, however, provided few specifications.

<sup>52</sup>The Millennium Challenge Act of 2003 requires MCC to include regular benchmarks in its compacts to measure progress toward achieving compact objectives.

**Figure 13: Indicator Structure for Honduras’s Rural Development Project**



Source: GAO presentation of MCC data.

Although the specifics of the countries’ plans vary, the monitoring component of each plan calls for the country’s MCA to submit periodic performance reports and data quality assessments to MCC. Performance reports will include quarterly assessments to alert the countries and MCC to any problems, periodic audits that analyze performance at all compact



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levels, and annual reports that consolidate the quarterly reports and recommend adjustments. Most performance data will be gathered by project implementers, either country government employees or contractors; the plans allow for contracting with other entities to prepare the reports. In addition, each plan calls for third-party data quality reviews over the course of the compact. For example, in Madagascar, data quality assessments are planned to occur every 6 months during the first year and annually thereafter.<sup>53</sup>

### Weaknesses in Monitoring and Evaluation Frameworks May Limit MCC's Ability to Measure Results

In reviewing the frameworks for monitoring and evaluation in the three countries, we identified several challenges that MCC faces in ensuring accountability for results. These challenges include (1) ensuring the availability and quality of baseline data, (2) establishing clear links between the economic model and the monitoring and evaluation framework, (3) accounting for the degree of uncertainty in expected outcomes, and (4) using randomized controlled trials in compact countries.

### Ensuring Baseline Data Availability and Quality

Baseline data are essential to measuring the results of MCC-funded compact projects. Although MCC has taken steps to collect baseline data for monitoring and evaluation, problems with data availability and quality may lead to challenges in measuring the progress and impact of the countries' projects over time. MCC officials told us that they worked with their country counterparts to set up a Management Information System that can meet the requirements for collecting performance data. In addition, MCC evaluated the technical capabilities of the country staff and the information system the country proposes to use for data management purposes. Finally, MCC budgeted funding for surveys in Madagascar and Cape Verde to collect baseline data when it was not available. However, we found that some of the baseline data in the countries' monitoring plans were not complete, and that some of the data MCC collected were not reliable.

- *Baseline data availability.* In some instances, the countries' monitoring and evaluation plans lack complete baseline data against which to measure progress. For example, two activity and final project indicators in Madagascar's plan—"volume of production covered by warehouse receipts in zones" and "volume of microfinance institution lending in the zones"—currently lack baselines because the intervention zones have

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<sup>53</sup>The Madagascar, Cape Verde, and Honduras compacts show that each country will use \$3 million to \$5 million in MCC funding for these monitoring and evaluation efforts.

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not yet been selected. Moreover, although the collection of performance data is closely linked to project implementation, Madagascar's plan contains no intermediate outcome indicators and target values, thereby making it difficult to effectively track project progress. (See fig. 13 for an example of the role of intermediate outcome indicators in the monitoring structure of Honduras.)

- *Baseline data quality.* MCC may face challenges in ensuring the quality of the baseline data that it uses to monitor and evaluate program impact and, as a result, may have difficulty in accurately measuring the impact of compact projects. MCC officials told us that it has been difficult to obtain accurate and reliable baseline data against which to measure program results. In some countries, MCC has funded surveys to obtain the needed baseline data. However, even with the additional resources provided by MCC, obtaining baseline data has been a challenge. For example, we found significant data quality problems associated with one of three surveys that MCC funded to collect baseline data in Madagascar. Our interviews with Madagascar and USAID officials who oversaw the survey revealed that the survey results, which were used to estimate average land values, are flawed in that they do not reflect recent significant changes in Madagascar's currency.<sup>54</sup> Madagascar's compact goal is to increase household income, as measured by the percentage of increase in land values.<sup>55</sup> Because of the survey error, the land value estimates may not be sufficiently reliable to evaluate the project impact and the compact as a whole.<sup>56</sup>

## Linking Monitoring Plans to Economic Analyses

Linking the indicators used to monitor and evaluate progress to the data and assumptions used in MCC's due diligence economic analyses will also

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<sup>54</sup>In January 2005, the Central Bank of Madagascar introduced monetary reform and a new currency with one-fifth the value of the prior currency. When the Agricultural Productivity Survey was conducted in April 2005, survey enumerators and respondents used both currencies when discussing land prices. However, in conducting the survey, enumerators did not clearly identify the currency in which they recorded land values. Madagascar's Statistical Institute, which conducted the survey, found that 30 percent of the surveys contained errors.

<sup>55</sup>Household income is expected to increase by 5 percent of the average land values in targeted project zones. In addition, the impact of a land tenure project will be measured by the amount of total new investment in the zones, with a target of increasing the average land value by an estimated 27 percent by the end of the 4-year compact.

<sup>56</sup>MCC officials stated that they were aware of the survey problem, and that data from a household survey could be useful as an additional measure of land values.

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present a challenge. In reviewing the draft plan for Honduras, we found consistent linkages between the indicators for monitoring and evaluation and the variables and assumptions used in the economic model. However, in the plans for Madagascar and Cape Verde—the first two plans that MCC approved—we found instances where MCC did not sufficiently link the monitoring plans to the economic models, which may hamper its ability to effectively measure project results. For example:

- After signing its compact with Cape Verde, MCC changed the interim targets for seven indicators. In two cases, neither MCC nor Cape Verde was able to identify the methodology used to select the indicators in the monitoring and evaluation plan.<sup>57</sup> According to MCC officials, they decided that the assumptions in the economic analysis were a poor basis for constructing the monitoring indicators and, therefore, chose other indicators and estimated the targets. According to MCC officials, the inability to identify the methodology, in conjunction with updated baselines and revised work plans in the country resulted in MCC's and Cape Verde's agreeing to reduce the interim targets that had been established.
- MCC's economic analysis for Madagascar's Land Tenure Project, which is approximately one-third of the compact budget, did not identify the expected benefits from the separate project activities. Therefore, we could not track the linkage between the activities in the model to those in the monitoring and evaluation plan.
- MCC's approved monitoring and evaluation plan does not include tracking the results of two finance project activities—modernizing the National Savings Institution and opening bank branches—although they were included in economic analysis calculations during due diligence. According to an MCC official, these two finance project activities will be tracked at a higher level of aggregation—the finance project level—and monitored by tracking the number and value of new accounts. However, this approach may not adequately capture the outputs and benefits from the institution's modernization and could potentially confound the effect of one activity (modernizing the institution) with that of other activities. For example, while an increase in the number and value of new accounts could result from the two finance project activities, it could

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<sup>57</sup>MCC also reduced five interim indicators for the Watershed Management and Agriculture Support Project because of a delay in implementing the project.

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also result from an overall increase in savings if customers invest in government savings bonds, issued recently and prior to the start of the MCC compact.

## Accounting for Uncertainty in Achieving Target Values

Although the countries' monitoring and evaluation plans acknowledge the uncertainty of achieving indicator target values, MCC project monitoring does not adequately address (1) the effect of potential variations in uncertainty on the range of acceptable target values or (2) the plausibility of target values. As a result, some targets specified in the countries' monitoring plans may not be achieved.

MCC disbursement agreements include as a condition precedent that, if an indicator value observed during compact implementation does not fall within 10 percent of the agreed-on target values, MCC may withhold disbursements. MCC applies this 10 percent margin to all projects, regardless of type (e.g., agriculture or infrastructure). However, our analysis suggests that several factors could cause indicator values for many projects to fall outside the 10 percent range.

- *External factors.* Uncertainty associated with external factors varies by country and project. For example, according to previous GAO work, external factors that could affect project implementation might include political instability, the lack of commitment of political leaders to necessary reforms, the magnitude of assistance from other bilateral and multilateral donors, weather conditions that affect crop yields, and the instability of international markets.<sup>58</sup> These factors could cause indicator values to fall outside the 10 percent range used across all countries and projects.<sup>59</sup>

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<sup>58</sup>GAO, *Foreign Assistance: USAID's Reengineering at Overseas Missions*, GAO/NSIAD-97-194 (Washington, D.C.: Sept. 12, 1997).

<sup>59</sup>The approved monitoring and evaluation plans for Madagascar and Cape Verde acknowledge that external factors, many of them beyond the control of program management, may directly affect progress toward project objectives. The countries' plans and the draft monitoring and evaluation plan for Honduras each include a discussion that elaborates on the assumptions in the economic analyses and the uncertainties associated with those assumptions. Although MCC performs a limited sensitivity analysis that analyzes the response of the variables used in the economic model to changes in some of the external factors that could affect it, MCC does not perform this evaluation systematically for all countries and projects.

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- *Time factor.* The 10 percent range also does not account for the increase in the uncertainty of targets over time—for example, target values for year 5 of a compact are likely to be less precise than those for year 1.

Therefore, to the extent that MCC bases its disbursement decisions on results falling within a common range, it may not fully account for variations in uncertainty across projects and over time.

According to MCC guidelines, the economic analyses and monitoring and evaluation plans should, as much as possible, be clearly linked. However, limitations in (1) the economic analyses due to problems with data quality, assumptions, and lack of country involvement and (2) the consistency between the economic analyses and the monitoring and evaluation plans constrain MCC's ability to set plausible targets. If targets are overly optimistic, countries may fail to reach them and MCC may not be justified in halting disbursements because the countries failed due to unattainable targets. Conversely, setting too conservative a target may not prompt the country to fully utilize MCC resources. A lack of plausible targets may lead to MCC's making ad hoc decisions regarding the consequences of missing targets and applying judgment subjectively and inconsistently in setting or modifying targets. MCC officials told us that they would use a missed target as a cue to discuss with the country's MCA its reasons for missing the target, and, on the basis of those discussions, they would determine whether to use their authority to withhold funding. According to MCC officials, senior management approval would be needed to significantly modify targets; however, MCC currently has no policy or documentation that defines a "significant modification" of targets, especially for targets used as conditions precedent to disbursements.

## Using Randomized Controlled Trials in Compact Countries

MCC has retained research organizations to help the countries evaluate program impact using, as appropriate, randomized controlled trials, but MCC's involvement of these organizations after project implementation begins may limit their ability to evaluate impact accurately.<sup>60</sup> These

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<sup>60</sup>As defined by the Office of Management and Budget (OMB), a randomized controlled trial is "a study that measures an intervention's effect by randomly assigning individuals or other units into an intervention group, which receives the intervention, and into a control group, which does not. At some point following intervention, measurements are taken to establish the difference between the intervention group and the control group." However, randomized controlled trials are not suitable for every program and generally can be employed only under special circumstances. See OMB, "What Constitutes Strong Evidence of a Program's Effectiveness?" ([http://www.whitehouse.gov/omb/part/2004\\_program\\_eval.pdf](http://www.whitehouse.gov/omb/part/2004_program_eval.pdf)).

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organizations' scope of work may include training MCC and compact country staff; designing the trials and data collection; and proposing appropriate methodologies for, and analyzing results from, impact evaluations. According to MCC monitoring and evaluation officials, MCC has begun designing impact evaluations by identifying those program components that can and cannot be evaluated using randomized controlled trials, which MCC has indicated are its preferred method of impact evaluation.<sup>61</sup> According to MCC officials, MCC considers evaluations using randomized controlled trials as "rigorous" and evaluations using other methodologies as "standard."

MCC has hired an independent consultant experienced in impact evaluations to work with compact countries to assess the appropriateness of using randomized trials to evaluate MCC's projects. When these assessments are completed, the five research organizations will be invited to compete to conduct randomized trials after compact implementation begins.<sup>62</sup> However, at that point, the organizations will not have had an opportunity to assess the design of the countries' evaluation strategy, including the adequacy and reliability of the baseline data. Without the involvement of these organizations before implementation of the relevant project(s) begins, MCC may not be able to ensure that they have the necessary data and have established appropriate research designs for their work. MCC officials told us that they thus far had not involved the five organizations because rigorous evaluations were turning out not to be feasible in some cases, or because the tasks were not large enough to warrant the use of the five research organizations.<sup>63</sup>

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## Conclusions

MCC continues to mature and evolve as an institution, taking on the ambitious task of creating new, country-managed organizations while developing processes to oversee what are expected to be relatively large amounts of foreign assistance. Toward that end, MCC has taken positive steps with regard to establishing policies and procedures for MCA organizations. However, it has taken time to complete the numerous

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<sup>61</sup>According to OMB, randomized controlled trials provide the highest-quality unbiased evaluation to demonstrate actual program impact.

<sup>62</sup>According to MCC officials, at that point, MCC also plans to invite other groups and individuals to compete for conducting randomized trials.

<sup>63</sup>As of May 2006, MCC had not awarded task orders for this work.

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agreements necessary for compacts to enter into force. This could continue to present challenges, given that MCC is working simultaneously with a number of nations to develop and implement compacts.

As MCC moves forward, partnering with countries to develop well-founded economic assumptions will be crucial to establishing a foundation for the work of MCC and its partners. Furthermore, holding countries accountable for results requires, to the extent practical and cost-effective: collecting reliable and accurate baseline data, linking economic analyses to monitoring plans, addressing the uncertainty associated with program results, and ensuring the timely development of the research design for randomized controlled trials.

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## Recommendations

Because of the central role of reliable economic analyses and the importance of partnering with countries in achieving MCC goals and ensuring accountability for MCC programs, we recommend that the Chief Executive Officer of MCC take the following two steps:

- Ensure that MCC officials, in partnership with country representatives, perform economic analyses that more fully reflect the countries' socioeconomic environment and are better understood by country public and private sector representatives.
- To the extent practical and cost-effective, improve MCC's monitoring and evaluation capabilities by
  - obtaining more accurate and reliable baseline data needed to permit tracking progress during compact implementation;
  - ensuring a clear linkage between MCC's economic analyses and monitoring and evaluation frameworks;
  - developing policies, procedures, and criteria for establishing targets and for adjusting those targets if unforeseen events affect outcomes; and
  - taking steps to ensure the timely development of the needed research design for randomized controlled trials, if they are undertaken, prior to project implementation.

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## Agency Comments and Our Evaluation

We received written comments on a draft of this report from MCC and the Department of State. In commenting on a draft of this report, MCC generally agreed with our findings, conclusions, and recommendations. MCC noted that our discussion of the evolving guidance provided to eligible countries in 2004 and 2005 was a result of the complex process of engaging with eligible countries while simultaneously developing policies and procedures. MCC stated that this criticism should not be valid beyond the initial instances covered in this report. We recognize that MCC was simultaneously addressing a number of issues during this period, but we felt it was important to discuss the evolving nature of guidance to provide a balanced perspective regarding the process eligible countries had to follow to sign compacts.

MCC also commented (1) that our characterization of data quality issues in Madagascar cited only a single survey and (2) that it differed with us on the appropriate level of aggregation in linking economic models and monitoring and evaluation plans. We note that there was one other instance of poor data quality in Madagascar, but that we focused on the Agricultural Productivity Survey because of the importance of accurately tracking land values to monitor results. We agree that disaggregation may not always be feasible, but note that aggregation poses some challenges that could limit the effectiveness of monitoring and evaluation. We reprinted MCC's comments, with our responses, in appendix V. We also incorporated technical comments from MCC in our report where appropriate.

State commented that some of our findings reflect minor or transitory problems and provided specific observations regarding MCC's evolving guidance, the assumptions used in MCC's economic models, country participation, staffing delays, fiscal accountability structures, and the use of randomized controlled trials.

State noted that MCC's guidance could be expected to evolve, given the newness of the organization, and that informal guidance from MCC was always available to eligible countries. We agree that guidance could be expected to evolve, but we sought to provide a balanced perspective by noting instances where MCC's verbal guidance may not have been sufficient to assist countries in submitting proposals that met MCC's criteria.

State questioned the findings from our Madagascar focus groups and our finding that MCC conducted economic analyses with limited country



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involvement. Our focus groups resulted in discussions of the assumptions used in the Madagascar economic analysis with a broad range of country stakeholders representing U.S. and Malagasy agencies and organizations involved in implementing the compact. Furthermore, MCC agreed in its comments that, in some cases, the level of country engagement on economic analysis could be improved. MCC outlined specific steps that it had taken to increase country involvement in economic analyses.

Regarding staffing delays and fiscal accountability structures, State commented that we offered no suggestions to MCC for things they could have done differently. We added additional material to the report to elaborate on the steps MCC has taken to reduce delays in staffing key positions. In regard to fiscal accountability, we agree that different countries will differ in their maturity of internal control. However, evaluating maturity is key to properly assessing risk and establishing effective oversight mechanisms.

Finally, State disagrees with what it terms our “reliance” on randomized controlled trials to measure success. This comment misconstrues our findings. We did not rely on or advocate this methodology, but rather are commenting on MCC’s use of randomized controlled trials as its preferred method of impact evaluation.

We have reprinted State’s comments, with our responses, in appendix VI.

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We are sending copies of this report to interested congressional committees as well as the Secretary of State, the Secretary of the Treasury, the CEO of MCC, and the Administrator of USAID. We will also make copies available to others upon request. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

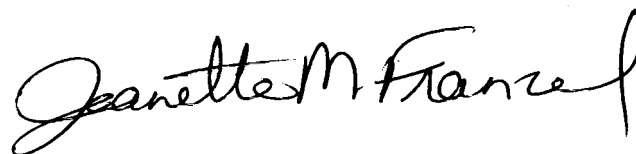
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If you or your staff has any questions about this report, please contact David Gootnick at (202) 512-3149 or [gootnickd@gao.gov](mailto:gootnickd@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix VII.

Sincerely yours,

A handwritten signature in black ink that reads "David Gootnick". The signature is written in a cursive style with a large, looping initial "D".

David Gootnick  
Director  
International Affairs and Trade

A handwritten signature in black ink that reads "Jeanette M. Franzel". The signature is written in a cursive style with a large, looping initial "J".

Jeanette Franzel  
Director  
Financial Management and Assurance

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# MCC Actions in Response to April 2005 GAO Recommendations

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The Millennium Challenge Corporation (MCC) has taken a number of steps to address our April 2005 recommendations regarding its strategic planning, internal controls, and human capital and governance policies, although some aspects of its organizational structure are not yet complete. MCC has prepared a strategic plan for fiscal years 2006 through 2011, and an annual performance plan for fiscal year 2006. MCC also has strengthened its internal controls and taken steps to implement some fiscal accountability mechanisms, established an audit committee within its governing board, and completed several required audits and reviews. However, MCC has not documented all financial control activities and continues to face risks from the poor interfacing of its systems with those of the Department of the Interior's National Business Center (NBC). MCC has reassessed its staffing model, developed a plan for recruitment, and implemented an improved performance management system; but, it does not systematically track the use of staff resources to verify its human capital model. Finally, MCC has approved a corporate governance policy and taken steps to improve board involvement in planning, management, and communication; but it has not yet fully addressed risk management for the corporation.

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## MCC Has Developed a Strategic Plan to Enhance Accountability and Completed a 2006 Performance Plan

Consistent with our recommendation to enhance corporate accountability, MCC completed a strategic plan, approved by the Office of Management and Budget (OMB) in November 2005. In April 2006, MCC completed an annual performance plan that provides goals and benchmarks for assessing its performance in fiscal year 2006. This annual performance plan will enable MCC to report in the future on its progress in meeting its goals.<sup>1</sup> As part of the annual performance plan process, MCC also has developed goals and benchmarks for its individual departments that support the attainment of the corporate goals identified in the strategic plan. (See table 4.)

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<sup>1</sup>As we noted in our April 2005 testimonies, strategic and performance planning and reporting processes that establish, measure, and report an organization's progress in fulfilling its mission and meeting its goals are important for organizational accountability. See GAO, *Millennium Challenge Corporation: Progress Made on Key Challenges in First Year of Operations*, [GAO-05-455T](#) (Washington, D.C.: Apr. 26, 2005) and [GAO-05-625T](#) (Washington, D.C.: Apr. 27, 2005).

**Table 4: MCC Response to GAO Recommendations for Corporatewide Accountability**

Summary of GAO recommendation	MCC actions completed	MCC actions not completed or in progress
Implement a strategic plan	✓ Completed strategic plan, November 2005.	N/A
Establish annual performance plans and goals	✓ Annual performance plan completed in April 2006.	N/A
Use performance measures to monitor progress in meeting both strategic and annual performance goals	✓ Annual performance plan completed in April 2006.	N/A
Report internally and externally on progress in meeting strategic and annual performance goals		Completed annual performance plan provides benchmarks against which to measure MCC's fiscal year 2006 performance.

Sources: GAO interviews and analysis of MCC documents.

## MCC Has Made Significant Progress in Establishing Internal Controls

In response to our April 2005 recommendations, MCC has made significant progress in establishing internal controls over program and administrative operations at both the MCC headquarters and compact levels.<sup>2</sup> MCC has made progress in each of the five components of internal controls discussed in our April 2005 testimony:<sup>3</sup> (1) control environment, (2) risk assessment, (3) control activities, (4) monitoring, and (5) reporting.

- *Internal control environment.* MCC has initiated several measures to establish a positive internal control environment, including documenting its organizational structure for the Administration and Finance and Accountability structures. The Fiscal Accountability area, which is a component of the Accountability structure, currently consists of a managing director and several directors; however, other positions to support the fiscal oversight of MCC compacts have yet to be filled. A formal ethics program has also been established for MCC headquarters.
- *Risk assessment.* MCC is developing a process for assessing risks facing the corporation and its programs. To this end, MCC has hired a third-party consulting firm to support the implementation of processes, based on OMB A-123, *Management's Responsibility for Internal Control*,

<sup>2</sup>Internal controls provide reasonable assurance that key management objectives—that is, efficiency and effectiveness of operations, reliability of financial reporting, and compliance with applicable laws and regulations—are being achieved.

<sup>3</sup>GAO-05-455T and GAO-05-625T.

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*December 2004*, criteria, to address risks associated with domestic and foreign operations.

- *Control activities.* MCC has instituted several control activities to reduce risk. MCC has submitted its Strategic Plan under the Government Performance and Results Act (GPRA) of 1993 and has completed required audits and reviews, such as those required under the Federal Managers Financial Integrity Act (FMFIA) of 1982 and the Federal Information Security Management Act (FISMA) of 2002.<sup>4</sup> MCC is in the process of addressing the various material weaknesses, reportable conditions, findings, and recommendations identified in the audits. For example, MCC continues to address the formal documentation of control activities for the financial reporting process at MCC headquarters. MCC also contracted with a third-party service-provider, NBC, to maintain its accounting system and the recommended Statement on Auditing Standards No. 70 (SAS 70) review<sup>5</sup> was performed; however, MCC is still addressing issues reported as a result of the review, such as the need to address manual processes that present inherent risks associated with accounting systems and related processes. For example, MCC forwards daily to NBC a package containing source documentation that is used by NBC to record transactions to the general ledger. Similarly, information for MCC's travel expenses is prepared at MCC headquarters office and daily communicated to NBC through manual processes. MCC is aware of the need to address these issues and is working with NBC to mitigate or eliminate the manual processes.
- *Monitoring.* MCC has taken steps to ensure ongoing monitoring and periodic testing of control activities. MCC's investment committee embodies functions of monitoring and testing and operating as an integral part of MCC's internal control program by overseeing the program units' compliance with both the procedural and substantive elements required by its internal processes. Also, MCC conducted its first comprehensive survey of internal controls, performed by outside consultants, in conjunction with its annual audit. In addition, MCC has formed formal review panels to monitor the progress of addressing

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<sup>4</sup>GPRA, Public Law 103-62; FMFIA, Public Law 97-255; and FISMA, Public Law 107-347.

<sup>5</sup>SAS 70, "Reports on the Processing of Transactions by Service Organizations," covers situations in which an organization has outsourced its financial operations. It is intended to provide a reasonable assurance that a service provider has adequate internal controls.

findings from internal and external reviews. For example, consistent with OMB guidance, MCC formed an FMFIA Management Review Panel to assess the results of the internal control survey along with the findings of MCC's independent financial auditors. Similarly, MCC implemented a specific procedure to address recommendations from reviews and audits performed by its Inspector General (IG).

- *Reporting.* MCC has made progress in establishing a process for assessing and reporting on the operating effectiveness of its internal controls. MCC established a formal board-level audit committee whose responsibilities include (1) financial controls; (2) the integrity of the reporting process; and (3) performance of the independent audit process. In addition, MCC's FMFIA Management Review Panel assessed the results of the internal control survey, along with the findings of MCC's independent financial auditors. The panel identified four material weaknesses and actions that MCC will be taking in future months to resolve them, which the acting Chief Executive Officer certified on November 7, 2005.

MCC officials told us that the development of new internal control policies and procedures and the revision of those already in place is a continuing process as MCC continues to mature as an organization. Table 5 summarizes MCC's progress in addressing our April 2005 recommendations.

**Appendix I**  
**MCC Actions in Response to April 2005 GAO**  
**Recommendations**

**Table 5: MCC Response to GAO Recommendations for Internal Controls over Program and Administrative Operations**

Summary of GAO recommendation	MCC actions completed	MCC actions not completed or in progress
Complete the development and implementation of overall plans and related time frames for actions needed to establish the following:		
A positive and supportive internal control environment	<ul style="list-style-type: none"> <li>✓ Documented the organizational structure.</li> <li>✓ Documented a corporate strategy.</li> <li>✓ Implemented a procedure for addressing IG audit findings.</li> <li>✓ Established formal ethics program, including training for all MCC employees.</li> <li>✓ Conducted audits required under FISMA and FMFIA.</li> <li>✓ Submitted Strategic Plan under GPRA.</li> </ul>	<ul style="list-style-type: none"> <li>• Positions within the accountability area remain vacant.</li> <li>• Continued efforts to address audit findings of material weaknesses and reportable conditions.</li> </ul>
A process for ongoing risk assessment	<ul style="list-style-type: none"> <li>✓ Identified 14 priority internal control areas relating to administrative and program risks.</li> </ul>	<ul style="list-style-type: none"> <li>• Risk assessment process is still being developed.</li> <li>• Outside consulting firm to support MCC risk analysis based partly on OMB A-123 criteria.</li> </ul>
Control activities and procedures for reducing risk, such as measures to mitigate risk associated with contracted operational and administrative services	<ul style="list-style-type: none"> <li>✓ Internal Controls Strategy Group identified 14 key internal control areas for MCC to focus efforts.</li> </ul>	<ul style="list-style-type: none"> <li>• MCC continues to work on implementing and formally documenting some procedures and control activities.</li> </ul>
Ongoing monitoring and periodic testing of control activities	<ul style="list-style-type: none"> <li>✓ Established formal review panels to monitor progress of efforts to address findings from internal and external reviews and formally documented a process for addressing MCC IG recommendations.</li> </ul>	N/A
A process for assessing and reporting on the effectiveness of internal controls and addressing any weaknesses identified	<ul style="list-style-type: none"> <li>✓ Created a board-level audit committee to monitor MCC's financial controls, integrity of the financial reporting process, and performance of the audit process.</li> </ul>	<ul style="list-style-type: none"> <li>• MCC continues efforts to establish a comprehensive database to track recommendations.</li> </ul>

Sources: GAO interviews and analysis of MCC documents.

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## MCC Has Taken Steps to Develop Human Capital, but Does Not Track Allocation of Human Capital to Key Activities

MCC has taken steps and is continuing to further develop its human capital systems by (1) assessing its staffing needs; (2) improving its recruitment, development, and retention systems; and (3) implementing a performance management system linking compensation to individual contributions toward corporate goals. However, despite having plans to increase its staff by an additional 38 percent between May and September 2006, MCC does not systematically assess its staffing needs, has not developed a human capital plan, and has not yet fully implemented its improved performance management system, as follows:

- *Staffing.* Although MCC has completed an assessment of its human capital needs since our April 2005 recommendation, it does not systematically track the use of staff time on an ongoing basis. MCC's updated assessment of its human capital needs shows that it plans to increase its staffing from 218 staff, as of May 2006, to approximately 300 staff, as of September 2006.<sup>6</sup> MCC also has created an organization chart that includes the specific approved positions for each department under the new 300-person staffing model, and it is hiring for many of these positions using limited-term appointments to provide greater flexibility in filling future needs.<sup>7</sup> According to MCC officials, MCC made its case to OMB for increasing staffing to 300 persons on the basis of an analysis of MCC staffs' recollection of the amount of time they spent developing the Georgia compact, which was thought to have been the most complex compact development process to date. However, MCC officials felt that this analysis may not have fully captured the amount of time spent by some departments in developing the compact. Retrospective analysis was necessary because MCC does not track employees' time on mission-related projects on an ongoing basis. Without such data, MCC management is not able to systematically assess the staffing requirements needed to carry out MCC's mission and consistently align its human capital with its changing needs.
- *Recruitment and retention.* MCC has identified priorities and committed resources for recruitment and is developing a human capital plan to address retention and training. To support its effort to hire

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<sup>6</sup>In April 2005, we reported that MCC had 107 employees in place toward a target of no more than 200 employees at the end of December 2005.

<sup>7</sup>Several development experts have stated that MCC's proposed staffing level (300) is very lean for an organization planning to disburse \$2 billion or more per year.



approximately 82 additional staff between May and September 2006, MCC has retained an outside consultant firm to work on-site and help with recruitment and has identified positions as first- or second-tier hiring priorities. MCC officials also told us that they are developing an overall human capital plan that will include planned activities and a time frame for identifying critical skills and competencies for MCC's key positions. The officials stated that the human capital plan also will include a strategy for staff retention and will address staff training. Currently, MCC has developed procedures for providing employees with outside training. MCC intends to develop a comprehensive training plan following the completion of the human capital plan, a draft of which it expects to circulate to MCC senior staff for their review and comment by September 30, 2006.

- *Performance management.* In keeping with our recommendation, MCC has established a performance-based compensation framework. MCC provided us with documentation of its employee ratings process, showing that employee expectations and performance reviews were keyed to organizational goals. However, according to MCC officials, MCC did not incorporate the departmental performance plans for the year into the performance framework for 2006 until March 2006, as the annual performance plan neared completion. MCC is shifting from a calendar year to a fiscal year performance evaluation schedule to better align employee compensation with its annual corporate goals. MCC anticipates that its strategic plan, annual performance plan, department plans, and individual performance goals will be fully synchronized beginning in fiscal year 2007. (See table 6.)

**Appendix I**  
**MCC Actions in Response to April 2005 GAO**  
**Recommendations**

**Table 6: MCC Response to GAO Recommendations for Human Capital Infrastructure**

Summary of GAO recommendation	MCC actions completed	MCC actions not completed or in progress
Establish an effective human capital infrastructure, including:		
A thorough and systematic assessment of the staffing requirements and critical skills needed to carry out MCC's mission	<ul style="list-style-type: none"> <li>✓ MCC has reassessed its human capital needs at approximately 300 staff, and OMB has approved this model.</li> <li>✓ MCC has completed an updated organization chart identifying the positions to be filled under the new human capital model.</li> </ul>	<ul style="list-style-type: none"> <li>• MCC currently does not track the amount of time its employees spend on specific tasks. Without this information, MCC cannot systematically assess its staffing needs on an ongoing basis.</li> </ul>
A plan to acquire, develop, and retain talent that is aligned with the corporation's strategic goals	<ul style="list-style-type: none"> <li>✓ MCC has identified priorities for hiring based on its 300-staff model.</li> <li>✓ MCC has retained an outside consultant firm in support of its effort to increase staff from 218 in May 2006 to approximately 300 at the end of September 2006.</li> <li>✓ MCC has developed a procedure for employee training.</li> </ul>	<ul style="list-style-type: none"> <li>• MCC has not completed an overall human capital plan but plans to circulate a draft to MCC senior staff for review and comment by September 30, 2006.</li> <li>• MCC plans to include a retention strategy and address training in the human capital plan.</li> <li>• MCC also plans to develop a comprehensive training plan following the completion of the human capital plan.</li> </ul>
A performance management system linking compensation to employee contributions toward the achievement of MCC's mission and goals	<ul style="list-style-type: none"> <li>✓ MCC has established a performance framework that links compensation to employee expectations and performance reviews to MCC goals.</li> </ul>	<ul style="list-style-type: none"> <li>• MCC is shifting from a calendar year schedule to a fiscal year schedule of performance evaluation to better align employee compensation with its annual corporate goals.</li> <li>• MCC anticipates that its strategic plan, annual performance plan, department plans, and individual performance goals will be fully synchronized beginning in fiscal year 2007.</li> </ul>

Sources: GAO interviews and analysis of MCC documents.

## MCC Has Taken Steps to Define Corporate Governance

The MCC Board of Directors (MCC Board) has taken steps to define the scope of its corporate governance and oversight.<sup>8</sup> The MCC Board has approved a corporate governance policy developed by MCC with the involvement of staff from MCC Board agencies.<sup>9</sup> According to MCC officials, the policy incorporates guidance on governance matters provided by board members at their previous meetings, and the board participated in

<sup>8</sup>Corporate governance can be viewed as the formation and execution of collective policies and oversight mechanisms to establish and maintain a sustainable and accountable organization, while achieving its mission and demonstrating stewardship over its resources.

<sup>9</sup>Four of the nine board positions established in the Millennium Challenge Act of 2003 are to be filled based on nominations from the House and Senate majority and minority leaders. As of May 2005, two of these positions had not yet been filled.

**Appendix I**  
**MCC Actions in Response to April 2005 GAO**  
**Recommendations**

formulating MCC's strategic plan before approving it in December 2005. The board has established a board-level audit committee and a charter for that committee. According to MCC officials, to address risk, MCC is recruiting for the position of risk specialist and has used a contractor to support MCC risk analysis. Finally, to improve communication with stakeholders in eligible countries, MCC has published and distributed updated guidelines for compact development and eligibility. MCC also has developed a series of open forums where input is sought from groups with an interest in MCC. (See table 7.)

**Table 7: MCC Response to GAO Recommendations for Corporate Governance**

Summary of GAO recommendation	MCC actions completed	MCC actions not completed or in progress
Recommended that the Secretary of State ensure that the MCC Board considers and defines the scope of its responsibilities with respect to corporate governance and oversight of MCC...including oversight of the following:		
Executive management	✓ The MCC Board has approved a corporate governance policy.	N/A
The formulation and execution of corporate strategies	✓ The board participated in formulating MCC's strategic plan and approved the plan.	N/A
Risk management and audit and assurance processes	✓ The MCC Board has formed an audit committee and approved a charter for that committee.	MCC has not yet hired a risk specialist for the corporation but has used an outside consulting firm to support MCC risk analysis.
Communication and coordination with corporate stakeholders	✓ MCC has published and distributed updated guidance on compact development and implementation. ✓ MCC has developed an outreach program of open forums.	N/A

Sources: GAO interviews and analysis of MCC documents.

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# Scope and Methodology

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At the request of the Senate Committee on Foreign Relations, we examined the structures and procedures MCC has developed in consultation with compact countries to manage compacts. Specifically, our work focused on (1) the key areas that MCC examined in its due diligence assessments of proposals for Madagascar, Cape Verde, and Honduras, and the criteria that MCC used in these assessments, and (2) the form and adequacy of the implementation structures that MCC and compact countries have put in place for governance, procurement, fiscal accountability, and monitoring and evaluation. In addition, we reviewed MCC's progress in responding to our April 2005 recommendations on its corporate management and accountability structures (see app. I).

To accomplish our objectives, we reviewed MCC's documentation of its processes and agreements, supplemented by interviews with MCC officials. We focused our review for objectives 1 and 2 primarily on the first three countries with signed compacts—Madagascar, Cape Verde, and Honduras. These countries' compacts were the first to enter into force. To further our analysis for objectives 1 and 2, we also visited Cape Verde and Madagascar in January and February 2006. We selected Cape Verde and Madagascar for our site visits because they had advanced further than Honduras in filling key positions and beginning compact implementation. While in Cape Verde and Madagascar, we interviewed a number of MCC, Millennium Challenge Account (MCA), and government officials and visited project sites.

To identify MCC's evaluation criteria and process for evaluating eligible country proposals in due diligence, we reviewed MCC guidance and the record of MCC analysis contained in (1) MCC's "due diligence books," which are its internal records of how it assessed proposals submitted by Madagascar, Cape Verde, and Honduras, and (2) investment memos, which are MCC's analyses based on due diligence and internal recommendations to its investment committee. These documents are restricted from public dissemination due to their sensitive nature, but MCC made them available to us for analysis. We have coordinated with MCC on describing the information from these books in general terms without disclosing sensitive information. We used MCC's definition of the due diligence process as beginning with MCC's opportunity memo and ending with the acceptance of the investment memo by MCC's investment committee. Our review, therefore, may not capture some changes and decisions made by MCC or eligible countries during proposal development and compact negotiations. To evaluate MCC's assessments of proposals' consultative process, project coherence, environmental and social impact, and institutional and financial sustainability, we relied primarily on MCC's data and analysis contained in

the due diligence books and, to some extent, in the investment memos. We compared MCC's analysis in these documents with criteria outlined in MCC's guidance. We were able to perform only limited independent verification of the use and adequacy of these criteria during our site visits. With regard to its economic analyses, MCC also made available to us the spreadsheet models it used to develop the economic rate of return calculations that formed the basis for its evaluations of the suitability of country-proposed projects for MCC funding. We independently analyzed these spreadsheets and validated their logic and conclusions on the basis of a review of economic literature and practices. In addition, in Madagascar, we conducted a series of focus groups with country officials to assess the data and logic used by MCC in developing their economic analysis.

To assess MCC's compact implementation structures, we reviewed the compacts with Madagascar, Cape Verde, and Honduras and the supplemental agreements required for those compacts to enter into force. We supplemented this review with our site visits to Madagascar and Cape Verde. In all cases, our ability to analyze the adequacy of these structures was limited by their relative newness and limited use in actual implementation. We addressed the following four areas of MCC's implementation structures:

- To determine the form of governance structures and key positions in these three countries, we reviewed the requirements of MCC compacts and supplemental agreements. We determined the progress of the country organizations in Madagascar, Cape Verde, and Honduras in filling these positions and establishing these structures by analyzing MCC's reported staffing and status information. We independently assessed MCC's progress in our site visits to Madagascar and Cape Verde. We discussed factors affecting the filling of these positions through discussions with MCC and compact country officials.
- To assess the adequacy of the countries' fiscal accountability structures, we reviewed MCC's overall fiscal accountability framework and the operations in place in Madagascar and Cape Verde. We assessed the adequacy of these structures according to the criteria contained in GAO's *Standards for Internal Control in the Federal Government*.<sup>1</sup> We assessed MCC's and the countries' implementation of these structures

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<sup>1</sup>GAO, *Standards for Internal Control in the Federal Government*, AIMD-00-21.3.1 (Washington, D.C.: November 1999).

by using criteria in the *Internal Controls Capability Maturity Continuum* developed by the independent risk consulting company, Protiviti, Inc. We independently verified the existence of the structures described in the plan and discussed its strengths and weaknesses during the site visits.

- To assess MCC's procurement structures, we reviewed the MCC fiscal accountability framework, and the implementing procurement documents for the first three compact countries. We then assessed the adequacy of MCC's framework, using criteria identified in previous GAO reports on international procurement. To determine the status and factors affecting the implementation of this framework in Cape Verde and Madagascar, we interviewed compact country officials and obtained documentation of procurement procedures.
- To determine the form of monitoring and evaluation structures in the three countries with entry into force, we reviewed the requirements of MCC compacts and supplemental agreements. We assessed the status of the country organizations in Madagascar, Cape Verde, and Honduras to establish these structures by analyzing the staffing and status information provided to us by MCC. We independently assessed MCC's progress in our site visits to Madagascar and Cape Verde. Additionally, we reviewed the scope of work of the independent U.S. evaluation contractors retained by MCC, and closely reviewed the monitoring and evaluation plan for Madagascar—the only plan approved by MCC prior to April 2006. We also reviewed the plan for Cape Verde and the draft plan for Honduras. We assessed the adequacy of the Madagascar plan against the criteria of data quality, and consistency with the economic model and logic identified in MCC's due diligence review of projects. We also applied general principles of economic logic, such as treatment of uncertainty in data, to assess how uncertainty was incorporated into MCC's monitoring and evaluation framework.

To review MCC's progress in responding to GAO's April 2005 recommendations (see app. I), we examined MCC documents, such as its strategic plan, planning documents, policies, procedures, and human capital documents. In December 2005, MCC provided us with a letter outlining the steps that the corporation had taken in response to our recommendations. Using this as a basis for discussion, we held additional meetings with MCC officials and received additional documentation of MCC's responses. We also reviewed the findings of the MCC IG analysis of the functions of the Corporation and met with the IG to determine the steps

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**Appendix II**  
**Scope and Methodology**

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that MCC had taken in response to IG findings related to our recommendations.

We conducted our review from June 2005 through May 2006 in accordance with generally accepted government auditing standards.

# MCC Projects in Madagascar and Cape Verde

**Figure 14: Jatropha Plantation, outside Antsirabe, Madagascar, Targeted for Assistance by the MCA-Madagascar Agricultural Business Investment Project**



Source: GAO.



**Figure 15: Antananarivo Land Records Storage Room, Programme National Foncier Offices**



Source: GAO.

Note: Digitization of these land records is being supported by MCA funds.

**Figure 16: Port of Praia, Cape Verde**



Source: GAO.

Note: The quay of the current port can only accommodate one large international vessel. Under the MCA program, the quay will be expanded to almost double its current length, enabling three ships to dock at a time.

**Figure 17: The Road from Assomada to Rincao, Cape Verde**



Source: GAO.

Note: Using MCA funds, about half of the road will be converted from cobblestone to asphalt. The cobblestones from the first half will be used to pave the second section of the road leading up to Rincao.

# Summary of MCC Procurement Agents, Standards, and Provisions in Madagascar, Cape Verde, and Honduras

**Table 8: Procurement Agents and Standards in Madagascar, Cape Verde, and Honduras**

Country	Type of procurement agent	Procurement agent	Procurement standards
Madagascar	Nongovernmental	GTZ <sup>a</sup>	Madagascar Law Number 2004-009 Dated July 26, 2004 on Public Contracts subject to listed exceptions in Procurement Agreement.
Cape Verde	Governmental	Cape Verde accountable entity	<p>World Bank Guidelines: <i>Procurement Under International Bank for Reconstruction and Development Loans and International Development Association Credits</i>, May 2004, as modified for nonconsultant services, works and goods.</p> <p>World Bank Guidelines: <i>Selection and Employment of Consultants by World Bank Borrowers</i>, May 2004, as modified, for consultants.</p> <p>Ministry of Infrastructure and Transportation rules apply to procurements below \$55,000 for transportation projects.</p>
Honduras	Hybrid governmental and nongovernmental	An outside project manager for the transportation project, and a government agency, the Fondo Nacional de Desarrollo Rural Sostenible, for the Rural Development Project. <sup>b</sup>	<p>World Bank Guidelines: <i>Procurement Under International Bank for Reconstruction and Development Loans and International Development Association Credits</i>, May 2004, as modified for nonconsultant services, works, and goods.</p> <p>World Bank Guidelines: <i>Selection and Employment of Consultants by World Bank Borrowers</i>, May 2004, as modified, for consultants.</p>

Source: GAO analysis of MCC procurement documents.

<sup>a</sup>Deutsche Gesellschaft für Technische Zusammenarbeit is a private company owned by the German federal government.

<sup>b</sup>National Fund for Sustainable Rural Development.

**Appendix IV  
Summary of MCC Procurement Agents,  
Standards, and Provisions in Madagascar,  
Cape Verde, and Honduras**

**Table 9: Procurement Provisions, Roles, and Responsibilities Stated in MCC Agreements with Madagascar, Cape Verde, and Honduras**

<b>Procurement-related provisions</b>	<b>Compact</b>	<b>Disbursement agreement</b>	<b>Procurement agreement</b>
Document	Outlines MCC's approval rights and documents the responsibility of compact country governments to ensure oversight of procurement.	Includes conditions precedent to disbursements of funds from MCC to the compact country that MCC can use to enforce the requirements in the procurement agreement and compact.	Lists specific rules and procedures that the procurement agent will follow in managing procurement for the compact country.
Compact country roles and responsibilities	<ul style="list-style-type: none"> <li>• Provide oversight, ensure the removal or disclosure of any conflicts of interest, and conduct audits on at least an annual basis.</li> <li>• Ensure transparency by establishing a Web site for the program and posting procurement documents online.<sup>a</sup></li> <li>• Create procurement review bodies in both Cape Verde and Honduras.</li> </ul>	<ul style="list-style-type: none"> <li>• Submit a report comparing actual procurement activity with procurement plans for the second most recent disbursement period as a condition precedent to disbursements.</li> <li>• In Madagascar, provide a semiannual review report on compliance with the procurement guidelines for MCC review.</li> <li>• In Cape Verde, establish a procurement review commission and its charter, prior to receiving MCC disbursements.<sup>b</sup></li> <li>• MCA-Honduras must create and approve a bid challenge system acceptable to MCC prior to receiving funds for the second quarter of operations.</li> </ul>	<ul style="list-style-type: none"> <li>• Submit reports; and obtain MCC approvals before undertaking procurements above thresholds.</li> <li>• Report deviations from approved procurement plan to MCC. Cape Verde and Madagascar to report deviations valued at more than \$10,000. Honduras to report all deviations.</li> <li>• Provide a procurement plan semiannually.</li> </ul>
MCC role and approval authority	<ul style="list-style-type: none"> <li>• Approve the members of Cape Verde's procurement review commission and Honduras's procurement supervisor agreement.<sup>c</sup></li> <li>• Authority to terminate the compact if the compact country government or another party materially breaches the compact or any supplemental agreement, such as a procurement agreement.</li> <li>• Requires the signing of a procurement agreement prior to entry into force.</li> </ul>	<ul style="list-style-type: none"> <li>• Review and approve periodic plans and reports.</li> </ul>	<ul style="list-style-type: none"> <li>• Approve procurements above thresholds.</li> <li>• Review and approve any deviations from approved plan above certain thresholds.</li> <li>• Review and approve the compact country's procurement plan, including proposed procurements and methods of procurement.</li> </ul>

Source: GAO analysis of MCC documents.

<sup>a</sup>In Cape Verde, MCC compact funding is also supporting the creation of an electronic procurement system. First, MCC is funding the establishment and implementation of a public e-procurement system for use in compact procurements. Second, it is funding the expansion of this system to all other units of the government.

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**Appendix IV**  
**Summary of MCC Procurement Agents,**  
**Standards, and Provisions in Madagascar,**  
**Cape Verde, and Honduras**

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<sup>b</sup>As conditions precedent to any disbursements for procurement management, MCC has required that the government of Cape Verde will (1) request, as a matter of national interest that requires urgent resolution of the National Assembly, that the passage of a harmonized public procurement law, with a supporting regulatory framework, be placed on the legislative agenda and (2) establish a long-term program, with support in the national budget, for the establishment of local procurement training capacity (facilities and personnel), which will be sustainable without donor funding within a period of 5 years.

<sup>c</sup>In Honduras, the compact also requires MCC approval of a procurement operations manual.

# Comments from the Millennium Challenge Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



July 7, 2006

Mr. David B. Gootnick, Director  
International Affairs and Trade  
Government Accountability Office  
441 G Street NW  
Washington, DC 20548

Dear Mr. Gootnick:

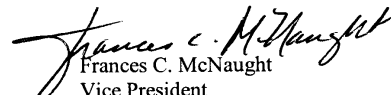
We appreciate the opportunity to review and comment on your draft report, "MILLENNIUM CHALLENGE CORPORATION Compact Implementation Structures Are Being Established, Framework for Measuring Results Needs Improvement."

The enclosed Millennium Challenge Corporation views are provided for incorporation with this letter as an appendix to the final report.

Thank you again for your willingness to accommodate our concerns and for the consistent professionalism of the GAO staff in their dealings with MCC.

If you have any questions concerning this response, please contact Rick Stilgenbauer, Program Officer, Department of Congressional and Public Affairs, at (202) 521-3629.

Sincerely,

  
Frances C. McNaught  
Vice President  
Congressional and Public Affairs

Millennium Challenge Corporation Comments on GAO Draft Report

**MILLENNIUM CHALLENGE CORPORATION Compact Implementation Structures Are Being Established, Framework for Measuring Results Needs Improvement**

**General**

The Millennium Challenge Corporation (MCC) would like to thank the Government Accountability Office for their thorough work in producing this audit. MCC appreciates the acknowledgement by GAO of the considerable effort and progress that we have made to develop structures, processes, and procedures at the same time that initial Compacts were being developed with eligible countries. There does however, appear to be some misunderstanding about the full complexity of *engaging* eligible countries and developing and writing policies and procedures for *how* we would engage countries at the same time, as exemplified in statements such as: "...in assessing the proposals, MCC used criteria contained in guidance issued after or shortly before the countries submitted their proposals" or "...although its assessments used criteria that it had not yet published in its guidance." MCC's mandate to engage directly with eligible countries shortly after its creation did not allow for the possibility of developing and vetting policies and procedures in advance of such engagement. We expect this criticism will not be valid beyond the early instances pointed out in this audit.

We also appreciate GAO's identification of several issues of concern to the Corporation.

**Economic Analyses**

MCC remains devoted to one of its founding principles: that economic analyses reflect country conditions and involve country participation. Indeed, this is one of the primary goals in developing Compacts. Whenever feasible, any MCC economic analysis uses data and makes assumptions based on information obtained from each country in order to accurately reflect the country's socioeconomic conditions. For example, in Madagascar, an important part of the analysis was based on a study using agricultural data from rural areas in Madagascar. In Honduras, the analysis was based on data that an agricultural consulting firm had collected from local activities. We agree that in some cases the level of country engagement on economic analysis could be improved. To address this issue, MCC revised its economic guidelines and other guidance materials to better prepare country staff to play a larger role in the analysis. MCC now asks each eligible country to engage an economist on its core team early in the proposal process. In addition, MCC economists make early technical guidance trips to work with the core team and the core team economist in the country. Finally, the new economic guidelines provide specific examples of economic rate of return ("ERR") analysis for development projects in order to reduce confusion about the analysis required for investment decisions.

**Baseline Data**

See comment 1.



See comment 2.

Obtaining more accurate and reliable baseline data is a priority for MCC. For example, in the case of Madagascar, MCC completed three large national surveys which were subsequently reviewed by the U.S. Census Bureau. These surveys collected information from hundreds of questions, most of which produced satisfactory data. Since baseline data collection has not been completed in Cape Verde or Honduras, it is not yet possible to assess data quality in those cases. (The decision to undertake and structure baseline data surveys must be conditioned by reasonable cost and likely value of additional precision.)

GAO's concern over unreliable baselines appears to stem mainly from the poor data on land value collected through Madagascar's Agricultural Productivity Survey. MCC and the Malagasy had hoped that a similar question in the Household Survey would fill the gap but unfortunately, this survey question has also proven to be unreliable; MCC and MCA-Madagascar are now discussing other methods of estimating targets for the high-level investment and income goal indicators. These will be outlined in a revised M&E plan to be completed in July.

As a more general point on baseline data, MCC, and all other donors, will continue to face data quality issues in the collection of baseline data in developing countries. MCC will continue to apply careful attention to baseline survey design, data collection, the review of data quality (as exemplified by our requirement for frequent data quality reviews), and data quality issues in a timely and transparent fashion. MCC remains committed to the value of these efforts and agrees with GAO in stressing their importance.

#### **Linkage of M&E Plans to Economic Analyses**

MCC agrees that there should be clear linkage of Monitoring and Evaluation plans to economic analyses. There has been notable improvement in this linkage since the development of the first Compacts. At the same time, MCC has a slight difference of opinion with GAO in terms of the appropriate level of aggregation in linking the two. MCC contends that not every estimated benefit from an ERR spreadsheet can be isolated and measured during implementation. MCC believes that the primary and most significant purpose of the M&E plan is to develop metrics that capture overall project results. In some cases, disaggregating each individual benefit stream from a project may not be possible or may prove to be too costly to be a feasible option.

See comment 3.

#### **Policies and Procedures for Establishing Targets**

As a rule, targets on performance indicators are set in accordance with the economic analysis justifying the program. At the same time, MCC agrees that more defined policies and procedures for establishing and modifying targets are needed. We will develop these further as additional Compacts are implemented.

#### **Timely Design of Impact Evaluations**

MCC appreciates the emphasis by GAO on impact evaluation and its timely design. MCC remains committed to credible and transparent impact evaluation which is another of our principles. In fact, M&E plans and disbursement agreements require evaluation plans to be substantially complete and baseline data gathered prior to disbursement on activities that might skew results measurement.

Compacts subsequent to those discussed in this report have benefited from earlier development of evaluation designs.

**Randomized Controlled Trials**

MCC would like to clarify that randomized controlled trial (RCT) is one of several methods that will be used to conduct rigorous impact evaluations. While most experts agree that evaluations using random assignment are best able to estimate and attribute the impact of specific interventions, MCC anticipates that, given the requirements of the design, RCT will be feasible and cost-effective for only a small number of projects to be evaluated in this manner. In all cases, metrics need to be developed before project or activity implementation begins. For example, Madagascar's evaluation of agricultural business centers cannot be designed until investment studies for the Compact regions are completed. These studies should be finished by December 2006 with evaluators targeted to begin work with country staff in September.

**Summary**

Overall, MCC is satisfied with the draft report GAO has produced from our nine-month audit and the constructive criticism within. However, GAO provided comments on a number of matters, but did not provide specific or tangible recommendations within these comments.

As always, MCC appreciates the efforts of the professionals at GAO and their willingness to work with the MCC to help us improve processes that will help carry out our mission of reducing poverty through sustainable economic growth.

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The following are GAO's comments on the Millennium Challenge Corporation letter dated July 7, 2006.

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## GAO Comments

1. MCC stated that "MCC's mandate to engage directly with eligible countries shortly after its creation did not allow for the possibility of developing and vetting policies and procedures in advance of such engagement." We recognize that MCC was simultaneously addressing a number of issues during its initial years of operation—selecting eligible countries, setting up MCC as an organization, and developing guidance and policies while also working with countries to finalize compacts. In the context of MCC as an evolving organization, we felt it was important to discuss the evolving nature of guidance to provide a balanced perspective regarding the process that eligible countries had to follow to sign compacts.
2. MCC stated that our concern regarding baseline data quality stems from one survey in Madagascar. However, we found issues with data reliability in Madagascar with both the Agricultural Productivity Survey and Household Survey. In the second survey, the error was smaller; therefore, we focused on the Agricultural Productivity Survey to illustrate the more significant example.

The measurement of land values is very important for Madagascar's monitoring and evaluation plan. Both the compact-level goal of increasing household income and the program objective of increasing investment in rural Madagascar are measured in terms of land values. In each of the zones, the expected increase in household income is estimated at 5 percent of the average land value, and the expected increase in investment is estimated at 27 percent of the average land value. With a large error in baseline data, it will be difficult to accurately track progress toward the compact-level goal and program objective.

3. MCC noted that not every benefit can be isolated and measured during implementation, and that disaggregating may not be feasible. We recognize that not all outcomes of the economic analysis can be directly tracked with indicators at different levels of monitoring or for impact evaluation. There are trade-offs between cost and level of detail. However, as we note in this report, aggregation poses some challenges that could limit the effectiveness of monitoring and evaluation.

# Comments from the Department of State

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



**United States Department of State**

*Assistant Secretary for Resource Management  
and Chief Financial Officer*

*Washington, D.C. 20520*

Ms. Jacquelyn Williams-Bridgers  
Managing Director  
International Affairs and Trade  
Government Accountability Office  
441 G Street, N.W.  
Washington, D.C. 20548-0001

JUL 10 2006

Dear Ms. Williams-Bridgers:

We appreciate the opportunity to review your draft report, "MILLENNIUM CHALLENGE: Compact Implementation Structures are Being Established, Framework for Measuring Results Needs Improvement," GAO Job Code 320370.

The enclosed Department of State comments are provided for incorporation with this letter as an appendix to the final report.

If you have any questions concerning this response, please contact Lawrence Connell, Financial Economist, Bureau of Economic and Business Affairs, at (202) 647-9462.

Sincerely,

A handwritten signature in black ink, appearing to read "Brad R. Higgins".

Bradford R. Higgins

cc: GAO – Michael Simon  
EB – Daniel Sullivan  
State/OIG – Mark Duda

**Department of State Comments on GAO Draft Report**  
*“Millennium Challenge Corporation: Compact Implementation Structures are Being Established, Framework for Measuring Results Needs Improvement”*  
(GAO-06-805, GAO Code 320370)

OVERVIEW

Thank you for the opportunity to comment on GAO’s draft report “Millennium Challenge Corporation: Compact Implementation Structures are Being Established, Framework for Measuring Results Needs Improvement.”

The GAO report is well researched, but has a tendency to make minor or transitory problems sound like major criticisms. The report should note the improvements that MCC made during and since the period it covers. The report makes six specific criticisms of the MCC that reflect its interviews, research, and country site visits. These criticisms are presented and addressed below.

1) *“MCC based its assessments on an evolving set of criteria: early, general guidance to the countries followed by later, more specific guidance.”*

GAO criticizes MCC for assessing country proposals based on 2005 guidance that was updated from the 2004 guidance countries used when drafting proposals. GAO claims that MCC’s initial guidance did not inform countries that their proposals should be linked to compact goals, but the notion that countries would be wholly unaware of the need to design their compact programs to specifically target compact goals in order to receive compact funding is erroneous. It is to be expected that MCC would update formal guidance as it grew, evolved, and built institutional knowledge. Countries requesting informal guidance from MCC could have received it at any time, and the notion that compact funding would be linked to compact goals was clearly implied. These mitigating factors should be acknowledged in the report.

2) *“MCC’s analyses of projects’ economic impact were limited in that some of the assumptions and data used may not reflect country conditions, and as a result, the projects selected on the basis of the analyses may not be the most likely to achieve compact goals.”*

See comment 1.

See comment 2.

MCC is criticized for making assumptions on the Economic Rate of Return (ERR) of projects which were not substantiated by GAO's in-country "focus groups." GAO fails to detail, however, the (1) methodology used by these groups, (2) group size, (3) gender, age, or racial status of participants, or (4) whether participants were urban or rural, etc. It is unrealistic to assume that GAO's focus group study should exactly reproduce the results of MCC country team's economic analysis.

MCC is criticized for analyzing proposals from Madagascar and Honduras before publishing formal economic analysis guidelines. One could argue that this was nonetheless the right decision, given the need for MCC to demonstrate progress by approving/signing compacts 15-18 months into its existence, rather than holding them up for finalization of such guidelines. The compacts themselves have not been criticized for their economic content.

3) *"MCC conducted the analyses with limited country participation, with the result that the countries had little understanding of the process."*

See comment 3.

GAO reports that representatives in the three compact countries analyzed, Cape Verde, Honduras, and Madagascar, reported receiving little assistance from MCC officials in developing the economic models and data used for analysis. GAO mentions that MCC officials told them that "countries' degree of involvement depended on the capability and willingness of the countries' proposal development team to actively participate in the analysis."<sup>1</sup> GAO does not rebut this point, which seems to explain fairly the limits on compact country participation.

4) *"Oversight structures for country management with MCC review...were not fully staffed for months after the compacts entered into force."*

See comment 4.

GAO criticizes MCC for the amount of time it took to hire in-country staff-- two to six months to fill critical positions. This timeline, however, compares favorably to general government hiring. GAO acknowledges that in the case of Honduras, two jobs had to be re-competed because there were initially no suitable candidates. GAO offers MCC no recommended alternative to its taking the time to find good, or at least fully qualified, candidates for positions of trust.

See comment 5.

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<sup>1</sup> Page 30.

5) *“Fiscal accountability structures for MCC-funded projects, and established procurement structures with effective characteristics...are still largely untested and some are still under development.”*

See comment 6.

GAO praises MCC for making “progress in defining the mechanisms and processes of internal control that provide reasonable assurance of fiscal accountability at the compact level.”<sup>2</sup> GAO notes that “each country’s compact requires the accountable entity to develop its own fiscal accountability plan,”<sup>3</sup> but criticizes MCC because the various compact agreements “differ in the maturity of their internal control”<sup>4</sup> systems. This is to be expected, given that some countries have more historically well-developed systems from which to draw on; GAO is not clear as to which if any of MCC’s choices it would have made differently. GAO notes that MCC will be conducting at least yearly audits, and consequently the processes and procedures in place will ultimately become even better developed through additional time and experience.

6) *“Limitations in the baseline data collected, linkage to economic analyses, addressing uncertainty associated with program results, and the timely design of randomized controlled trials may constrain MCC’s ability to monitor and evaluate programs.”*

See comment 7.

The Department concurs with GAO that baseline data is vital for measuring results, and that a lack of quantifiable baseline data could be problematic for assessing project results. However, we believe that GAO’s reliance on project evaluation criteria that make use of randomized controlled trials to measure success, while appropriate in judging scientific experiments, is not likely feasible for most infrastructure and social development projects. Use of cost-benefit analysis that measures projected and actual outcomes with and without the projects is a better model, and could be usefully adopted by MCC if it has not done so already.

See comment 8.

The Department notes that in the footnotes on Page 8, “country credit rating” is listed as one of the Encouraging Economic Freedom indicators, when the report should list this indicator as “the cost of starting a business,” to reflect the change made for FY 2006. We would also like to suggest that on Page 1, the sentence “MCC expects to raise incomes and lift thousands out of poverty in countries receiving MCC assistance,” be changed to “MCC expects to permanently raise

See comment 9.

<sup>2</sup> Page 37.

<sup>3</sup> Page 38.

<sup>4</sup> Page 39.

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incomes and lift tens of thousands out of poverty in countries receiving MCC assistance,” to underscore MCC’s transformational goal.



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The following are GAO's comments on the Department of State letter dated July 10, 2006.

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## GAO Comments

1. In referring to our discussion about MCC's guidance on project coherence, State Department commented that it would be erroneous to indicate that countries were wholly unaware of the need to design their compact programs to target compact goals, and that informal guidance from MCC could have been received at any time. We agree that countries could have requested informal guidance from MCC. According to MCC, they did provide verbal guidance to countries regarding the need to link projects to compact goals.

However, MCC rejected tourism and preschool education projects proposed by Honduras because they were not linked to the impediments to growth that emerged from the consultative process. MCC also rejected projects in Cape Verde because MCC's due diligence did not indicate that these projects addressed key constraints in Cape Verde. Given that these two countries submitted projects that did not meet project coherence criteria, MCC's verbal guidance may not have been sufficient to direct countries to submit proposals meeting these criteria.

We recognize that MCC was simultaneously addressing a number of issues during its initial years of operation—selecting eligible countries, setting up MCC as an organization, and developing guidance and policies while also working with countries to finalize compacts. In the context of MCC as an evolving organization, we felt it was important to discuss the evolving nature of guidance to provide a balanced perspective regarding the process that eligible countries had to follow to sign compacts.

2. State noted that we did not detail the methodology and composition of our Madagascar focus groups. We summarized the composition of the focus groups in the letter of this report. We met with these 29 individuals, including representatives of MCA-Madagascar and Madagascar ministries, during the course of our week in Madagascar and reviewed with them the assumptions used in MCC's economic model for its projects. As previously discussed in this report, we found that these officials were not closely involved in MCC's economic analysis. According to MCC and Madagascar officials, an MCC economist met with four Madagascar representatives in Paris, France,

during compact negotiations and reviewed the model with them at that time. (MCC officials did travel to Madagascar during due diligence to assess proposed projects.) When we discussed this with MCC officials, they stated that not traveling to Madagascar to develop the model was a mistake, and one that has not been repeated.

3. State commented that we do not rebut MCC's point that countries' degree of involvement depended on their capability and willingness to participate. (See comment 2.)

In its letter, which is reprinted in appendix V, MCC agreed that in some cases, the level of country engagement on economic analysis could be improved. MCC also now requires that countries engage an economist on the core country team, provides examples of the economic rate of return analysis, and has MCC economists make early technical guidance trips to work with the core country team and the core country team economist. These procedures were not in place when MCC conducted the economic analysis for Madagascar, Cape Verde, or Honduras.

By not thoroughly involving the countries in this analysis, MCC risks not meeting its stated principle of focusing on results. In MCC's results-based framework, the economic model is the basis for determining performance targets against which funding is conditioned. MCA-Madagascar may find that the targets are unrealistic if the targets have not been thoroughly discussed with, and understood by, Madagascar officials.

4. State noted that the time for the in-country MCA organizations to hire staff compares favorably with general government hiring. Management unit officials are hired by a compact country's MCA program steering committee, not the U.S. government. As such, it is not "general government hiring" and should not be compared with it.
5. State correctly observed that we did not offer MCC a recommended alternative to its taking the time to find good candidates for positions. We did not make a recommendation for addressing this issue because MCC has adopted a policy implementing the authority given it by section 609(g) of the Millennium Challenge Act of 2003 to make grants to facilitate compact development and implementation. MCC's current policy includes a provision where, if certain conditions are met, it may fund an eligible country's request for "management support payments"

for salaries, rent, and equipment for the country's team prior to compact signature. We have added a discussion of this policy in the letter of this report to clarify this point.

6. In referring to our discussion about the different maturity of internal control between Madagascar and Cape Verde, State pointed out that differences in the maturity of internal control between the countries are to be expected, given that some countries have historically more well-developed systems. We agree that different countries will differ in their maturity of internal control due to historical differences in the underlying systems and accountability infrastructures. The current maturity of internal control in each country, however, is a key consideration in assessing risk and establishing effective oversight mechanisms to deal with the unique risks in the key financial processes and activities of each country.
7. State referred to "GAO's reliance on project evaluation criteria that make use of randomized controlled trials to measure success." This comment misconstrues our findings on the use of randomized controlled trials. We do not rely on these criteria. We are commenting on MCC's use of randomized controlled trials, which MCC has indicated are its preferred method of impact evaluation, and on the potential challenges to the use of this approach. State's comments regarding cost-benefit analysis would be more appropriately addressed to MCC.
8. State correctly noted that we did not capture the change to one indicator for fiscal year 2006. We have updated the list of MCC indicators in footnote 8.
9. State suggested rewording MCC's expected results to "MCC expects to *permanently* raise incomes..." We did not use the word "permanently" because in the three compacts that we focused on for this report, it was not used to describe MCC's expected results at the country level.

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# GAO Contact and Staff Acknowledgments

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## GAO Contact

David B. Gootnick, Director, 202-512-3149

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## Staff Acknowledgments

In addition to the person named above, Phil Herr (Assistant Director), Claude Adrien, Cara Bauer, Gergana Danailova-Trainor, Jeanette Franzel, Keith Kronin, Reid Lowe, Norma Samuel, Mona Sehgal, and Michael Simon made key contributions to this report. Also, Tim DiNapoli, David Dornisch, Etana Finkler, Ernie Jackson, Debra Johnson, Bruce Kutnick, Janice Latimer, Charlotte Moore, and Celia Thomas provided technical assistance.

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