Helpdesk Research Report: Performance-based Funding
Date: 05.03.2010

Query: What is the international experience of using performance based funding in development (focusing on donor-to-country disbursement mechanisms)?

Enquirers: United Nations and Commonwealth Department, DFID

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1. Overview

Performance-based funding, also referred to as performance-based financing or results-based financing, comprises a broad variety of mechanisms. It includes donor-to-country disbursement mechanisms designed to improve aid effectiveness, intergovernmental transfers, donor-to-supplier disbursement mechanisms, and a range of tools that national governments can adopt. The vast majority of the literature focuses on the latter two mechanisms, in particular in the area of health care. There is very limited literature on donor-to-country arrangements. Of the literature that exists, the two mechanisms that receive the most attention are the Millennium Challenge Corporation (MCC) and the European Commission Governance Initiative Tranche (ECGIT). As such, this helpdesk report focuses on these two performance-based funding mechanisms. A detailed description of each mechanism is provided at the beginning of their respective sections. There is more literature on the MCC as it has been in operation since 2004, whereas the ECGIT was launched in 2007. In addition, the MCC has produced more publicly available information than the European Commission on the GIT.

The MCC and the ECGIT provide an interesting comparison of performance-based funding as they differ in their approach. The literature is generally complementary of the MCC and there is evidence that it has been effective in motivating countries to engage in reforms. In contrast, the ECGIT has been criticised for poor design and weaknesses that limit its ability to promote reform. Some of the key areas of divergence include:

- **Reward approach**: The MCC incentives are based on disbursement of aid that is contingent on past performance. It adopts a model of selectivity. The ECGIT, on the other hand, disburses aid in exchange for promises of reform and pays little attention to past performance. The MCC approach has been found to be effective in promoting country reforms and the adoption of sound policies; whereas the ECGIT has been critiqued for risk of non-compliance.
- **Incentive**: The EC’s governance incentive tranche is not considered to be financially significant, whereas the Millennium Challenge Account offers much higher financial rewards. As such, the latter is considered to be more instrumental in influencing
country government decision-makers. Those within the Commission, however, stress that the incentive created by the ECGIT is primarily political and that the promotion of dialogue on governance issues is the key element of the mechanism. While the initiative seems to have promoted dialogue among EU donors on governance, it is less clear whether political dialogue between the EC and recipient countries has been sufficiently and systematically established.

- **Transparency:** The MCC has adopted a policy of transparency in its country selection process and also in terms of encouraging public participation in compact proposal development and programme implementation. Information about programmes is often available in the local media and on the MCC website. In contrast, the ECGIT has been critiqued for poor transparency concerning the negotiation and outcome of tranche allocations. The lack of public disclosure makes it difficult for civil society to monitor resources and to hold recipient governments accountable for their commitments.

- **Country Differentiation:** The EC adopts a ‘one size fits all’ approach to its country assessments and does not provide different criteria for fragile states (although it does provide an incentive tranche bonus for fragile states that submit an action plan). This has been critiqued for failing to take in consideration the weak ability for governments in fragile states to implement reforms. In contrast, the MCC provides some support through its Threshold programme and in its support to compact implementation for building country governance capacity.

### 2. Millennium Challenge Corporation

The Millennium Challenge Act of 2003 established an independent government entity, the Millennium Challenge Corporation (MCC), and created the Millennium Challenge Account (MCA) as a clearinghouse for “results-based” foreign aid. Proponents of this form of aid argue that aid is more effective when given to well-governed countries and that countries will respond to such rewards by pursuing reforms and sound policies (Johnson and Zajonc, 2006).

Stubbs (2009) provides a detailed overview of how the MCA operates:

- **Foreign aid is provided in the form of specific infrastructure and economic development grants to developing countries that demonstrate a commitment to:**
  1. ruling justly: addresses good governance and rule of law;
  2. investments in people: particularly in women and children, through programmes that promote broad-based education, public health and that aim to reduce child mortality; and
  3. economic freedom: addresses commitment to economic policies that encourage private sector growth, sustainable management of natural resources, market forces and participation in international trade, and respect for worker rights

- **Progress in these areas is measured by sixteen indicators (see p. 637). A range of third-party sources provide data used to assess each indicator.**

- **In order to be eligible for MCA funding, a candidate country must:**
  1. fall within per capita income limits;
  2. score above the median relative to other potentially eligible countries on at least half the indicators in each category;
  3. score above the median on the “control of corruption” indicator; and
  4. not be barred from receiving U.S. aid (i.e., trade sanctions).

- Although these performance indicators are the main method of country selection, the MCC Board has some discretion to designate countries as MCA-eligible even if they
do not strictly meet the indicator minimums, and to exclude countries that may technically qualify.

- Countries who pass the minimum indicator thresholds and are selected as candidate countries by the MCA Board of Directors may then submit Compact proposals to the MCA. A Compact is a legally binding multiyear agreement between the MCC and an eligible country to fund specific programmes aimed at poverty reduction and economic growth.

- The MCC encourages eligible countries to submit proposals based on the perceived needs of the country, as determined by the country's leaders in conjunction with citizens, civil actors, and development partners. These proposals are to be implemented, managed and maintained by the recipient country.

- MCC works with the country to ensure the proposed programs are reasonable, measurable, and attainable.

- For countries that fall slightly short of MCA eligibility, the MCC has a Threshold Programme, whereby it has discretion to provide funds to these countries (no more than 10 percent of the total amount of MCA funds). These funds are aimed at improving their MCA indicator scores such that they can qualify for Compact funding.

- Once selected to receive Threshold assistance, countries must create their own plan that identifies measurable ways to improve a specific indicator score and then submit that plan to the MCC for review and approval.


This paper is the first systematic attempt to evaluate whether the incentives provided by the Millennium Challenge Corporation (MCC) are effective in encouraging countries to reform and pursue sound policies. Although the MCC had only been in operation for two years at the time of this study, the authors find substantial evidence that countries respond to the prospect of MCC Compact funds and consider them sufficient incentive to undertake tangible reforms.

The study’s empirical analysis aims to provide robust evidence by comparing candidate countries to a reasonable control group and using reform patterns from before and after the MCC was created. The study finds that on nine of thirteen governance indicators upon which aid rewards are based, candidate countries are more likely to improve and display larger absolute increases in the post-MCC period (p. 22). In addition, the study finds that “over 25 percent of candidate countries improve their civil liberties, education expenditure, health expenditure, immunization rate, inflation and regulatory quality indicators because of the MCC” (p. 2).

This empirical evidence that the MCC has caused candidate countries to reform provides more conclusive findings and strong support to anecdotal evidence. Such anecdotes include:

- “In Armenia, presidential contender Vartan Oksanian referred to the Millennium Challenge Account (MCA) funds when calling for increased openness in the upcoming election stating: ‘We are now in a situation where any step away from democratization and a repeat of electoral fraud would have an economic cost. And I can name that cost: 235 million dollars’.

- According to the MCC website, the minister of finance for Bangladesh, Saifur Rahman, pointed to his country's exclusion from the list of MCC eligible countries as one of the heavy consequences for its high level of corruption.

- Representatives of the countries themselves have identified the MCA funds as a principal rationale behind reforms” (p8).
This paper reviews the Millennium Challenge Account (MCA) and finds that it demonstrates the effectiveness of results-based foreign aid: “the MCA is directly influencing candidate countries to make tangible improvements in governance, transparency, regulatory environments, and the rule of law” (p. 682). It has fostered such reforms in three ways:

- **ex ante** through the MCA Effect, whereby developing countries are changing domestic laws and policies specifically in order to qualify for MCA funding;
- **ex post** through the MCA Compacts, whereby recipient countries are implementing various governance programming mandates; and
- through the Threshold Programme, whereby less stable governments are engaging in judicial and legal reform.

Part IV of the paper highlights empirical and anecdotal evidence of successes. It highlights the anecdotal and empirical evidence provided in the Johnson and Zajonc study summarized above. It also provides additional anecdotal evidence that suggest a direct correlation between the incentive of receiving MCA Compact funds and governance and regulatory reforms:

- The Government of Lesotho enacted the *Legal Capacity of Married Persons Act* in direct response to MCA funding negotiations: “This Act abolishes a husband’s exclusive marital power and grants women independent access to credit. Prior to enactment of the Act, married women had the same legal status as minors and were prohibited from entering contracts or owning property. Married women also had no standing in civil court. Although Lesotho was technically eligible for Compact funding, the MCC strongly encouraged rapid action to correct this serious legal inequality. The MCA built upon this MCA Effect by assisting with implementation of the new law through Lesotho’s MCA Compact” (p. 651).
- Since signing a Compact with the MCC in 2005, Madagascar has simplified regulations for new businesses, which has led to a 26% increase in new start-ups.
- Threshold Programme recipients have made notable improvements in indicator scores, making them eligible for MCA Compact funding.

The paper cautions, however, that the MCC should focus more on encouraging improvements in governance indicators in the eligibility process and in actual MCA Compacts. The Johnson and Zajonc study indicated that the MCA Effect is more robust in improving economic and social investment indicators than governance indicators. Although this could be attributed to greater difficulty and a longer time frame necessary to enact policy changes to improve governance indicators, the paper stresses that MCA Compacts have increasingly centred on agriculture and industrial expansion with little attention to complicated governance reform initiatives. This is in contrast to the Threshold agreements, which often target corruption and rule of law indicators. These are two of the biggest stumbling blocks for Threshold countries. The paper also cautions against partisanship and pushes for the continued independence of the MCC.
This report documents the MCA experience, based on varying stages: compact proposal development (Mozambique, Ghana, and Tanzania); compact implementation (Honduras, Madagascar and Nicaragua); and the Threshold Program (Tanzania and Malawi). It is the outcome of visits conducted between July 2005 and March 2007 as part of the Center for Global Development’s MCA Monitor Program. The following are some observations and lessons:

Successes of the MCC approach:

- **Changing national mindsets about development**: government officials have been gaining confidence in managing their own development -- in setting priorities, planning programmes, and in some cases, managing budgets and promoting policy change.
- **Making bold and integrated investments**: the MCC has sought to tackle difficult reforms in land tenure and the financial sector. In addition, MCC compacts often pair a mix of central-level policy reform with community-level interventions.
- **Raising the bar on transparency**: “the MCC’s transparency starts at the selection process, when countries are chosen based on performance relative to their peers on publicly-available, objective criteria. But the transparency goes deeper than this. The MCC’s emphasis on public participation in compact proposal development and program implementation means that information about MCA country programs is often available through local radio, TV and written media. The MCC manages a well-designed and accessible website that makes public a lot of information about country programmes, and it requires partner countries to do the same. In a number of countries, the MCC fosters government planning processes that raise country standards for publicly sharing information and setting priorities” (p. 3).

Key Challenges Going Forward

- **Defining and demonstrating results**: the MCC needs to do a better job at publicizing outputs as opposed to inputs (i.e. disbursements). Unlike other US development programmes that channel money through NGOs to get immediate results on the ground, the MCC focuses on investing in country capacity to strengthen planning, financial management, reporting, and monitoring during the first year of many MCA programmes. The MCC has also learned from prior problems of rushing the entry into force (EIF) of early compacts before countries were ready and is now seeking to ensure that a structure is in place before EIF. In addition, it seeks to foster civil society participation and build evaluation functions. These aspects, however, are largely hidden to MCC observers in the US.
- **Refining the notion of country ownership**: the MCC model is based on the premise that countries are ready, willing and able to take ownership of the planning, implementation and monitoring of development strategies. However, such capacity is often lacking in the poorest countries. As such, the MCC now seeks to combine “country ownership” during compact development and implementation with clear guidance and a hands-on partnership. In addition, the MCC also needs to continue to explore its proper role in encouraging countries to adhere to MCC principles such as meaningful civil society consultation and donor coordination. Countries differ greatly in their ability and will to foster ‘meaningful participation’ and consultation, and there is room for the MCC to invest time, expertise and resources to promote such consultations.
This report reviews El Salvador's Millennium Challenge Account (MCA) programme in the early phases of implementation. It notes that El Salvador stands out as a case in which country ownership and the will to succeed are unusually high. The country has paid attention to careful sequencing and has completed agreements to allow existing ministries to execute component activities, both of which, alongside a strong civil society, contribute to effective programme implementation.

The report stresses that high country ownership on the part of all stakeholders in the country will likely lead to results and commitment to reform that goes beyond the programme. The MCA programme has fostered multi-party collaboration. Although the Millennium Challenge Corporation (MCC) process focuses on central government functionality, it has contributed to political linkages at the local government level: “for the first time mayors from Arena, FMLN, and PCN (the major political parties) are meeting and working together to take advantage of the opportunities offered through MCC investments in their respective regions. The MCC presence is not only encouraging stakeholders to share information on how best to organize and help constituents bid on MCA projects but also fostering a sense of shared commitment to raise additional funds for projects that will build upon their infrastructure and human development components” (p2).

The report finds that another key benefit of the MCC is institutional capacity building. The entity managing El Salvador's MCC compact has been able to compel ministries to fulfill their respective mandates, thus strengthening and capitalizing on existing governmental capacity. In addition, the MCC is helping to strengthen existing ministerial capacity in El Salvador. For example, the government is developing its capacity to engage in environmental assessment (with the help of a World Bank grant) in order to fulfill the compact requirement of completing a strategic environmental assessment in the Northern Zone as a precedent for disbursement of funds. Management of the natural resource base had previously been neglected. Another example of capacity building involves the Ministry of Public Works and Transportation (MOP). It has been gaining substantive experience in managing a suite of infrastructure projects that are larger in monetary value and scale than any previous single programme: “At the conclusion of the compact, MOP will have developed a cadre of experienced project managers who can implement large scale domestic transportation projects critical to sustained economic growth and poverty reduction” (p. 3).

3. European Commission Governance Incentive Tranche

The European Commission announced in 2006 the establishment of the ‘Governance Incentive Tranche’ for African, Caribbean and Pacific (ACP) countries in 2006. It forms part of the European Development Fund (one-twelfth of the budget, around €2.7 billion) and consists of supplementary funding to states which commit themselves to satisfactory governance reforms.

Molenaers and Nijs (2009) provide an overview of how the Governance Incentive Tranche (GIT) operates:

- The EC first produces a governance profile of the partner country, divided into nine sections. The first six are based on the World Bank’s governance indicators.
- The local EC delegation than conducts its own assessment for all nine sections.
- All governance profiles are checked for their comparability at headquarters in Brussels, after which they are sent back to the EC field missions, where the most
significant weaknesses identified in the assessments are singled out by the EC and prioritised.

- At this stage, dialogue begins with the partner country: “the EC delegation encourages the government to propose reforms that adequately tackle the identified governance concerns. If the government agrees to do this, it is expected to put forward an action plan that lists all the planned measures, which preferably derive from other reform plans (for example, the PRSP)” (p. 567).

- EC headquarters assesses these action plans based on three criteria:
  1. Relevance: matching of the weaknesses recognised in the governance profile by relevant reforms;
  2. Ambition: political will, and level to which weaknesses are dealt with;
  3. Credibility: results-oriented indicators and realistic timelines, and the capacity to carry out the action plan. Previous performance may be relied upon here.

Alongside qualitative assessments, a quantitative score is given based on these three criteria. This quantitative score determines the tranche awarded. The tranche serves as a ‘top-up’ to the initial country allocations. The four tranches are:

1. Initial level (10%): basic or intermediate score on all three criteria
2. Second level (20%): one or two criteria given a basic or intermediate assessment; at least one high score
3. Third level (25%): at least a high score on all three criteria (p567)
4. Fourth level (30%): all criteria assessed as very high

- An extra 5% is added for countries that have concluded the African Peer Review Mechanism (APRM). Fragile states also receive a 5% bonus.

- The action plans are then sent back to the field for discussion and are attached to the Country Strategy Papers, which must be approved by the EDF committee.


This report reviews the Governance Initiative for African, Caribbean and Pacific (ACP) countries and Africa, launched in 2007. The ACP initiative has two key components:

- An incentive mechanism (the Governance Incentive Tranche) that gives ACP partner countries access to additional funding, based on their commitments to achieve tangible results in democratic governance reform; and
- Political and financial support for the African Peer Review Mechanism.

The report outlines the tranche allocations for the 67 countries that have presented a Governance Action Plan:

- 5 Plans – 10% incentive tranche
- 12 Plans – 20% incentive tranche
- 47 Plans – 25% incentive tranche
- 3 Plans – 30% incentive tranche

The process and nature of allocations have been critiqued for various reasons, which include:

- Lack of transparency: stakeholders have complained about a lack of transparency in the review process. In addition, individual assessments and the amount of incentive tranche allocated to each country have not been made public.
Politicisation: the lack of transparency has contributed to perceptions that the allocation process is a political exercise. Many stakeholders feel that there is little understanding of the differentiation between countries.

Insufficient incentive: The difference between levels of incentive tranche is also considered too small. Moreover, comparison between the size of the additional tranche and national income and total aid receipts demonstrates that the incentive tranche is not financially significant: “For nearly all the ACP countries the incentive tranche is equivalent to less than 0.5% of gross national income (the average figure is 0.29%). Expressed as a percentage of official aid, the governance incentive tranche is slightly higher” (p. 9).

The review highlights some positive aspects of the Governance Initiative:

- The Initiative is intended to encourage regular political dialogue between the EU and partner countries. Where such a political dialogue exists, governance forms a component of it in most cases.
- The Initiative is also linked to the application of the Paris Principles on Aid Effectiveness and the harmonisation of Member States’ policies on governance: “In many countries the Initiative has improved discussion between EU donors on governance issues and led to clearer diagnosis and a sense of greater shared understanding of the main challenges” (pp. 9-10). This, however, has yet to lead to enhanced donor coordination, joint action, joint monitoring or joint dialogue.

The review provides the following recommendations:

- The various processes involved in the Governance Initiative need to updated to provide more clarity, inclusiveness and transparency;
- A sound monitoring system needs to be set up to monitor the action plans such that performance assessments can be results-based. Member States and ACP partners should be consulted on the development of appropriate indicators;
- The report sees the incentive created by the tranche as primarily political. It encourages partner countries to engage in a political dialogue on governance and to formalize its political commitment for reform in a “contract”. It advocates that political dialogue should increase, be more systemic and regular, and be seen in a more strategic long-term perspective. It recommends that the EU set clear objectives regarding what it wishes to achieve through such political dialogue on governance issues;
- An increase in the financial incentive of the tranche should be considered; and
- The governance incentive process and the APRM should jointly develop more intensive interaction.

http://www3.interscience.wiley.com/journal/122540113/abstract

The European Commission's Governance Incentive Tranche (ECGIT) is one of the few instruments that explicitly links financial transfers to the governance situation in recipient countries. This paper seeks to assess the ECGIT, in particular the extent to which it contributes to aid effectiveness. The evaluation is based on a desk study of European policy documents, interviews with Commission officials in Brussels and with other relevant donor agency staff. The authors stress the very limited publicly available information available on the actual implementation of the tranche in the field. This is due in part to the relative newness of the instrument, which began disbursing funds in 2008, and the withholding from the public realm of the full report of the only EC commissioned evaluation.
The paper finds that although the EC presents the tranche as an ‘incentive’ and a ‘dialogue’-based approach, distinct from more traditional, conditionality-based aid allocations, its approach is not necessarily realistic: “It supposes that all ACP governments will enthusiastically undertake governance reforms requested by donors, even without clear agreements on how these commitments will be followed up. This reasoning actually makes the need for a financial ‘incentive’ seem contradictory” (p. 569).

The paper identifies a range of weaknesses of the ECGIT, which it argues result in a low probability that the ECGIT will actually instigate governance reform. These weaknesses include:

- **Risk of non-compliance:** The ECGIT is essentially based on disbursement of aid in exchange for “promises of reform”: This, the paper argues is similar to governance efforts that have failed in the past. Political will to reform and track records of performance will vary from country to country. The ECGIT moves away from new ideas of selectivity by paying minimal attention to partner countries’ past track record or commitment. In addition, where partner countries are not committed to reform, the ECGIT takes on the form of *ex ante* adversarial conditionality, instead of notions of dialogue, partnership and ownership.

- **Poor quality governance action plans:** Some of the action plans produced by recipient countries are vague and lack measurable performance indicators or timeframes, failing to demonstrate serious government commitment to reform. In some cases, the action plans do not reflect existing governance strategies and were produced in parallel. There was also some critique that political negotiation and bargaining between Member States was opaque and consultation with stakeholders (e.g. civil society and parliament) was weak.

- **One size fits all approach:** The EC adopts ‘a one size fits all’ approach despite the very different levels of governance and capacity among ACP countries. In particular, it does provide different assessment criteria for fragile states. The paper contrasts this with the approach adopted by the Millennium Challenge Account, which has a special programme to improve governance in countries that are on the ‘threshold’ of eligibility of funding.

- **Absence of support with implementation and capacity building:** No specific funding is envisioned to assist with implementation of action plans, nor was there support to assist partner countries in developing their action plans.

- **Lack of transparency:** There is little transparency concerning the dialogue on action plans or the final commitments themselves and stakeholder awareness of the process and outcomes are low. In addition, the negotiations and the outcome of tranche allocations in the EDF committee are kept confidential. This makes it difficult for civil society to monitor resources and to hold recipient governments accountable for their commitments.

- **Weak financial incentives:** The paper states that the assessment methodology for the governance action plans make it impossible not to get access to a tranche. So long as a country submits an action plan, it will receive a minimum of 10%. Incentive to move up to higher tranche levels will vary depending on the extent to which it would affect the total aid budget. The paper finds that in contrast to the Millennium Challenge Account, the “ECGIT exercise does not confront partner countries with terribly high stakes … [In the case of Mali, for example], its yearly allocation from the MCA is 2.5 to 3 times bigger than the yearly ECGIT it receives” (p. 574).

- **Weak monitoring and evaluation:** Despite the importance of a strong M&E system to render a results-based approach effective, there is little in EC documents on the GIT on M&E. Some of the people interviewed as part of this study expressed the hope that the EC and the Member States would have the “political courage to reconsider the allocations of partners who have not shown enough progress in the implementation of their action plans. Unfortunately, the EC did not prepare in detail
how this monitoring will take place. There is no exact methodology for monitoring the implementation of the action plans nor is there yet a lot of clarity on how it will affect the country allocations” (pp. 575-576).


This section of the conference proceedings looks at the coexistence of the EC Governance Incentive Tranche (ECGIT) and the African Peer Review Mechanism (APRM). In so doing, it provides a brief overview of the ECGIT. It outlines the three key tools of the ECGIT:

- The Profile
- The Dialogue
- The Governance Action Plan

The profile is an analytical tool that assesses the governance situation of the country and points out the main challenges and shortcomings. The profile is not taken into consideration when allocating a tranche; however, it helps in assessing the relevance of the Governance Action Plan. Within the framework of programming of the tenth EDF (2008-2014), more than 60 ACP countries submitted a governance action plan. Only one country, the Bahamas, decided against submitting a plan. The Incentive Tranche allocation process took place over 18 months (from the end of 2006 to mid-2008) and involved intensive work and discussions and dialogue with EU member states and partner countries.

The author notes that the EC had expected greater progress with the APRM process; however, only six of the 29 subscribed countries had completed their review. The Commission had the option of freezing the tranche funds until further progress was made, but ultimately decided to proceed with distribution while still trying to support the APRM.

The author acknowledges that the financial incentive of the ECGIT is not very much. Rather, he argues that political dialogue is the key element of the whole mechanism.

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Selection of websites visited
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