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The Good Governance Indicators of the Millennium Challenge Account: How Many Dimensions are Really Being Measured?

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Summary. — This paper assesses the validity of the perception-based governance indicators used by the US Millennium Challenge Account (MCA) for aid allocation decisions. By conducting Explanatory and Confirmatory Factor Analysis of data from 1996 to 2009, we find that although the MCA purports to measure seven distinct dimensions of governance, only two discrete underlying dimensions, the perceived "participatory dimension of governance" and the perceived "overall quality of governance," can be identified. Our results also show that some of the doubts that have been raised concerning the validity of perception-based governance indicators *are less warranted when the indicators are applied exclusively to developing countries.*

Key words — aid allocation, governance indicators, Factor Analysis, MCA, United States

1. INTRODUCTION

In 2003, the Bush administration launched the US Millennium Challenge Account (MCA), an innovative development assistance program whose aid allocation mechanism is largely based on a competitive assessment of developing countries' governance performance. In contrast to the donor agencies who, in response to the aid effectiveness debate, implemented new or modified existing aid programs in order to encourage improved governance under existing partnership frameworks, the MCA made good governance an explicit and rigid precondition for the granting of aid to developing countries. The MCA is the first and only bilateral aid agency that has adopted a competitive aid allocation mechanism which explicitly relies on a set of publicly available governance indicators.

With the MCA's increasing significance—the program has since its foundation in 2003 committed nine billion US dollars in grants to 18 developing countries—an extensive debate on its modalities of delivery has ensued. Various aspects, such as the strictly bilateral approach to program implementation without participation in donor harmonization efforts on the ground; its ambiguous relationship to existing US aid agencies such as USAID; and the issue of funding volumes and the absorptive capacities of recipient countries, have been abundantly analyzed and discussed (see, e.g., Clemens & Radelet, 2003; Sperling & Hart, 2003).

Yet little attention has been devoted thus far to a key question: Are the perception-based governance indicators used by the MCA conceptually valid, robust, and therefore appropriate for making aid-allocation decisions? In light of the general debate that has emerged on whether perception-based governance indicators satisfactorily measure and distinguish between various dimensions of governance, this question is particularly salient (Arndt & Oman, 2006; Langbein & Knack, 2010; Thomas, 2010).

This paper discusses the validity of the MCA's governance assessment framework. In particular, it explores the merits of the argument often voiced in the literature that the perception-based governance indicators used by the MCA fail to distinguish between various dimensions of governance, especially in the case of developing countries. Using standard statistical techniques to detect latent variables, including Explanatory and Confirmatory Factor Analysis, we find that while the MCA ostensibly measures seven distinct dimensions of governance, only two distinct underlying dimensions—namely, the perceived *participatory dimension of governance* and the perceived *overall quality of governance*—can be identified. Our results suggest that the general doubts that have been voiced concerning these indicators—in particular the singular dimensionality of perception-based governance indicators are less warranted when the indicators are applied exclusively to developing countries.

The following section reviews the current debate on the reliability and validity of perception-based governance indicators. Section 3 provides an overview on the MCA's program modalities and its allocation mechanism. Section 4 assesses empirically to what extent the MCA's specific indicator-based method for measuring the quality of governance is reliable, robust, and conceptually valid.

2. LITERATURE REVIEW

While issues such as institutional development, democratic legitimacy, and accountability were of ancillary importance to geo-political and geo-strategic considerations for aid allocation during the Cold War era, in the 1990s *good governance* emerged as the new *sine qua non* of development cooperation (e.g., Chhotray & Hulme, 2009; Doornbos, 2001; Hermes & Lensink, 2001). The seminal paper by Burnside and Dollar (2000), which identified a strong relationship between sound policies and economic growth, as well as an abundance of subsequent research provided the empirical grounds for a realign-

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ment of aid allocation mechanisms toward explicit or implicit conditionality on good governance (e.g., Arndt & Oman, 2006; Berthélemy & Tichit, 2004; Burnside and Dollar, 2004).

In recent years, the supply of governance indicators has risen exponentially in line with the development community's growing demand for a quantifiable operationalization of the governance concept. The World Bank Institute suggests that there are currently more than 140 sets of indicators available, comprising several thousand individual quantitative measures (World Bank Institute, 2006). The best-known indicators are those provided by the World Bank, the World Bank Institute, the International Country Risk Guide, Freedom House, the Heritage Foundation, and Transparency International. Because of their extensive country coverage, sophisticated statistical methodology, and excellent methodological documentation, the indicators provided by the World Wide Governance Project of the World Bank Institute have in recent years advanced to become the most widely used and quoted governance indicators (Arndt, 2010; Kaufmann, Kraay, & Mastruzzi, 2004, 2005, 2007a, 2008; Kaufmann, Kraay, & Zoido-Lobatón, 1999a, 1999b).[1]

Recent research has discussed several aspects of conceptual and technical limitations of perception-based governance indicators in general, and the World Wide Governance Indicators (WGIs) in particular. Kurtz and Schrank (2007) suggest that the dominant measures of governance, in particular the WGIs, are problematic and suffer from perceptual biases and adverse selection in sampling. Similarly, Thomas (2010) warns that lacking empirical evidence in support of their construct validity, the WGIs might amount to little more than an elaborate but unsupported hypothesis. Langbein and Knack (2010) generally question the ability of the WGIs to measure distinct underlying concepts and present empirical evidence of strong content overlap and a tautological construct.

Due to a lack of alternatives, these perception-based indicators are nevertheless used for ranking countries and for subsequent aid allocation (Kaufmann & Kraay, 2002); the most prominent example being the MCA. Accordingly, the question is naturally raised as to whether these indicators are suitable for assessing policy performance in developing countries.

The existing literature focuses to large extent on some general properties of governance indicators (e.g., Kurtz & Schrank, 2007; Langbein & Knack, 2010), including their intertemporal incomparability, the limitations of cross-country comparability due to large standard errors, and the methods used to aggregate a varying number of source measures (Kaufmann, Kraay, & Mastruzzi, 2007b). The present paper instead seeks to make a unique contribution by assessing to what extent the application of these indicators to developing countries yields reliable and robust conclusions in terms of dimensionality and measurement reliability. In this way, our analysis, which specifically examines the MCA's aid allocation mechanisms, aims to provide important insights into the dimensionality and validity of governance assessments of Low Income Countries (LICs).

3. THE MILLENNIUM CHALLENGE ACCOUNT

(a) *Scale and scope*

At the 2002 UN Financing for Development Conference, President G.W. Bush announced the establishment of a new Millennium Challenge Account to provide an additional five billion dollars per year in grants to developing countries. In the words of the President, aid would be disbursed to those countries that *govern justly*, *invest in their people*, and *encourage economic freedom*.[2] Aside from the amount of aid promised, the most notable aspect of the MCA program is its competitive allocation process, which uses predefined and transparent governance measures to determine country eligibility. This means that the MCA's mechanism to identify eligible countries is clearly segregated from US foreign policy objectives; an aspect that has received considerable attention (OECD, 2003; Radelet, 2002a, 2002b).[3] Furthermore, the program displays a commitment to strengthening recipient ownership and accountability by assigning developing countries the lead in program development and implementation. This has been perceived as a progress toward delivering on the commitments to provide more effective aid made by the international donor community at Monterrey.

Although the original commitment of an additional five billion US dollars per year has never been met, the scale of MCA funds is significant in both absolute and relative terms (Table 1). In 2008, funds appropriated under the new program amounted to 1.75 billion US dollars and accounted for approximately 12.5% of US core development assistance, as classified under the budgetary sub-function International Development and Humanitarian Assistance (IDHA).[4]

This is a substantial figure, considering that a large share of US assistance subsumed under the IDHA function is dedicated to emergency relief or tied to reconstruction programs from the military interventions in Afghanistan and Iraq. Since fiscal year 2004, a total of 9.22 billion US dollars have been appropriated to the MCA from the US federal budget.[5] So far, 18 recipient countries have received funding through so-called Millennium Challenge Compacts.[6]

In order to realize the MCA's transformational potential and encourage recipient countries to implement projects and programs critical to their economic and social development, the MCA intended to place its assistance among the top aid donors in eligible countries (Nowels, 2006). Over the last 5 years the financial value of compact programs has constantly increased. While the compact agreements signed in 2005 averaged around 180 million US dollars, more recent programs have been significantly larger in size,

Table 1. *MCA appropriations in USD billions*

	2004	2005	2006	2007	2008	2009
MCA funds requested by the President	1.300	2.500	3.000	3.000	3.000	2.225
MCA funds appropriated by Congress	0.994	1.488	1.752	1.752	1.752	1.486
US International Development and Humanitarian Assistance[a]	13.807	17.696	16.693	15.524	14.074	22.095
MCA funds as a percentage of US International Development and Humanitarian Assistance	7.20	8.41	10.50	11.29	12.45	6.73

Source: Tarnoff (2009) and The White House (2010).
[a] According to outlays of functions and sub-functions of the Office of Management and Budget of the White House. This includes funding for bilateral development programs such as USAID, the MCA, the Global HIV/AIDS Fund, assistance to transition countries, contributions to multilateral organizations, the Child Survival and Disease Program, humanitarian aid, emergency relief, migration and refugee assistance, and efforts to combat the drug trade.