Governance Indicators, Aid Allocation, and the Millenium Challenge Account: A Summary

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Aid is more effective when it is directed to countries with better institutions. The U.S. now plans to allocate funds from the new Millenium Challenge Account (MCA) to low-income countries which perform well on a set of 16 concrete indicators. Five of these are composite governance research indicators we have constructed for 1997/98 and 2000/01, measuring perceptions of *voice and accountability, government effectiveness, regulatory quality, rule of law,* and *corruption*. Among these, special emphasis is given to corruption: countries scoring below the median on this indicator would be ineligible for MCA funding. In early 2003 we expect to have the governance indicators for 2002.

Aid allocations ought to take corruption into account. When measuring corruption across countries for this purpose, there are no practical alternatives to the more subjective type of data, based on reports from experts, firm managers and citizens, on which we rely. However, the use of this data raises important issues we discuss in detail in the brief accompanying paper. These challenges also largely apply to the other MCA indicators. The views are ours; thus not necessarily those officially of the World Bank.

- Governance indicators have margins of error. The same is true for virtually any other indicator. This means that simple "in-or-out" allocation rules risk misclassifying countries. We quantify such errors. These risks are not trivial: for one-third of the potentially MCA-eligible countries, there is at least a 25% chance they will be mistakenly classified as below the median when they should be above, and vice versa. *Rather than simply eliminating countries below the median, special scrutiny should be given to borderline cases.* Concrete suggestions are provided in the paper.

- Reducing margins of error requires more data. The governance indicators we construct draw on many of sources of information in an effort to minimize margins of error, and so are more reliable than any individual source. Yet for many low-income countries until now we have had information from only one or two data sources, and rankings for these countries should be treated with special care. [A number of MCA indicators in fact lack any data for a number of countries]. *Expanding the coverage of existing sources of governance data, and generating new information through tools like the World Bank's governance diagnostic surveys, would improve the reliability of aid allocation rules, and assist in monitoring performance trends (see below).*

- Measuring trends over time in governance is difficult yet important. Governance rankings can vary considerably from year to year, both because of actual changes on the ground, and also simply because of measurement error. Distinguishing real changes from noise is difficult, but it is important to identify countries with real improvements in order for them to become eligible for MCA resources, and conversely for deteriorating countries. The MCA Fact Sheet just released does not yet address this issue. *While existing indicators can identify some large changes in governance, they remain a blunt tool for assessing changes over short periods of time. Both additional sources of information as well as a measure of flexibility will be required in deciding how countries' MCA eligibility changes over time.*