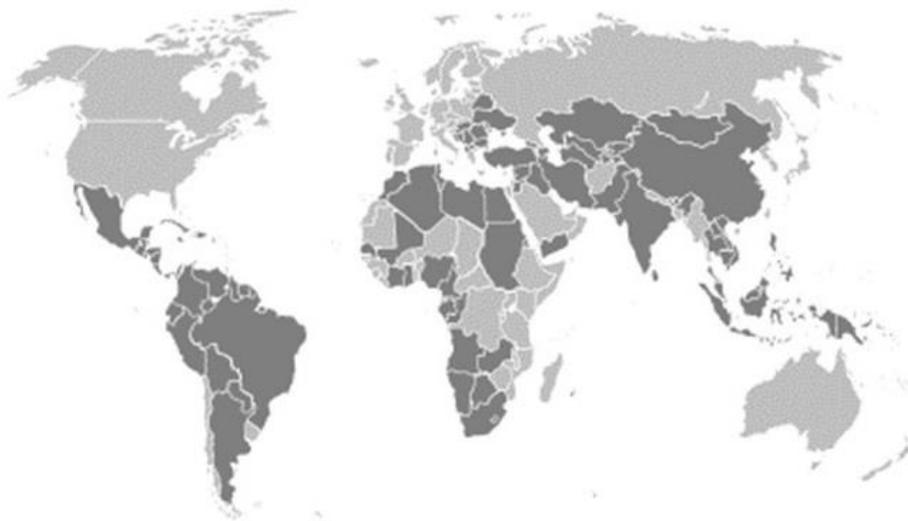


Recipients *and* Contributors

Middle income countries and the
future of development cooperation

Executive summary and main recommendations



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Introduction¹

Middle income countries (MICs) still face considerable structural deficits and vulnerabilities that affect their development process. Not only do MICs need the support of the international community; the international community needs MICs to succeed if global development goals are to be met.

In spite of the development problems in MICs, many international donors are in the process of reducing financial support to them. This is concerning. Nothing automatically changes for a country when it crosses per capita income threshold. While it is true that policy coherence is likely to be more important for MICs than financial transfers, it does not follow that such transfers are unimportant. They remain a key part of the global effort to reach sustainable and equitable growth.

We therefore urge the international community to reconsider current trends and further plans to reduce international public finance for middle income countries.

“Traps” and “gaps” – a needs analysis

Despite the diversity of the MICs category, some useful observations can be made about the challenges faced by countries as their per capita income increases. We use the term “MIC Traps” to mean those constraints to progress resulting from a set of mutually reinforcing blocking factors. By ‘MIC Gaps’, on the other hand, we mean those constraints which require large financial investments to overcome. Inevitably, there is somewhat degree of overlap between these concepts.

MIC Traps

As countries rise up the income ladder they tend to be affected less by absolute shortages and more by asymmetries and bottlenecks in the development process including:

TRAP 1 Productivity and technological change: moving from traditional productive specialization towards more dynamic and technological sources requires structural change

TRAP 2 Green technological transformation: improvements in energy efficiency and an accelerated shift to sustainable energy while preserving the drivers of economic growth

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TRAP 3 Macroeconomic stability and international financial integration: integration into international financial markets while preserving the macroeconomic stability required for sustained growth

TRAP 4 Social cohesion, governance and institutional quality: improving governance within a context of high inequality and social fragmentation

MIC Gaps

Financing estimates depend on a set of assumptions about growth and inequality and notably, on the ambitions of the international community – less ambitious objectives will require less money because financing gaps will be smaller. In our view the responsibility of the international community for the poor and marginalized does not end when a family or a country crosses a somewhat arbitrary income line. The vast majority of the world's poor, and an increasing amount of its problems with sustainability, are located in MICs.

GAP 1 Persistent poverty

Even if one is optimistic about extreme poverty, projections for the next 20 years show a burgeoning mass (3-4 billion people) of insecure people in the \$2-\$10 range, mostly in MICs.

GAP 2 Infrastructure

In the long run, the impact of infrastructural development can be felt in an increase in productivity and energy efficiency, in the reduction of transportation and communication costs, in strengthening regional integration, and in a more adequate supply of social services. In the short term, however, it can be very expensive, especially if it is to be “green”.

MICs as recipients: The role of development cooperation in MICs

As countries climb the income ladder and (in most cases) more funds become available domestically or from international private sources, countries will rely less on external public finance in the form of aid. But the fact that countries may not *need* aid as much as before does not mean that it may not still be a very important contribution to development. Development cooperation should be oriented to complement and encourage MIC capacities.

International support can help overcome MIC **traps** more by accompaniment than large-scale funding. We identify five key roles of this kind of incentivising financial cooperation:

1. *Encouraging improvements in policies/politics.* Whether the level of cooperation is large or small, the incentivising effect has always been a crucial part of its effectiveness, and will continue to be so.
2. *Supporting non-government actors.* As the development problem gradually shifts from absolute lack of resources to their poor distribution, the advocacy and accountability roles of civil society, broadly understood, become even more important.
3. *Leveraging and adding value to private finance.* Just as it can at the national level, international public money can play a crucial role in bringing private funds forward to invest in public-interest projects.
4. *Capacity development (individual and institutional).* There is not a reduced need for technical capacity building in MICs, just an evolving one.
5. *Risk coverage, including environmental disasters and financial shocks.* Some MICs are among the countries most exposed to natural disasters, and they are more likely to be at risk of financial shocks than LICs, as they are generally more integrated into global financial markets.

Many MICs have significant **gaps** in public budgets for reducing poverty and achieving a more sustainable path to development. In some, towards the poorer end of the spectrum this is still linked to an absolute lack of resources; in others, it is related to poor revenue mobilisation or other governance problems. So old-fashioned large-scale financial transfers often remain crucial. But there are two objections.

First, the perception that MICs can raise the required resources without recourse to aid or development cooperation. We argue that domestic taxation is often insufficient to deal even with the cost of ending \$1.25 or \$2 poverty, let alone end persistent insecurity. There may also be significant limitations in terms of access to private capital markets.

Second, that external funding may slow the pace of political change (such as the need to increase taxes) by reducing the pressure on governments to act. We argue that aid at low levels relative to the size of GDP is unlikely significantly to slow progress to a more equitable use of resources – on the contrary, in many instances, when it is carefully oriented in terms of good incentives, it may further the pressure for change.

In short, MICs can make good use of international public funds to complement domestic finance (public and private) and international private finance, whether to respond to traps (quality of funding) or gaps (quantity). That funding need not necessarily be grant aid; it could be concessionary finance. We are aware of the downward pressure on aid funds in many OECD countries, but we do not believe that the progress of many countries up the income ladder should be seen as an excuse for aid reductions, when the real reasons are domestic political perceptions in OECD countries. More aid is needed for MICs; whether it is provided is one of the major choices facing the international community.

MICs as contributors: Supporting the contributions of MICs to international development

Development cooperation should not only support MICs to overcome the constraints that affect their own development processes, but also back their efforts to participate more intensely in the development agenda regionally and globally.

Supporting south-south cooperation (SSC)

The progressive participation of all countries, especially the more wealthy MICs, in international cooperation should be promoted by *HIC donors* through various forms of triangular and regional cooperation:

- Helping official agencies and their technical bodies to strengthen their cooperation systems
- Taking part in triangular cooperation
- Scaling-up successful innovations
- Backing SSC platforms for technical support

Meanwhile, *SSC contributors* could enhance their development cooperation by:

- Improving their information systems for better transparency and accountability
- Encouraging the involvement of non-governmental actors
- Diversifying modalities of cooperation
- Establishing learning mechanisms through more intense evaluation and peer review

Providing regional and global public goods

The appropriate provision of regional and global public goods is crucial for promoting material progress and reducing instability and international risks. To encourage MICs to assume a committed role in such provision, the international community has to define the right incentives and supporting measures to compensate costs.

- MICs should actively share their experiences, and provide technical assistance and financial and in-kind support, in response to the most urgent international public goods (usually environmental).
- Vulnerability to environmental and global risks should be integrated into allocation criteria.
- All contributors should work together in promoting progressive change in patterns of energy production and consumption.

A regional perspective

A regional focus is more likely to promote inclusive mechanisms of voice and representation and better adaptation to country-specific problems; several public goods are regional in scope, and the stability and economic growth of large MICs is a factor of equilibrium and progress in their region. International cooperation should focus on:

- Promoting an ambitious regional connectivity plan
- Support for technological cooperation programs
- Encouraging MICs to take leading roles in regional integration processes
- Strengthening regional development banks and bond markets

Policy coherence, global rules and governance

Improvements in policy coherence should be promoted in some MICs as well as the established developed countries. Monitoring policy coherence could be carried out at regional level, as a part of south-south cooperation, in order to maintain ownership of the process. Voice and representation should be adapted in some global governance structures to reflect countries' current weight in the international arena. Without such an enabling international environment many national development efforts will be fruitless.

Implications for allocation and effectiveness

We turn finally to two key areas for development agencies, particularly in the context of current international negotiations: allocation and effectiveness. What does the foregoing analysis mean for the prioritisation of scarce resources, the means of transfer (modalities), and accountability mechanisms?

Allocation

It has become commonplace to recognise that the income per capita threshold at which LICs graduate to MIC status is insufficient and somewhat arbitrary. Nevertheless, the main problem is not with the classification itself but the fact that donors use it to decide countries' eligibility for, and allocation of, aid. Given the proliferation of country classifications and the likely contentious nature of any new

categorisation, an alternative is to identify countries by specific issues that development cooperation is seeking to support or respond to. When the issue is well-defined and the support measures well-designed, the problems that affect comprehensive (or country-based) categories (such as MICs) could be avoided. By way of example, we suggest the following three issues:

An access to credit constraint

Although most MICs do have credit ratings and thus access to capital markets in principle, their ratings are often the lowest non-speculative grade investment and thus concessional lending from donors in itself may remain important particular for long-run development financing. An issue-based classification could consider the credit ratings and/or rates of interest on 10-year treasury bonds as one way to differentiate between MICs.

Space for redistributive policies (and the taxable population)

MICs have very different levels of fiscal space for funding redistributive policies, and development cooperation should take this factor into account. An issue-based classification could use an indicator of domestic fiscal space to prioritise different subsets of MICs.

Environmental vulnerability

Within the MICs group there are countries that suffer severe environmental threats. One way to approach these threats is through the Economic Vulnerability Index (EVI), an indicator used in the definition of Least Developed Countries (LDCs). Many MICs also provide opportunities to invest in climate-compatible growth.

Effectiveness

There has been strong endorsement for the five principles of the Paris Agenda (ownership, alignment, harmonisation, managing for results, and mutual accountability) from a wide range of development actors, and they remain useful in many circumstances. But there have also been concerns that they are overly focused on “traditional” relationships between western donors on the one hand and low-income aid, fairly aid dependent, countries on the other. Thus, the concerns of the MICs, both as recipients and contributors, may not have been given enough space.

As the Paris process morphed into the Global Partnership for Effective Development Cooperation (GPEDC) at Busan in 2011, there was a clear attempt to expand the purview of the process to include the exciting innovations taking place in and between MICs. However, there are still some points of contention, including the stipulation to “use country systems” and to “untie aid”. MICs engaged in south-south

cooperation or as recipients may find alternative modalities more appropriate to achieve agreed results as effectively as possible. More generally, it is simply against the instincts of many non-OECD countries, enjoying their growing influence in international affairs, to tag onto an OECD-conceived project, however valid many aspects of it are.

It is likely that much of the work will need to be opened up again in order to define a new consensus on managing aid that involves these new players without renouncing the experience accumulated by traditional donors. It is possible that a sliding scale of indicators could be built, with some aid effectiveness priorities more appropriate in some contexts than others.

The High Level Meeting of the GPEDC in Mexico in April 2014 is an opportunity to further a more horizontal type of cooperation, more selective, based on incentives, integrated by multiple actors and using various instruments going beyond ODA which, up to a certain point, anticipates what future development cooperation should be like. That is the discussion that those involved in the aid effectiveness process should now be having – it will require a substantial review of the process as well as discussions of substance.