



***Aid allocation:
how to reconcile performance and fragility concerns
by addressing structural vulnerability***

**by
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The issue in a nutshell

- The so-called “performance based allocation” of aid (PBA) used by multilateral development banks gives an overwhelming weight to good policy and governance
- But the “fragile states”, that are recognized to need special support, are themselves designed by a low level of policy and governance
- Then the needed special support given to fragile countries and in particular those affected by conflict appears as a major exception to the PBA
- Exception particularly challenging for IDA and AfDF
- The two concerns, performance and fragility, can be reconciled, once fragility, vulnerability and performance are disentangled



PBA formulas at IDA and AfDF

- ***IDA Resource Allocation Index (IRAI)***

$$A_i = \text{CPR}_i^5 \cdot \text{GNIPC}_i^{-0.125} \cdot P_i$$

$$\text{CPR}_i = 0.24 \text{CPIA}_{\text{ABC}} + 0.68 \text{CPIA}_{\text{D}} + 0.08 \text{PORT}$$

- ***African Development Fund Allocation Formula***

$$A_i = \text{CPA}_i^4 \cdot \text{GNIPC}_i^{-0.125} \cdot P_i$$

$$\text{CPA}_i = 0.26 \text{CPIA}_{\text{ABC}} + 0.58 \text{CPIA}_{\text{D}} + 0.2 \text{PPA}$$



Other PBA formulas

- **Asian Dev. Bank (ADF): Country Allocation Share (CAS)**

$$A_i = \text{CCPR}_i^2 \cdot \text{GNIpc}_i^{-0.25} \cdot P_i^{0.6}$$
$$\text{CCPR}_i = \text{PIR}_i^{1.4} \cdot \text{GR}_i^{2.0} \cdot \text{PR}_i^{0.6}$$

- **Caribbean Development Bank**

$$A_i = (\text{country needs}) \cdot (\text{country performance})$$

$$\text{Country needs} = \log P \cdot \text{GNIpc}^{-0.9} \cdot \text{VUL}^2$$

$$\text{Country performance} = (0.7 \text{ PIP} + 0.3 \text{ PORT})^2$$

- **Inter-American DB (FSO): « Enhanced PBA »**

$$A_i = P^{0.5} \cdot \text{GNIpc}^{-x} \cdot (0.7 \text{ CIPE} + 0.3 \text{ PORT})^2$$

- **IFAD: Allocation Formula**

$$A_i = \text{GNIpc}^{-0.45} \cdot \text{RURPOP} \cdot (0.2 \text{ IRAI} + 0.45 \text{ RURSPA} + 0.35 \text{ PORT})$$



The response as presently given to the fragility issue

- Design of a *special category* benefiting from a special treatment, with definitions and devoted schemes differing
 - according to the international financial institutions
 - and changing over time, eg:
 - IDA: successively Licus, fragile states, post-conflict and reengaging, fragile and conflict affected
 - FAD: post conflict, then fragile states
- Possible use of *specific criteria* of performance for those countries: for instance at IDA the « post-conflict performance index » (PCPI)



AfDB and IDA operational treatment of FS compared

- Similar PBA formula (slight differences in coefficients)
- Specific enveloppes for Fragile States (FS)
- Specific indicator of governance for FS at IDA, not at AfDB
- Adjustment coefficient (top up) with the same indicator at AfDB, for Pillar 1, plus Pillars 2 (arrears clearance) and 3 (targeted support)
- Not the same name: now “ FS ” for FAD, FS&Conflict Affected for IDA
- Not the same list of African countries, although ongoing convergence through an« Harmonized list of fragile situations »



Outline of the argument

- (I) While state fragility is a major issue, the category of FS is elusive: need to disentangle state fragility and structural economic vulnerability, as well as FS and LDCs
- (II) Shortcomings of the treatment of fragility as an exception to the PBA, contrasting with relevance of a treatment of fragility through aid modalities
- (III) Content of a new approach of aid allocation, addressing both the performance and the fragility concerns by taking into account the structural vulnerability of countries



I

**State fragility, a major issue,
fragile states, an elusive category**

Disentangling state fragility and structural economic vulnerability



State fragility, still a major issue

- The number of conflicts may have decreased in the last fifteen years
- But increasing awareness of the risks and threats raised by political troubles, civil conflicts and state fragility for national development prospects and global stability
- Growth resumption of the last decade in Africa threatened by state fragility (Mali)
- Many poor countries still highly vulnerable to various external and natural shocks, and their states remain fragile



The design of state fragility...

- In 10 years, many definitions, not a clear concept, even a fragile one
- Around 2005 meetings and papers at the DAC (fragile states group), USAID, DFID... following previous naming (difficult partnership, failing states...)
- “Lack of political commitment and insufficient capacity to develop and implement pro-poor policies” (DAC)
- “Government cannot or will not deliver core functions to the majority of its people” (DFID)
- More generally lack of (state) *capacity*, political *will* (or authority) and *legitimacy*
- Any indicator of state fragility debatable, often heterogenous, none commonly agreed



... and the identification of fragile states

- Initially combination of a low income and a low CPIA, with various kinds of CPIA thresholds, either absolute (WB) or relative (DAC)
- Now attempt at OECD for designing FS both from CPIA and other classifications (which themselves rely on many indicators of quantitative and qualitative elements)... resulting in 43 FS, of which 30 LDCs
- More narrow design implicit in the G7+ group/club (« New Deal ») (19 countries)
- And (operational) definitions even more narrow in the MDBs



African Fragile States at FAD and IDA

- ADF (2012) 12 ***Fragile States***: Burundi, RCA, *Comores*, RDC, Côte d'Ivoire, *Guinée-Bissau*, Liberia, *Sierra Leone*, *Sud-Soudan*, *Sudan*, Togo, *Zimbabwe*
(2008): 9 Id. less *Soudan*, *Sud-Soudan* and *Zimbabwe*
- This list of 9 countries was quite different from IDA (2009) with also 9 African *Post Conflict and Re-engaging* Countries, not including the 3/9 in italics (or 6/12 of 2012) and including 3 others: Angola, Rep.Congo, Eritrea...
- New (2012) IDA list with 9 African ***Fragile and Conflict Affected*** countries closer to FAD list, including one more country (Chad) and three less countries: Comoros, Sud Sudan and Togo
- Result from ***Harmonized list of fragile situations*** including 30 countries (26 IDA eligible) and 2 territories, of which 26 identified from an harmonized average of WB/ADB/AfDB CPIA score <3.2 (21 LDCs), of which 13 with political and peace-building missions or peace-keeping missions (11LDCs), of which 9 African countries



Structural vulnerability as distinct from state fragility

- State fragility, whatever the definition, is designed and identified only from present policy and institutional factors, even now observable in MICs... not eligible to ADF or IDA
- Economic vulnerability is the risk for a country to be affected/harmed by exogenous shocks (either natural or external)
- Structural economic vulnerability is the part of general economic vulnerability that *depends on structural and long term factors, not on the present will of the country*
- As such depends on the likely size of recurrent shocks and the exposure to them, rather than on the resilience: the Economic Vulnerability Index (EVI), used for the identification of LDCS



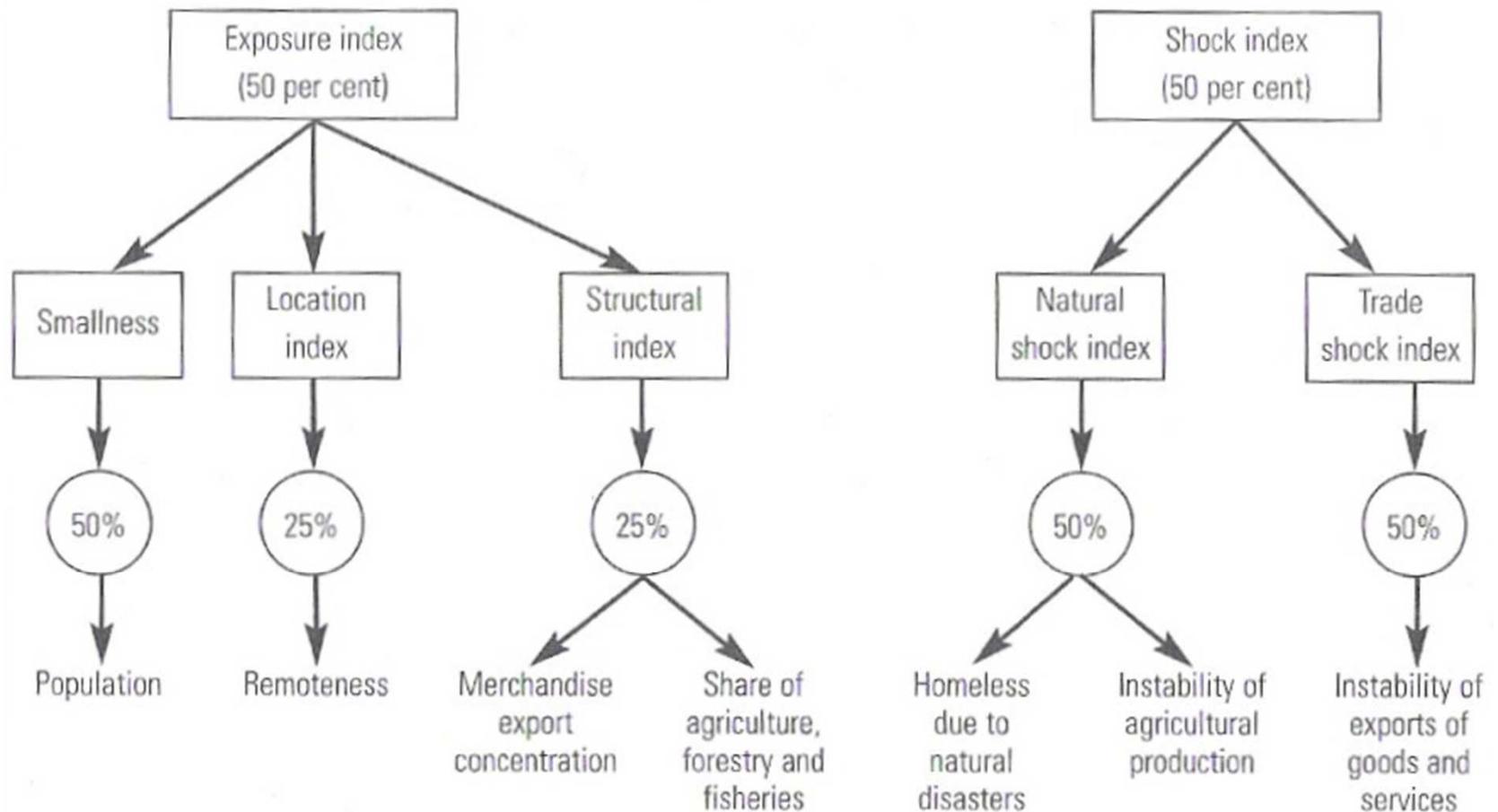
Identification of Least Developed Countries (LDCs)

- LDCs are designed as the LICs suffering the most from structural handicaps to growth and as such most likely to stay poor (« *Caught in a trap* »)
- *Only official UN subgroup* among developing countries (1971)
- From 25 to 50, now 48
- Identified from 3 criteria complementary for inclusion: low income pc, low human capital, high structural economic vulnerability
- *Structural category*, the stability of which is amplified by the precautionary graduation rules

Economic Vulnerability Index (EVI)



CDP





Why structural resilience has been kept aside

- General vulnerability also depends on the capacity to react, indeed dependent on present policy (main part), but also (a minor part?) on structural factors, the structural resilience
- These structural factors of resilience are broad factors, rather well captured by GNIpc and the Human Assets Index (HAI), that with EVI are used as complementary criteria for the identification of LDCs
- Including them in the vulnerability index would blur the specificity of the vulnerability concept

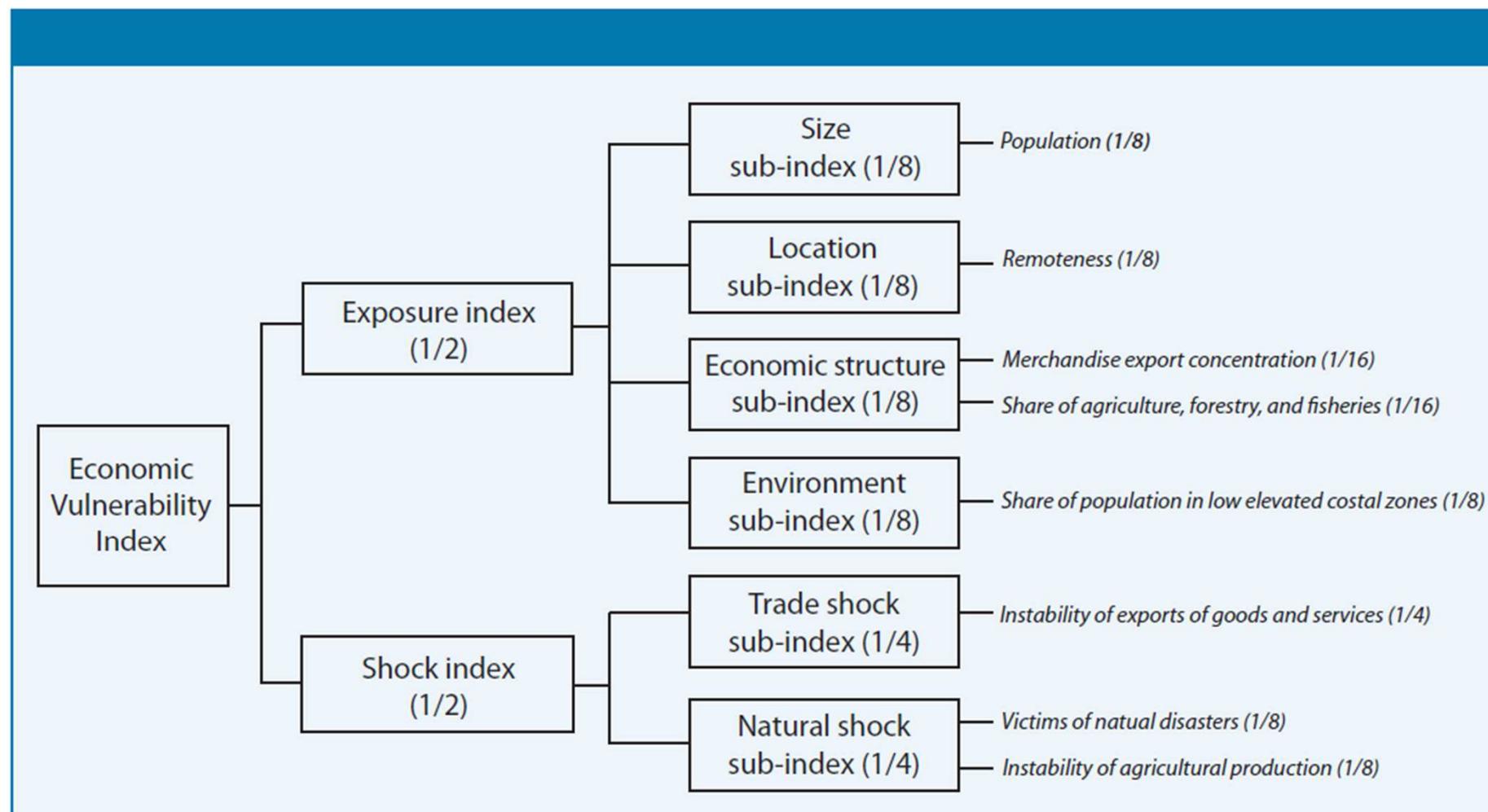


Changes recently brought in EVI ...and challenges

- Changes brought in 2011 for the 2012 review
- Same structure, but
- Among shocks components, homeless population due to natural disasters replaced by population affected...
- And a new exposure component added ,
the % of population living in low coastal area,
same weight being given to each of the new 4 sub-components
- Means a small move to make LDCs countries meeting structural obstacles for sustainable development, rather than only for growth
- Raises a debate about the distinction between economic and climatic vulnerability
- Anyway, it illustrates that the EVI gives a conceptual framework that may be adapted to various goals and contexts

Composition of the Economic Vulnerability Index (EVI)

Numbers in parenthesis indicate the weight in the overall EVI.





Links between structural economic vulnerability and state fragility LDCs and fragile states

- Structural economic vulnerability, distinct from *state fragility*,
- Leads to clearly separate LDCs and fragile states (FS)
- State fragility designed and identified only from present policy and institutional factors: lack of state capacity, political will and legitimacy (many changing definitions)
- Structural economic vulnerability designed from factors (exogenous shocks and exposure) independent of policy
- But structural vulnerability influences state fragility, because it influences policy : $CPIA = f(GNIpc, HAI, EVI)$
- And many LDCs are also FS (most of them are or have been so)
- But separately treated on the international agenda (Istanbul vs Busan)



II

Shortcomings of the present « allocation approach » to fragility

- The *design of state fragility*, unavoidably debated
- The *inconsistency* raised by a major exception to the rule
- *Discontinuity* and threshold effects due to the use of a category
- An approach not addressing the structural causes of fragility, i.e. purely curative and *by no means preventive*
- A confusing mix of aid *allocation* and *modalities* issues...
- Risks of indirect perverse effect



The « inconsistency » issue

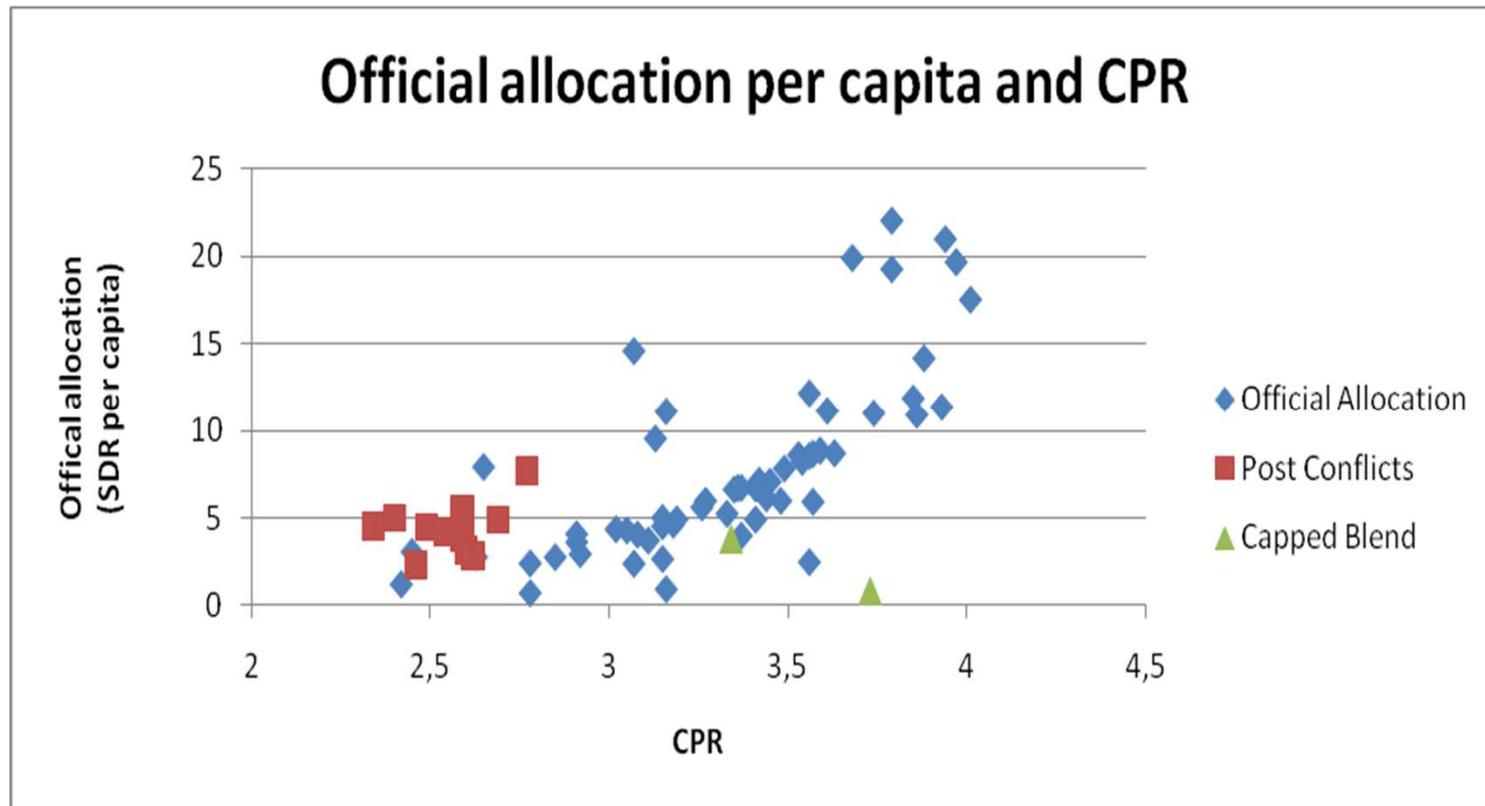
- The rule is supposed to allocate aid according performance,
- So making allocation higher for countries mainly designed by a their very poor performance is not consistent with the rule
- And all the less consistent that the number of these countries is likely to be significant
- An exception for very few countries facing exceptional circumstances becomes another rule, and an opposite one, undermining the « performance base » of allocation if applied to a large share of eligible countries



The resulting discontinuity and inequity

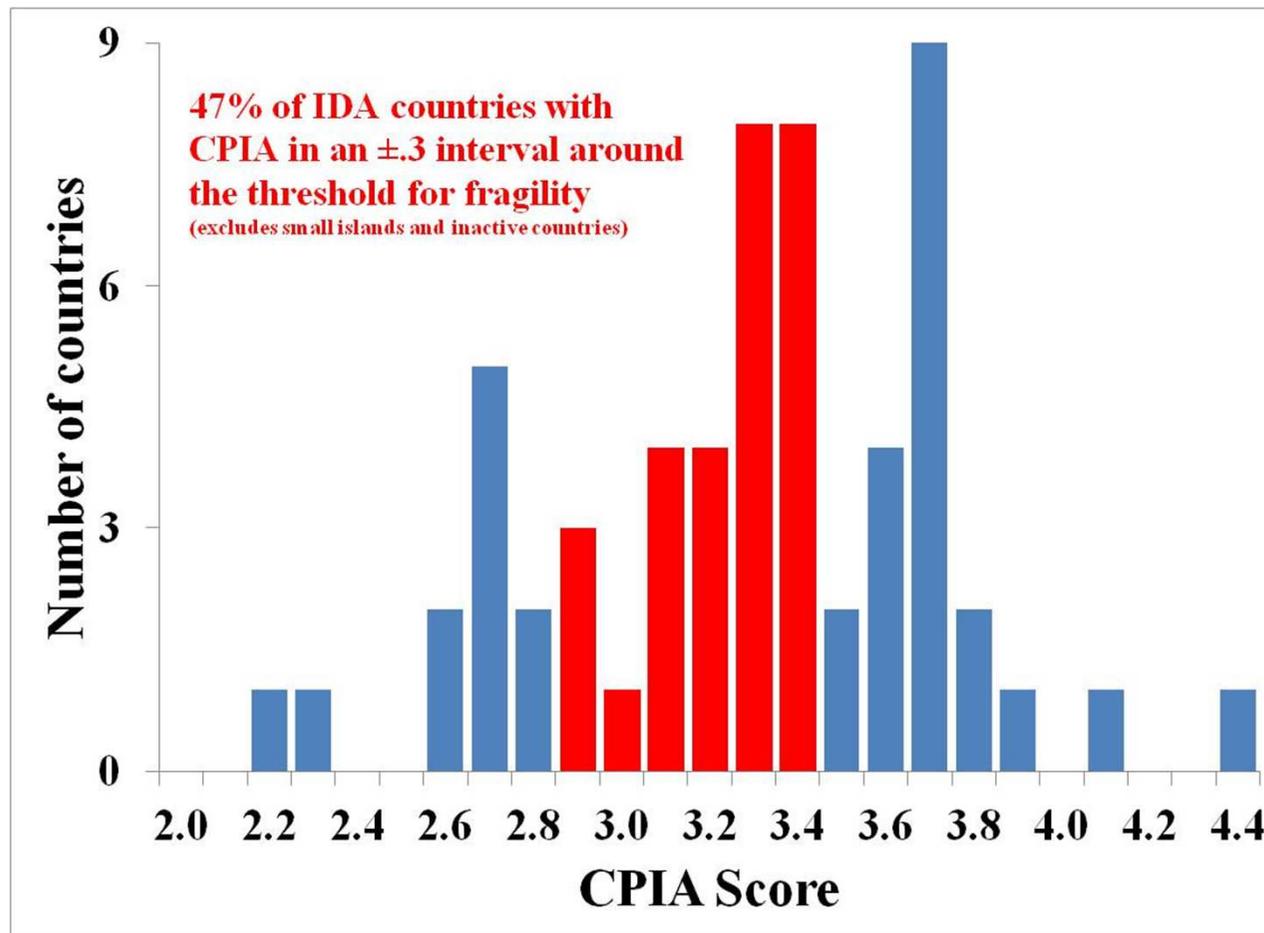
- Result of categorization
- Risk of arbitrariness in the choice of threshold, evidenced by the difference between lists of FS
- Threshold effects: crossing the threshold and being included into the group of FS results in a large deviation from the ordinary treatment (for instance if a CPA decrease of 11% instead of 10% makes a country fragile, it results in an increase of aid instead of a 40% decrease)
- Resulting non linearity in the relationship between “ performance ” and allocation (cf. graphs on IDA, two ones from IDA)

Figure 2. IDA aid allocation in 2009 as a function of the agreed measure of performance



Challenges in dealing with allocation issues

- Significant share of FCS and non-FCS have CPIA ratings around the 3.2 threshold for fragility (47 percent with a CPIA between 2.9 and 3.5)



Challenges in dealing with allocation issues

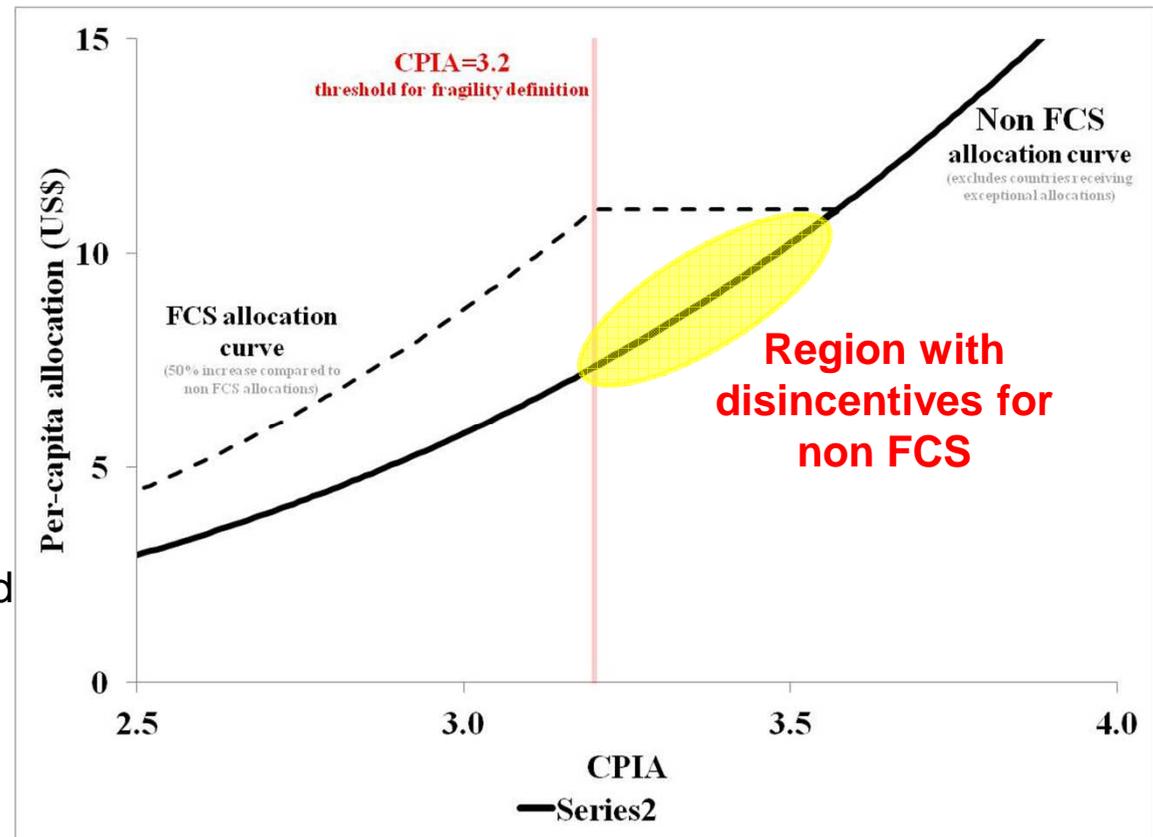
(Illustration: 50% increase across the board increase in FCS allocation)

Disincentives and moral hazard:

- For FCS: an improvement in CPIA rating beyond 3.2 would lead to a significant reduction in allocation
- For non-FCS: lower CPIA ratings would lead them to higher allocation levels

Also equity of treatment issues:

- Non-FCS and some FCS could feel discriminated against and could claim the same benefits





A curative, rather than a preventive treatment: the role of structural economic vulnerability

- Discontinuity induces a treatment of fragility transitional and curative, neglecting a permanent and preventive treatment needed for countries at risk to become fragile
- CPIA, then fragility, undermined by structural factors, in particular vulnerability, as well as low human capital and low income (significant results of a panel estimation)
- High elasticity of CPIA to EVI (-0.3), even higher at lower levels of CPIA; major reaction of CPIA to export instability



A mix of issues of aid allocation and aid modalities: relevance of the differentiation concern

- The current approach by addressing *state fragility* through aid allocation not only neglects it highly depends on *structural economic vulnerability*
- Relying on a single category, it is also a misplaced or too rough differentiation : *differentiation* between the various kinds of fragility is most appropriate to design aid modalities, a crucial task
- State fragility should be taken into account firstly in *aid modalities*, whereas structural economic vulnerability should be so in aid *allocation*
- WDR 2011: Box by Paul Collier, “ resolving the donor risk and results dilemma ” :needs should govern allocation, fragility should govern modalities



Risks of indirect perverse effects

- Identification as “ fragile state ”, meaning very poor governance, may crowd out private investment
- No such effect from the LDC category membership, perceived as corresponding to structural factors, not to bad policy and governance
- Reluctance of recipient countries to be categorized as FS



III

A new approach: treating state fragility in an integrated allocation framework

Relying on basic principles of geographical aid allocation:
equity, effectiveness and transparency

and

using common criteria, in particular structural vulnerability
rather than categories



Three principles to be met

- Aid allocation should
 - promote effectiveness (or real performance)
 - meet a need of equity between countries
 - be transparent and predictable (then simple)
- It can be done by taking into account structural vulnerability, and lack of human capital as well, and by using available and agreed indicators, such as EVI for structural vulnerability and HAI for human capital, used at UN for LDCs identification



Enhancing equity, by compensating structural handicaps...

- Among countries, as well as among individuals, promoting equity means *equalizing opportunities and capabilities*
- Opportunity equalization involves a *compensation for structural handicaps*
- 2 main structural handicaps to growth are in LICs the vulnerability to exogenous shocks and a low level of human capital, two obstacles not considered in the PBA
- These two handicaps, along with a low income pc, are the main features and identification criteria of LDCs, most of which are or have been once classified as FS



... leading to a more genuine concept of “performance”

- Performance assessment is debated, all the more it is overwhelming, with a strong weight given to governance
- Performance means outcomes with regard to initial and exogenous conditions
- As presently assessed, it less refers to development outcomes than to policy, then is a subjective and uniform assessment
- Adding criteria of structural handicaps to the assessment of policy/governance (CPIA) amounts to adjusting this assessment for the significant negative impact of these handicaps on policy
- It would lead to a more genuine concept of performance, an « *Augmented performance based allocation* », more favourable to all FS



Aid effectiveness : drawing lessons of literature (the stabilizing impact of aid)

- A double main lesson of literature: aid effectiveness is conditional on the features of recipient countries, but
- Although present policy is a significant *positive* factor of growth (or fragility a negative one), its impact on aid effectiveness is *uncertain*
- Although vulnerability is a significant *negative* factor of growth, its impact on aid effectiveness is *positive* (Chauvet & Guillaumont 2001, 2004, 2010; Collier and Goderik, 2010)
- Effect linked to the stabilizing impact of aid (Ibid and Guillaumont Jeanneney and Tapsoba 2010)
- Using vulnerability as a criterion of aid allocation makes it more effective to promote growth



Increasing transparency, consistency, and stability, weakened by the exceptions to the rule

- Implementation of the PBA has needed exceptions to the rule, in particular for country size and state fragility
- Transparency and consistency improved by limiting exceptions
- Size can be treated on a more continuous basis (pop. exponent <1)
- Using *structural* economic vulnerability and human capital indicators which are quite more stable than CPIA would contribute to make allocation more stable, predictable... as well as less procyclical (CPIA & CPA not stable and allocation highly sensitive to small changes of CPA , moreover often procyclical)
- It would make the allocation more transparent, consistent and stable



What would be an optimal solution?

- Treating the case of fragile states and conflict-affected in an *integrated framework...*
- ... with exceptions limited to very few cases of extreme fragility or conflict needing a special attention of the international community
- Two main features of the approach
 - *it relies on criteria*, not on a category
 - it uses *common criteria* for all eligible countries and not specific criteria for the countries belonging to this category



Using criteria rather than a category, in particular structural economic vulnerability

- 2 new criteria to be taken into consideration: structural economic vulnerability and low level of human capital
- It results in a more continuous approach, avoiding threshold effects of the category
- It is more preventive, by dampening the possible impact of shocks in vulnerable countries (not yet “fragile” ...)
- It avoids an abrupt diminution when a country is said no longer fragile, then lowers the risk of resurgence of fragility and conflict



Towards more uniform criteria

- Policy and governance of FS would not be assessed from a specific index (such as PCPI at IDA)
- But CPIA would include a dynamic cluster reflecting the *improvement* in security and peace indicators, that are likely to significantly improve *only* in fragile and post-conflict countries
- Thus it would capture the specific performance of the fragile states
- Other dynamic and outcome based components could also be used for CPIA



Feasibility of the approach

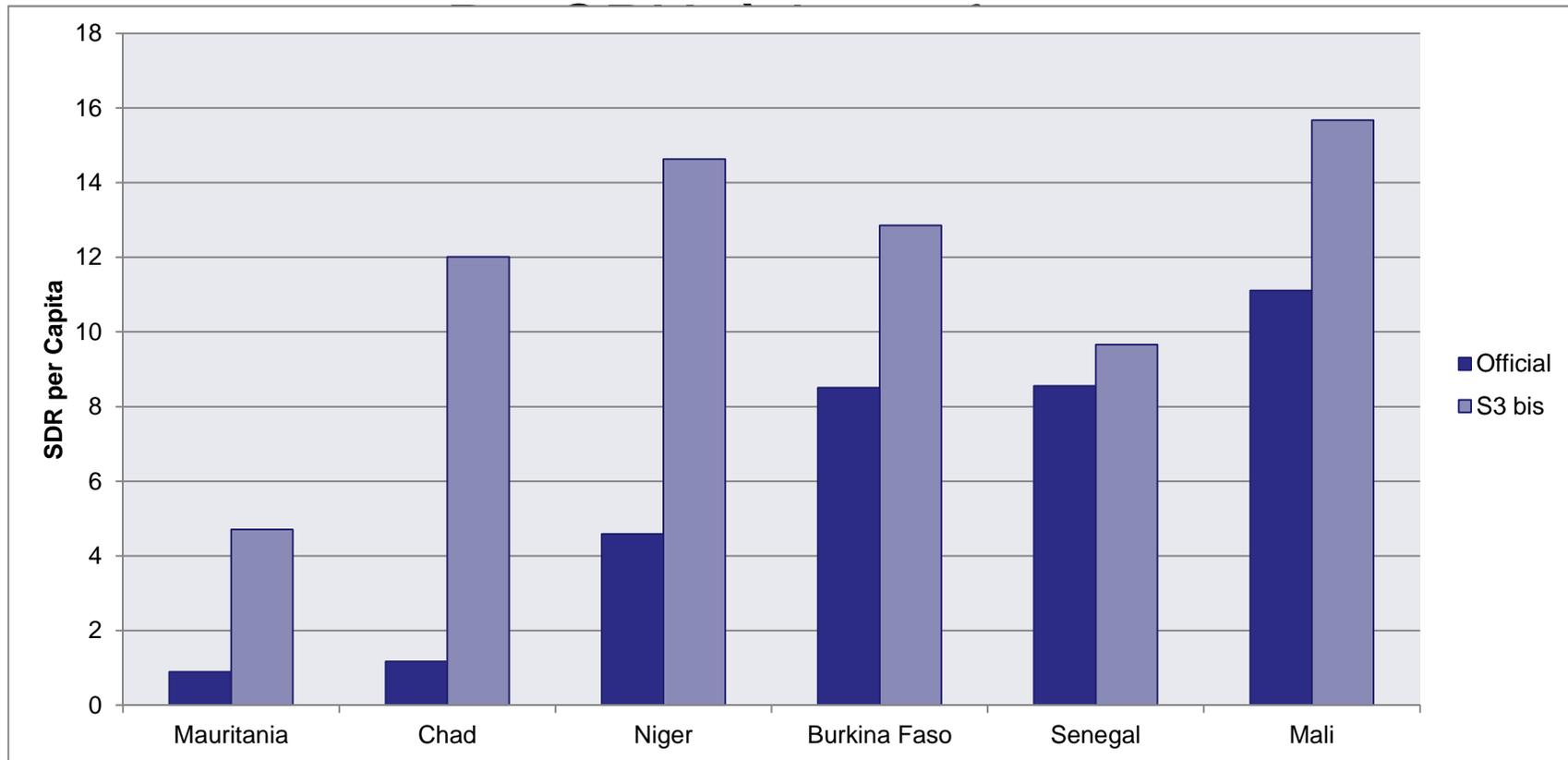
- Possible to use agreed and stable indicators, such as EVI (Economic Vulnerability Index) and HAI (Human assets Index), set up at UN for the identification of the LDCs or similar ones
- Useful to retain an exponent lower than one for the population in the formula, as done by As DB, IADB, and Cari DB, again to avoid threshold effects resulting from caps and floors corresponding to very low or very large countries
- Also useful to retain an exponent ≤ 0.125 for GNIpc (as done by AsDB and IADB)
- For FAD in 2008 and IDA in 2009 it would have resulted in an allocation to the fragile states at least equal or higher than the official one (depending on simulations)



Illustration by simulations for IDA 2009

Shares of the total allocation to FS (PCREC) and LDCs
*no base allocation, population to the power 0.8 instead of 1,
two methods*

- Augmented PBA (CPR replaced by ACPR)
ACPR = $0.33 \text{ CPR} + 0.33 \text{ EVI} + 0.33 \text{ LHAI}$
FS 15.9% instead of 9.7%; LDCs: 61.9% instead of 48.1%
- Balancing performance and needs
 $\text{PBA}_i = (0.5 \text{ CPR} + 0.25 \text{ EVI} + 0.125 \text{ LHAI} + 0.125 \text{ LGNIPC}) \cdot P^{0.8}$
FS 10.7 %, LDCs 49.8%





Increasing support of the approach

- Move of ideas in favour of taking into account structural vulnerability for aid allocation
- UN SG report to the *Development Cooperation Forum* in 2008, then again in 2010
- Examination of the feasibility of such a reform in a study of the *AfDB* 2009
- *Joint Ministerial Declaration* on Debt Sustainability, from Commonwealth and OIF, 2009, followed by more recent positions from Commonwealth Secretariat and Zone franc Finance Ministers
- Move of EC into this direction
- Resolution of the UN General Assembly in December 2012



**Resolution of the United Nations General Assembly
(A/C.2/67/L.53) of 4 December 2012
*(Follow-up to the 4th UN Conference on the LDCs)***

« 23 . *Invites* development partners to consider least developed country indicators, gross national income per capita, the human assets index and the economic vulnerability index as part of their criteria for allocating official development assistance »



Indirect support to come from the allocation of resources for the adaptation to climate change

- Similar debate about the balance between performance and needs for the international resources for adaptation
- But clear recognition and consensus that poorest countries are not responsible for climate change, while they are likely to much suffer from it
- Then a consistent and equitable major criterion would be the *physical vulnerability to climate change* (measured by an index such as the Ferdi one)
- If accepted in that case, why not the structural economic vulnerability for development assistance



An increasing need of a consistent solution

- Increasing risk of inconsistency with the present system, and need to find a solution, since the exception may become the rule: potential increase in the number of FS and decrease in the number of FAD or IDA eligible (according to Ben Leo, the number of IDA eligible countries is likely to have decreased from 68 in 2010 to 31 in 2025)
- Fragile and/or structurally handicapped countries are the least likely to be graduated
- Most of the remaining eligible countries will then be either fragile states or structurally handicapped countries, most of them being LDCs
- Exceptional and political treatment should remain for cases of extreme and sudden fragility



More details from the author in

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