

## Why stick to the wrong way in aid allocation?

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While the consequences of the recent economic crisis on the poorest countries-by no means responsible for it- appear to be strong and lasting, discussions have been engaged on the replenishment of resources of the main multilateral development banks. Linked to this replenishment is the agreement of the banks governors on the principles determining the allocation of aid among the eligible countries.





.../... In the main multilateral development banks (MDBs) these principles are summarized in a formula, called “performance based allocation”, PBA. With some small differences from one MDB to the other, the formula is intended to determine the amount of aid per capita received by a country according to two main indicators, income per capita and “performance”, the latter having an overwhelming weight. Several exceptions, caps, floors, as well as special windows, are also applied to temperate the results of the formula, in particular to address the case of the very large, the very small and even more the fragile states.

There has been a growing discontent among researchers and policy makers about the PBA formula, as it is presently designed, in particular because it ignores the need of assistance generated by the economic vulnerability of countries. However there is a high risk it will be maintained nearly unchanged. The strong reasons to change meet the even stronger inertia of aid bureaucracies.

We first summarize the main shortcomings of the PBA which is neither equitable, nor effective, and even less transparent. Then we argue for a reform that is altogether simple, logical and operational, consisting of inclusion of indicators of vulnerability and low human capital, in addition to the previous criteria, coupled with the deletion of most exceptions, caps and floors. We finally explain why the reasons given for the deferral of such a reform are not relevant. A more detailed analysis, with related references, has been presented in several papers to which the reader can refer (**Amprou** et al. 2007, **Guillaumont** 2008, 2009, **Guillaumont** et **Guillaumont Jeanneney** 2009, **Guillaumont, Guillaumont Jeanneney** et **Wagner**, 2010).

## ► Main shortcomings of the present PBA

Six main reasons for the discontent with the present PBA can be identified.

### **Confusion about what performance means**

No doubt the success of the PBA has come from the word “performance”. Everyone wants developing countries to perform and aid to support their performance. The problem lies in the ambiguity of the word performance or more precisely in the fact that the performance of the PBA formula is far from the genuine meaning of performance. Performance refers to the results or outcomes obtained by a country in a given initial situation, whereas PBA performance refers to a subjective assessment of the country policy, indeed a different animal.

This assessment is done thanks to the CPIA. Although the CPIA has strongly been debated and criticized, we do not conclude that it should be deleted from the formula, but we argue that, even reformed, it should not be given the overwhelming weight it receives today. A main concern comes from the fact that it is a subjective assessment, with regard to uniform norms, what does not particularly fit the principles of alignment and ownership, so often reaffirmed in international meetings. Moreover it is not stable, what makes the allocation unstable and hardly predictable (while predictability is another concern of international community). Furthermore it is pro-cyclical more often than the opposite, which means it leads to less aid when the countries need more.

The CPIA has been initially retained as a major aid allocation criterion, and a major indicator of aid selectivity as well, because it was supposed to correspond to a factor of aid effectiveness for growth, a result that has been found to be somewhat insignificant in the academic literature. Playing with the word “performance”,

the main single reason to maintain this criterion has been a vague feeling that helping those countries considered as good guys will push the other ones to become virtuous.

### **Denying the existence of structural handicaps to development, in particular vulnerability**

Why not to consider that aid allocation should first be equitable? Of course there are many views on the meaning of equity. A commonly accepted meaning is related to equal opportunities. Aiming at equalizing opportunities among countries involves taking into account the structural obstacles to growth they face in aid allocation. It is a dynamic design of justice, with regard to growth prospects. The present PBA formula fails to take into account any of the main structural handicaps, such as those considered at the UN for the identification of the least developed countries (LDCs). These are the economic vulnerability and the low human capital faced by a country independently of its present will. This vulnerability is due to the recurrence of exogenous shocks, either natural or external (droughts as well as commodity prices instability) and the exposure to these shocks (small size, remoteness, structure of production).

### **Forgetting the lessons of aid effectiveness literature**

While the impact of governance on aid effectiveness has been repeatedly debated in the academic literature, there is a consensus to consider that aid effectiveness depends on the specific features of the recipient countries. Among those features, vulnerability to exogenous shocks has received increasing attention in the literature, not always fully understood in policy circles. Indeed shocks and vulnerability are negative factors of development, whereas good governance is a positive factor, but they both are also factors increasing aid effective-

ness. In other words a major reason why aid can have a macro-economic impact on growth and development is due to its stabilizing impact: it dampens the negative impact of shocks.

Thus, for effectiveness reasons, and not only for equity reasons, it is not legitimate to omit structural economic vulnerability to exogenous shocks in the aid allocation criteria.

### **Enforcing a double punishment... and confusion between aid allocation and aid modalities**

The fact to consider only the quality of governance and policy as a criterion of aid allocation has an unexpected unfair consequence. Populations suffering from bad government and policies are at the time penalized by aid allocation. They are punished twice... thanks to aid!

It does not mean that aid policy should not take into account the quality of governance and policy, but that it should do it through aid modalities rather than aid volume ( by giving less budget support and more project support, including through private channels).

### **Exceptions made as important as the rule, with resulting opacity and inconsistency**

Facing the difficulty to rigorously implement the PBA, the MDB have been led to multiply the exceptions by way of caps, floors and a special treatment applied to some countries. In particular, when the level of the CPIA has reached very low levels because of situations of chaos or civil conflict, which is the case of the so-called fragile states and post-conflict states, a special treatment has been designed leading to an allocation to these countries higher than to the countries with a low CPIA, but not low enough to make them eligible for this special treatment.

The final result is a purely curative and not at all preventive treatment of fragility in an opaque and not consistent framework. Other

exceptions designed to address the case of very large or very small countries have amplified opacity and inconsistencies due to threshold effects. Briefly stated the present PBA no longer meets the principles of equity, effectiveness and transparency that it was initially supposed to meet.

## ► Main lines of a new approach

We suggest reforming the PBA formula to make it more equitable, more effective for promoting development and more transparent, by redesigning and rebalancing the variables retained in the formula, and at the same time limiting the exceptions through caps, floors and special windows. We particularly focus on Africa, with reference to a study made for the African Development Bank, where the approach here summarized is explained with more details (Guillaume and Guillaume-Jeanneney 2009). Similar simulations have been done at FERDI for the IDA aid allocation, with similar conclusions (Guillaume, Guillaume-Jeanneney et Wagner, 2010).

### Two new variables added

Two new variables would be added in the formula to the present GNlpc and the country “performance” rating. These two variables would be measured by well accepted indicators.

The first new variable is the structural economic vulnerability, measured by an index reflecting both the size of recurrent exogenous shocks, either natural or external, and the exposure to these shocks: the introduction of this variable is legitimate because it corresponds both to the goal of compensating a handicap and to a factor of aid effectiveness.

The second new variable is the low level of human capital, also measured by an index reflecting both the level of education and the level of health and nourishment. The introduction of

this variable is legitimate essentially because it corresponds to a structural handicap to growth.

It is suggested to use the Economic Vulnerability Index (EVI) and the Human Assets Index (HAI), set up at the UN as structural handicap indices to identify the least developed countries. To be noted, the Caribbean Development Bank already uses an indicator of vulnerability.

Why propose using HAI instead of the more popular HDI yearly published by UNDP Human development report? There are two reasons: (1) the allocation formula already refers to the GNlpc, already included in the HDI; (2) the human capital indicators included in HAI are both more statistically reliable and larger (including undernourishment).

### Discretionary weighting of components

To make the formula easily readable, it is proposed to measure all the criteria on a common and understandable scale (0 to 100), then to invite the administrators to choose the weights given to each component, the simplest weighting being of course one fourth to each of the four (GNlpc, “performance”, EVI, HAI). Anyway the choice of weights is a political decision which should be as transparent as possible.

Moreover to avoid the threshold effects linked to caps and floors set up in the case of extreme population cases, the population factor would be introduced with an exponent lower than one, as it is already done at the Asian Development Bank.

### Integrated treatment evidenced as relevant by simulations

Various simulations made for the African Development Fund show that the application of the simple revised PBA leads to results not only avoiding the shortcomings of the present formula, but also allowing the decision-makers to treat the case of the fragile states, as well as that of the smallest and the largest countries, in an

integrated and continuous framework. Similar simulations have been made for the IDA resource allocation. Both sets of simulations show that the new approach is feasible and can lead to allocations more or less different from the actual ones, depending on the weights given to the formula components.

### ▶ Wrong reasons to reject the new approach

#### **Donors and their public opinion are opposed to a change**

The main argument given by the bureaus in charge of the mobilization of resources and the implementation of the formula is that donors are completely in favour of a formula which, relying on an appreciation of policy and governance, is likely to give an insurance that the resources will be well utilized. MDB bureaucracies sometimes legitimate their defensive attitude by an alleged request of donors.

But the international environment, as well as donors' minds, have changed. The recent crisis has evidenced even more than before the importance of vulnerability. Also, ideas about aid effectiveness have evolved, making the need of a revision of the formula clearer. The paradox will be that, reversing the roles, a conservative attitude of the aid mobilization bureaus, would lead the donors to lower their contribution to the replenishment of the MDBs!

Noticeably enough, the principle of including structural economic vulnerability among the aid allocation criteria has been endorsed in two important international documents. One is the UN Secretary General report to the ECOSOC Development Cooperation Forum in 2008. The other is the final Declaration of the Joint Ministerial Forum on Debt Sustainability organized by the Commonwealth Secretariat and the Organisation internationale de la francophonie in April 2009.

#### **Performance should remain the key reference**

The reform proposed does not mean giving up the reference to performance. It even does not mean lowering the weight of performance in aid allocation, if performance is given its genuine meaning (of achievement with regard to initial conditions). Because there is a negative impact of the structural economic vulnerability (evidenced by econometric tests) on the CPIA, introducing the structural vulnerability in the PBA formula means that the policy and institutional assessment is corrected for the exogenous influence of vulnerability. The key reference becomes a more relevant measure of performance, leading to an augmented PBA.

#### **Losers will oppose more than gainers will support the reform**

An aid allocation reform will probably be difficult to implement with a constant volume of aid, since some will lose, while others will gain. But is quite more acceptable by all countries concerned when the total amount to be allocated is increased. In that case it is conceivable to have a transitional system, subject to condition that no country should receive a smaller amount due to the new allocation formula.

#### **Vulnerability cannot be measured**

Structural economic vulnerability, the only relevant one for aid allocation, can be measured and has been measured by the EVI, Economic vulnerability index, used at the UN for the identification of the LDCs. While mainly designed to measure the structural vulnerability of low-income countries, it is available for all developing countries... and if needed, it can be adapted by each MDB for its own purpose.

### **Vulnerability can be addressed by another way**

Vulnerability should also be addressed by other ways, but these other ways do not allow the international community to fully address the issue. As evidenced by past experience, the schemes aiming at providing compensatory finance when a shortfall occurs in export earnings, although needed, are either too long to be mobilized and too conditional, or leading to wrong incentives. Also they risk being arbitrarily allocated. The same holds true for vulnerability special windows. This is even more clearly illustrated by the shortcomings of the present treatment of the fragile states. An interesting exception is given by the so-called countercyclical loans (as implemented by AFD), where debt service is automatically linked to exogenous variable such as terms of trade, but it is only a partial and progressive answer.

More important vulnerability ex ante allocation criterion has a preventive role, whereas compensatory finance, as well as fragile states windows, is only curative... It will probably be less costly and/or more effective to prevent collapses and conflicts than to overcome their effects.

### **A vulnerability criterion would generate a risk of moral hazard**

It could be the case if the vulnerability taken into account was not structural, in other words if it was depending on the present policy. On the opposite, structural vulnerability does not depend on the present policy. EVI actually measures structural vulnerability, the component of which can hardly be influenced by aid allocation perspectives. The risk of moral hazard is higher with compensatory finance of export earnings. And it is probably higher too for fragile states treatment.

## References

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