How to Take into Account Vulnerability in Aid Allocation Criteria and Lack of Human Capital as Well: Improving the Performance Based Allocation

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Summary. — This paper considers why and how the Performance Based Allocation (PBA) used in multilateral development banks and in particular at IDA, could be improved by taking the structural handicaps of eligible countries into account. The PBA relies on a debatable definition of performance. It does not meet the equity concern raised by the existence of structural handicaps to growth. It neglects the lessons of the aid effectiveness literature. Finally, it suffers from some opacity. We show how it is possible to increase the share of specific groups of countries, such as Sub-Saharan Africa or post-conflict states, in a transparent manner.

Key words — aid allocation, economic vulnerability, human capital, Performance Based Allocation, multilateral development banks, aid effectiveness

1. INTRODUCTION

For the main Multilateral Development Banks ( MDBs) the principles determining the allocation of aid among eligible countries are governed by a formula, called “Performance Based Allocation” (PBA). This formula which has been used since 1977 by the World Bank for the International Development Association ( IDA) has been modified several times. It is used by the main Multilateral Development Banks, namely African Development Bank (AfDB), Asian Development Bank (AsDB), Inter-American Development Bank (IDB), Caribbean Development Bank (CDB), and by the International Fund for Agricultural Development (IFAD), with minor differences in application between the institutions. The PBA formula is intended to determine the amount of aid to be received by a country according to two main indicators, income per capita and performance. Performance has an overwhelming weight. The different PBA formulae used by the various institutions and their modifications are given in Table 3 and 4 in the appendix. For instance the performance-based allocation formula used by the World Bank for IDA during the IDA15 and IDA16 periods (2008–14) was as follows 1:

\[ \text{PBA}_i = (\text{CPR})^5 \times \text{GNI}_i / P + 0.125 \times P_i \]

PBA is the share of country \( i \) allocation based on performance, GNI/\( P \) is the gross national income per capita (in U. S. dollars), \( P_i \) is the population. The evaluation of the Country Performance Rating (CPR) is itself the sum of three indicators:

\[ \text{CPR} = 0.24\text{CPIA}_A + 0.68\text{CPIA}_D + 0.08\text{ARPP} \]

The CPIA (Country Policy and Institutional Assessment Index) is composed of sixteen indicators grouped into four clusters: (A) macroeconomic management, (B) structural policies, (C) social policies, (D) public sector management and institutions (D refers to the concept of governance). One component of the CPR takes into account clusters A, B and C, while another one, which is given a higher weight, takes into account cluster D. Besides the two components related to the CPIA, the CPR also includes a rating for each country’s implementation performance based on the World Bank’s Annual Report on Portfolio Performance (ARPP). The level of the CPIA components is assessed by an internal evaluation process within the World Bank, and by the other MDBs for their own CPIA. The non-World Bank MDBs also have their own CPR or equivalent, combining CPIA components with portfolio assessment.

The application of the PBA formula has met several difficulties which have led to tempering the rule with numerous exceptions. In particular, minimum allocations have been set which are advantageous to very small countries, and a ceiling has been set to avoid the most populated countries receiving large shares of the total amount of aid. Moreover, a special treatment with various modalities has been designed for countries called "fragile states" (or a similar name), whose poor performance did not allow them to receive a level of aid in accordance with their needs. During recent years the special treatment of fragile states has received growing attention.

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and increasing importance in the management of PBA, in particular for the replenishment of IDA17 and ADF13. It clearly illustrates the main issue faced by Performance Based Allocation, because the fragile states are mainly characterized by a low CPIA.

There has been growing discontent among researchers and policy makers about the PBA formula, as it is presently designed, in particular because it ignores the need for assistance generated by the economic vulnerability of countries (except at the Caribbean Development Bank, CDB), and by low levels of human capital. The detrimental consequences of the structural economic vulnerability of developing countries, notably of the least developed countries (LDCs), have been the object of much concern in the academic literature for a long time (see Hnatkovska & Loayza, 2005; Norrbir & Pinar Yigit, 2005; Ramey & Ramey, 1995 and a survey in Guillaumont, 2009a, 2009b), without being reflected in the PBA.

On the policy side ideas have been moving. In 2008 the African Development Bank (ADB) commissioned a study to examine how a reform of the PBA taking vulnerability into account could be implemented (Guillaumont, Guillaumont Jeanneney, & Vencatellachum, 2009). Although the proposal was not endorsed, it has influenced thinking at the ADB, and resulted in some revision of the formula used for the new African Development Fund (AfFD13), in particular through the inclusion of an index of infrastructure weakness (see ADF 2014 and Annex I). At the same time, the principle of including structural economic vulnerability in the aid allocation criteria has been proposed in several international meetings. More recently in a resolution on the “smooth transition for countries graduating from the list of least developed countries” the UN General Assembly “invites development partners to consider least developed countries 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” (Resolution A/C.2/67/L.57). Recently using a simple model prepared by FERDI (Fondation pour les études et recherches sur le développement international), the European Commission used a similar rule for the assessment of the allocation of the new European Development Fund and Development Cooperation Instrument. However there is still a high risk that the PBA formula will be maintained almost unchanged by the MDBs, partly as a result of lack of clear proposed reforms.

This article first explains why it would be legitimate to take the structural handicaps of developing countries into account to define aid allocation, for effectiveness and equity reasons, and for transparency. Then various solutions are presented to improve the Performance Based Allocation (PBA) used by the multilateral development banks. Our proposals are illustrated by simulations of IDA allocations, in order to demonstrate their feasibility and relevance with respect to their effectiveness, equity, and transparency.

2. WHY TAKE INTO ACCOUNT STRUCTURAL HANDICAPS IN PBA?

Four main reasons for improving the present PBA have been identified, related to performance, effectiveness, equity, and transparency. They lead to propose the integration of structural economic vulnerability and low human capital, as structural handicaps, into the formula. Addressing the transparency issue we underline why this approach strongly differs from that which consists of applying a special treatment to a somewhat arbitrary category called “fragile states”.

(a) What does performance mean?

Without doubt the success of PBA has come from the word “performance”. Everybody wants developing countries to perform, and for aid to support performance. The problem lies in the ambiguity of the word “performance”, or more precisely in the fact that the performance used in the PBA formula is far from the normal meaning of performance. Performance normally refers to the results or outcomes obtained (in this case by a country) in a given initial or external context. PBA performance refers to a subjective assessment of the country policy, which is indeed a different animal (on the meaning and measurement of performance: Guillaumont & Chauvet, 2001; Guillaumont & Guillaumont Jeanneney, 1988). The CPIA, and in particular its cluster D, because it is not an index of development results and it is not assessed with respect to initial or external conditions, is not an index of performance in the real meaning of the word (see the paper by Guillaumont, McGillivray, and Wagner (2013) in the same issue). Put simply, governance is not performance.

Moreover, the CPIA has been much debated and criticized (for instance Michaïlof, 2005 and Kanbur, 2005), we do not conclude that it should be removed from the formula, but we argue that it should not be given the overwhelming weight it receives today. The main concern comes from the fact that it is a subjective assessment, with regard to uniform norms, which does not fit well with the principles of alignment and ownership adopted by the Paris Declaration, reformulated in the Accra and Busan conferences, often reaffirmed at international meetings. These principles are intended to increase aid effectiveness.

(b) Aid effectiveness: drawing on the lessons from research

The CPIA was initially retained as a major aid allocation criterion because it was supposed to represent a factor of the effectiveness of aid for growth, a result of the famous paper by Burnside and Dollar (2000). However in the academic literature this result has been found not to be significant (see for instance Easterly, Levine, & Roodman, 2004; Hansen & Tarp, 2001; Roodman, 2007, or more recently Akramov, 2012). The supposed relationship between governance and aid effectiveness has also been used to assess the selectivity of donors, i.e. the quality of their geographical aid allocation (Roodman, 2012), which has also been debated (Amprou, Guillaumont, & Guillaumont Jeanneney, 2007). The main single reason to maintain the CPIA as a criterion of allocation and selectivity has changed: rather than a direct factor of current aid effectiveness, it is intended to be an incentive. This reflects the feeling that giving more help to those countries considered as “good guys” will push other countries to become more virtuous. This is a significant change compared to the initial Burnside and Dollar model where aid effectiveness was supposed to depend on policy, and policy not to depend on aid. Of course, as far as better policy is good for growth, an incentive for better policy may become an indirect factor of growth, regardless of the ownership issue mentioned above. It must be underlined, that having an improved measure of performance that takes into account the structural handicaps developing countries are facing would maintain the present signal effect of the PBA, but would also make it more acceptable to the recipient countries. So it could enhance their commitment to good policies.

While the impact of governance on aid effectiveness has been repeatedly debated in the academic literature, there is a consensus that considers that aid effectiveness depends on the
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