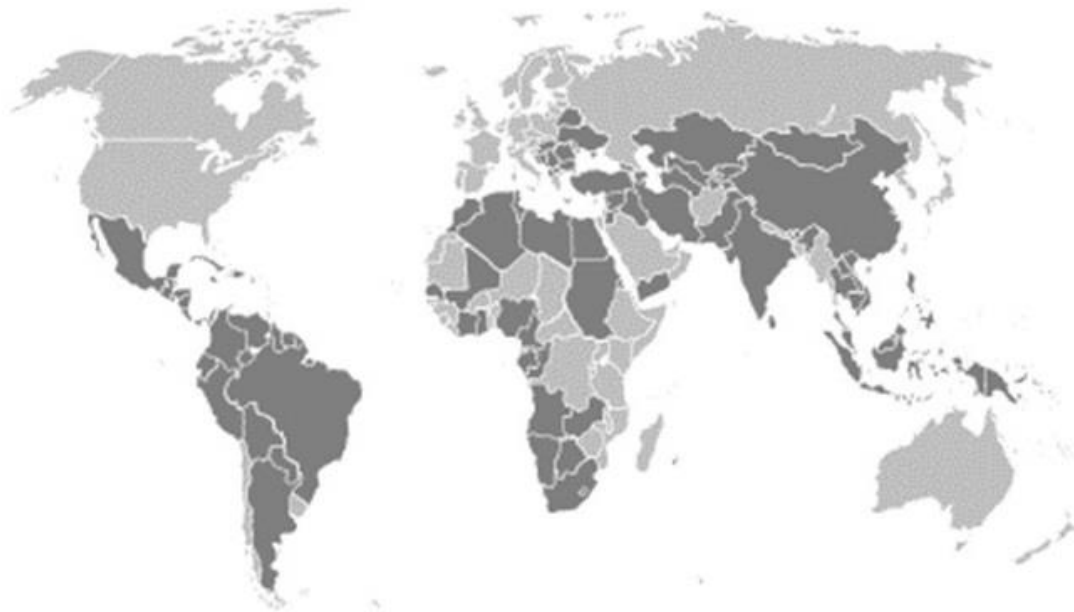


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Middle income countries and the future of development cooperation



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Authors' note: In the interests of providing a succinct and readable paper, we have tended to eschew a reiteration of context, evidence and argument found in our previous papers, and those of other analysts, in favour of arriving more swiftly at proposals for policy makers and development practitioners. We have kept references down to a minimum- We wish to thank DFID, AECID and the UN Foundation for their support for this paper and their useful comments, along with comments from Nancy Birdsall, Shoayb Casoo, Christian Freres and Daniel Titelman. None of the institutions and individuals previously mentioned is responsible for opinions, gaps or mistakes which the document may contain, as these remain the authors' exclusive responsibility.

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List of acronyms

- DAC** Development assistance committee of the OECD
- G20** Group of 20 largest economies
- GDP** Gross domestic product
- GNI** Gross national income
- GPEDC** Global Partnership for Effective Development Cooperation
- HIC** High income country
- HIPC** Heavily indebted poor country
- IPG** International public good
- LDC** Least developed country
- LIC** Low income country
- LMIC** Lower middle income country
- MIC** Middle income country
- ODA** Overseas development assistance
- OECD** Organisation for Economic Cooperation and Development
- PIU** Project implementation unit
- PPP** Purchasing power parity
- SSC** South-south cooperation
- UMIC** Upper middle income country

1. INTRODUCTION

The role of middle income countries (MICs) in the development cooperation system as both recipients and contributors is the subject of heated debate. Following a good decade for global growth, most developing countries are now described as “middle income countries” taking the World Bank’s definition (approximately \$1000 to \$12000 GNI per capita). Some have argued that there is little role for the international community in middle income countries, given the increased domestic resources and international private capital at their disposal. We think there are two responses to this. First, most MICs still face considerable structural deficits and vulnerabilities that affect their process of development. Second, future international progress and collective human well-being will be strongly impacted by the success or otherwise of development in MICs.

So not only do MICs need the support of the international community, the international community need MICs to succeed to help support global development goals. The question now is how the international community can further the active contribution of an growing group of successful MICs to overcome common global challenges, both within and outside their borders, and, specifically, what is the role of development cooperation.

Given its wide GNI per capita boundaries (approximately \$1000 and \$12000) the MICs category groups a large number of countries – 103 – with, inevitably, considerable diversity. Some MICs are G20 members such as India and Indonesia, while others have very small populations, such as Tuvalu and Vanuatu. Within the group there are many other forms of differentiation relevant to ODA allocation criteria: 19 MICs are fragile states²; 17 are least developed countries (LDCs); 13 are heavily indebted poor countries (HIPC). Just a third of MICs have “graduated” from low income status since the end of the Cold War in 1990; two thirds were MICs prior to 1990 and remain so today.

An obvious way to differentiate current MICs is the LMIC/UMIC split at approximately \$4000 per capita. Generally speaking the older MICs are better off UMICs, while the newer MICs are still very poor LMICs. Average GDP per capita in purchasing power parity (PPP) in the group of LMICs is still less than \$4/day, which is only about 5 per cent of the GDP per capita PPP income of OECD members.

² According to the OECD DAC list

Further, the poverty headcount ratio at \$1.25/day is a quarter of LMIC population, rising to half the population at \$2/day poverty. The indicators are better for the UMIC group but are still a considerable distance from OECD levels. Official development assistance (ODA) is drastically lower in the LMICs and UMICs group compared to the LIC group. Whilst the LIC group average is almost 10% for ODA/GNI and almost 40% for ODA/Gross capital formation, the corresponding data for LMICs is 1% and 3% and for UMICs close to zero (see table 1).

Table 1: Selected indicators by country groups, 2012 or most recent year (group mean)

	Low income	Lower middle income	Upper middle income	Middle income	High income	OECD
GNI per capita, Atlas method (current US\$)	588	1,913	6,977	4,383	38,182	37,612
GDP per capita (constant 2005 US\$)	423	1,221	4,315	2,731	31,373	31,356
Poverty headcount ratio at \$1.25 a day (PPP) (% of population)	48.3	27.1	8.4	18.0	-	-
Poverty headcount ratio at \$2 a day (PPP) (% of population)	74.3	56.3	19.5	38.3	-	-
Net ODA received (% of GNI)	9.1	0.8	0.1	0.3	-	-
Net ODA received (% of gross capital formation)	37.6	2.6	0.3	0.8	-	-

Source: Data processed from WDI (2013)

In spite of the continuing development problems of MICs, international donors are reducing, or planning to reduce, financial support to them. In some cases, donors are closing their delegations in MICs; in others they are beginning to exclude such countries from their aid. Consequently, the share of ODA directed at the 100 or so countries designated MIC in 2011 fell from about 55% in 1990 to under 40% in the most recent World Bank data, even as rising aid overall saw absolute amounts almost reach 1990 levels (see figure 1, below). This is concerning. Nothing automatically happens when a country crosses a line in per capita income. However, it appears that as countries grow and aid becomes less significant as a proportion of GNI, OECD donors find it increasingly hard to defend aid to them; they are no longer “the poorest countries in the world.”

Figure 1: ODA to MICs in million dollars and percentage over total (constant US\$ 2011)



Source: World Development Indicators. Excluding Iraq.

Policy coherence (i.e. policy changes undertaken by wealthy countries to encourage development elsewhere in the world) is likely to be much more important than financial transfers for MICs, and potentially also for LICs too as the financial benefit can outweigh ODA values. But it does not follow that such financial transfers are unimportant. They remain a key part of the global effort to reach sustainable and equitable growth. The aim of this paper is to suggest policy directions for the development community regarding how best to manage the dilemmas involved in supporting MICs to achieve and contribute to global development.

In the following section we set out a framework for understanding the problems faced by countries moving up the income ladder, which we divide into development “traps” and financing “gaps”. In section 3 we look at MICs as recipients of development cooperation. What should donor priorities be, and why? In section 4 we look at the other side of the coin, the increasingly important role of MICs as contributors to global development. Can other countries support MICs in this, and how? Finally, in section 5 we look at the implications for prioritising/allocating aid and cooperation, looking beyond income per capita, and for the aid effectiveness agenda, given that development cooperation with MICs can be substantially different to “traditional” north-south aid.

This is a complex subject, and there are a number of routes the international community could pursue. We hope this paper helps decision-makers come to good decisions.

Finally, a note on terminology. In an attempt to move on from an over-reliance on the MIC category, which we criticise, we adopt language such as “countries moving up the income ladder”. We use the term “development cooperation” to cover a broad concept of international support, including “traditional aid” (i.e. Overseas Development Assistance), emergent forms of south-south cooperation (SSC), and contributions to international public goods. Our focus in this paper relates to financial support in particular and also refer to other aspects of cooperation as appropriate.

2. “TRAPS” AND “GAPS” – A NEEDS ANALYSIS

Any attempt to generalise the particular problems faced by MICs that might benefit from international support faces two problems. First, as we have seen, the MIC category is diverse making it hard to generalise across it. Second, few of the challenges faced by countries with MIC levels of income per capita are exclusive to them; the richest and poorest countries of the world will recognise in the following generalisations many problems which they also face.

That said, some useful observations can be made about the challenges faced at higher levels of per capita income – areas of particular difficulty for those countries in the (sometimes lengthy and rocky) transition from very poor to somewhat better off, specific features and effects of an intermediate level of development. Their need for international financial and technical assistance also evolves, both in terms of quantity and type. These challenges are not inevitable or universal but they are common and lay the ground for thinking about the foundations of development cooperation with MICs.

In the diagnostic of issues and challenges faced by MICs two words with long tradition in development studies can be particularly useful: traps and gaps. It is worth clarifying the meaning in which these terms will be used in this paper since they have been used in various ways. When we use the term ‘Traps’, we mean those constraints to progress that result from a set of mutually reinforcing blocking factors. Technically a trap remits to a problem of “coordination”, requiring policy or political responses in different areas, in a context of several restrictions. In some cases financial support is needed to overcome the traps, but not necessarily. When we use the concept of ‘Gaps’, on the other hand, we mean those constraints which require large financial investments to overcome, which is in relation to the ambition of the goals assumed.³

Inevitably, there is a large degree of overlap between these concepts, and in some cases a set of gaps that mutually interact might transform into a trap. Nevertheless, we think this is a useful framing to help distinguish the kind of response and support required both nationally and internationally. Theories on aid have historically tended to focus on capital transfers and the gaps

³ This approach is different from the one adopted in ECLAC (2012)

so a focus on *traps* reminds us that this is not all about money by any means. However, plans to reduce aid flows to MICs prompt a reminder that many *gaps* exist as well, and that significant sums of money may be needed to overcome them.

2.1 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 (although it is important not to forget that absolute shortages do remain, as we emphasise in the next section). These bottlenecks have a similar effect to the well-known “poverty traps”, insofar as they drive countries to fall into a low-level equilibrium that ends up blocking or delaying growth (Alonso 2007). Many MICs have undergone – in some cases repeatedly – episodes of accelerated growth which have not led them to paths of sustainable growth over time (Spence, 2011). According to one study, only one in ten countries defined as middle income (using a different, author defined definition to the common World Bank definition we note earlier) in 1960 had reached high-income status by 2010 (Agenor, Canuto and Jelenic, 2012).

Typically one ‘MIC trap’ has been emphasised more than any other, related largely to productivity and the likelihood of being unable to compete either in low wage manufacture markets due to rising wages, or in high value-added markets due to limited skill and innovation investments. However, we would suggest there are at least three other traps in addition to this one, related to: (i) green technological transformation, (ii) macroeconomic stability and international financial integration, and (iii) social cohesion, governance and institutional quality (Alonso, 2007 and 2013). We set them out very briefly here.

2.1.1 Productivity and technological change

The traditional ‘MIC trap’ relates to difficulties sustaining a process of technical and productive change. The productive specialization of emerging countries tends to be based on sectors which are intensive in resources and unskilled labour, particularly agriculture. To move towards more dynamic sectors, they need to promote structural change, nurturing their human capital and generating employment and technological capacities (Agenor and Canuto, 2012; Aiyar et al, 2013). Necessary to achieving this is a combination of investment in physical and human capital, continuous promotion of technological capacities, creation of efficient infrastructure, and the ease of entry and

establishment of new businesses. It is worth noting that China's growing monopoly of hi- as well as lo-tech manufacture is making structural transformation even more problematic for many countries (Paus, 2009).

2.1.2 Green technological transformation

MICs need to take advantage of the drivers of their growth in order to meet their development objectives in a reasonable time-frame. That implies developing new industrial sectors and productive capacities. But because many components of their existing patterns of growth are linked to the use of non-green technologies, their further could lead to drastic increases in energy demand, waste and pollution (especially if we consider that most MICs have a growing and increasingly urban population). In fact, MICs show the highest ratios of increase in greenhouse emissions in the last decade. This implies the need for fundamental technological and productive changes.

2.1.3 Macroeconomic stability and international financial integration

A third set of vulnerabilities relates to difficulties achieving integration into international financial markets with macroeconomic stability while at the same time maintaining enough space for counter-cyclical macroeconomic policies. Given their high exposure to international financial markets, some MICs face special difficulties in preserving macroeconomic stability associated with their high tendency toward indebtedness in foreign currencies, limited fiscal space, and narrow national capital markets. The international financial environment accentuates the pro-cyclical tone of economic policy, which relaxes during times of abundance, when there is an influx of capital, and contracts when capital leaves the country. Debt and financial crisis are symptoms of this trap, which has been aggravated by financial and capital account liberalization; deregulated financial flows can produce macroeconomic disruption, particularly in developing countries (Ocampo, 2003; Ocampo and Griffith-Jones, 2007)).

2.1.4 Social cohesion, governance and institutional quality

As countries progress, they require more complex institutions to manage a more developed economy, and to respond to a more demanding society in terms of governance conditions. However, economic and institutional processes frequently do not evolve at the same pace, with institutions more subject to inertia. In other words, the development process requires a path of institutional change. There are a range of technical capacity issues that need to be responded to, as well as

constraints such as civil service reform. But this is not a merely technical issue – sometimes, the problem lies not only in the weakness and limited efficiency of institutions, but also in their reduced credibility. Problems of governance are often driven by the extraordinary levels of inequality (and sometimes low social mobility) that characterize many MICs and which corrode institutional legitimacy. For example, institutional weaknesses and social inequality make it more difficult to build a sound taxation system and finance the provision of the public goods that societies need (Alonso and Garcimartin, 2013). Recent social demonstrations and conflicts in Brazil and Turkey, in spite of economic progress, could be examples of these problems. The failure to integrate all sectors of society into the political process also means that policies may favour a small elite rather than the majority.

2.2 MIC Gaps

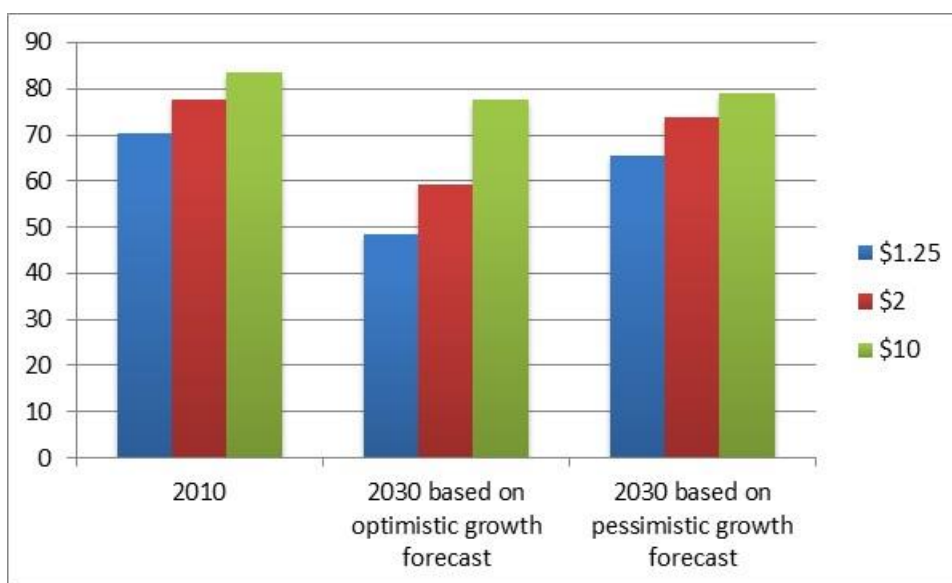
Financing gap analyses are common in international development and date back to 1950s development economics; the famous 0.7% calculation for aid (which dates from the late 1960s) was based on savings and forex gaps. In the last decade, a number of estimates put a monetary cost on achieving the MDGs in order to work out how much international public funding would be required, having taken into account complementary private and domestic sources. For instance, an action plan for MDG implementation calculated that the financing gap of meeting the MDGs globally was “\$121 billion in 2006, rising to \$189 billion in 2015” (UN Millennium Project, 2005). Recently, the World Economic Forum has outlined a set of finances to meet the ending of extreme poverty (WEF, 2014).

Clearly any such financing estimates depend on a set of assumptions on 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. The MDG era has achieved a great deal, including focusing the world on the halving and perhaps eventually the eradication of extreme poverty as an overarching priority. One of the negative side-effects of this worthy focus has been the reduced emphasis on other important aspects of the development process. In this paper we focus on two such aspects: non-extreme poverty (i.e. poor people living on over \$1.25/day) and sustainable infrastructure supporting national economic development. It is our contention that if these are adequately factored into development objectives, the size of the financial hole still faced by most MICs, and the need to fill it, will become increasingly apparent.

2.2.1 Persistent poverty

The majority of global poverty at \$1.25 and \$2 is located in MICs (Sumner, 2012). Edward and Sumner (2014) estimate across a range of growth and inequality assumptions that even in 2030 MICs could continue to account for between a third and a half of global \$1.25 and \$2 poverty, or even more (up to two-thirds) if inequality trends continue on their current trajectory (see figure 2). Similar proportions for current poverty are estimated by Alkire et al (2011 and 2013) for multi-dimensional poverty; Glassman et al (2011) for a range of ill-health; and Kanbur and Sumner (2011) for nutrition and primary education. MICs also have a larger share of the global burden of disease, measured by disability-adjusted life years (DALYs) (Salvado and Lah, 2013).

Figure 2: Proportion (%) of global poverty (at \$1.25, \$2 and \$10/day) in MICs, 2010 and projections for 2030



Source: Edward and Sumner (2014). Notes: MICs = countries currently classified as MICs; Optimistic growth forecast = IMF projections; Pessimistic growth forecast= half of IMF projections; Estimates here assume historical inequality trends continue. For a range of further scenarios see Edward and Sumner (2014).

Even if one is optimistic about \$1.25 or \$2 poverty, projections for the next 20 years show a burgeoning mass of insecure people in the \$2-\$10 range; 3-4 billion people could find themselves in this bracket by 2030 and most of them will live in MICs. In our view the objective of development is not just to get everyone above to \$1.26 and above but to move the whole world to a reasonable and secure standard of living such as something like \$10/day or perhaps even \$13/day PPP, the US poverty line (Ravallion, 2009). Whilst estimates of ending \$1.25 and \$2 poverty are small as a

proportion of global GDP, ending \$10/day poverty would take 20% of global GDP (Edward and Sumner, 2014) suggesting a much longer term project of development cooperation.

2.2.2 Infrastructure

One can argue that reducing the purpose of the international cooperation system to fighting poverty alone promotes an excessively narrow vision of the development agenda, even when less extreme poverty is included; other objectives need consideration if a fairer distribution of global development opportunities is to be achieved, including correcting those market failures that penalize the convergence process. Infrastructure is likely to be the most expensive of these concerns.

Investment in infrastructure not only promotes economic growth and competitiveness, but also expands capital markets and broadens the portfolio of projects for domestic and foreign investors. In the long run, its impacts can be felt in increases of 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 cash-intensive.

A number of analyses have been carried out recently to replicate the MDG financing gap analyses of a decade ago. For example, Greenhill and Ali (2013) looked at five sectors likely to be included in the post-2015 framework (education, health, water and sanitation, sustainable energy, and food security/nutrition/agriculture) and found that the additional funding required “over and above all existing spending” to finance development objectives would be between \$150-250 billion per year. However, given the annual ODA budget is \$130bn/year and climate finance commitments are potentially higher this is not unreasonable. However, a further \$400-900 billion per year will be necessary to achieve renewable energy goals, which require very significant infrastructural investments. They warned that these “are likely to be under-estimates”. Another recent report estimates that, with populations growing, annual spending on infrastructure in the developing world will need to increase to between US\$1.8 – 2.3 trillion each year by 2020 (Bhattacharya, Romani and Stern, 2012). Current spending on infrastructure in developing countries is approximately US\$0.8-0.9 trillion per year.

Things get even more costly when we consider that this infrastructure has to be “green”. A drastic improvement in energy efficiency and an accelerated shift to sustainable energy will be needed in MICs to respond to climate change, the major global public bad, and this could mean difficult trade-offs in terms of consumption growth and collective human wellbeing, which will need to be compensated. Climate finance for mitigation and adaptation is an area of finance that has developed in negotiation processes distinct from the usual aid discussions but it will inevitably become ever more indistinguishable from development cooperation *per se* as the post-2015 framework comes into effect, and as the donor-recipient paradigm continues to evolve towards a more horizontal relationship.

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. Furthermore, both developed countries and MICs should in theory be interested in working together in the search for and dissemination of clean technologies and alternatives to fossil fuel to support a gradual change in the energy production and consumption patterns. The international community should, and is, integrating the MICs agenda ever more profoundly into international discussions. Development cooperation should be oriented to complement and encourage MIC capacities. In the following section we look at how that might be done.

3. MICS AS RECIPIENTS: THE ROLE OF DEVELOPMENT COOPERATION IN MICS

In the previous section we presented the scale of need in MICs in terms both of a variety of development blockages, the traps, and holes in the budget, the gaps. One could argue that the weight of responsibility for dealing with these problems will always fall squarely on the shoulders of the countries themselves, but what can development cooperation do to support 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. That is obvious and a truism. It is a source of pride for such countries, for whom high aid dependence may well have had negative political as well as economic consequences (Glennie, 2008). 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. With more resources, development objectives will be achieved faster and with greater success than without such support. This is especially true when those resources are public in nature, deliberately focused on achieving mutually-agreed objectives and bringing policy experience, knowledge sharing, technical capacities and institutional support.

Of course, everything depends on country context. Some MICs may still require large-scale financial transfers to help reduce poverty if the tax-base is limited, others to build green infrastructure and contribute to sustainable global development. Some MICs will require much less financial aid, but will benefit from technical support and exchange, which makes up about a fifth of ODA and is the mainstay of much south-south cooperation. Nor does the debate about development cooperation with MICs hinge on the question of need alone. One aid dollar is likely to *more effective* in slightly better off developing countries such as MICs where state capabilities are stronger and indeed more likely to reduce poverty if people are closer to the poverty line, again, more likely in MICs (Bräutigam, 2000).

While the global context is certainly changing, with a larger number of countries now relying less on aid, the role of aid in Low Aid countries is well established if often overlooked (Glennie and Prizzon,

2012). Analyzing the role aid has played in Low Aid countries for many decades, especially when it has been effective, can help us map a response to the traps and gaps outlined above, projecting how the role of aid might change in countries moving from higher to lower aid reliance, or continue to evolve in countries that have long been non-reliant on aid.

In response to the traps, as we have already implied, the main role of aid will be incentivising and catalysing change, building on its nature as a publicly oriented intervention. The more traps look like gaps, aid will continue its role as a large-scale financial transfer, relying as much on quantity as quality.

3.1 Development cooperation and MIC traps: an incentives-based approach

International support can help overcome MIC traps more by accompaniment than large-scale funding. In this sense, south-south cooperation is very much leading what will become a dominant and important form of cooperation in the years ahead, and that all countries (north and south) can learn from. However, money is almost always needed to facilitate such a process and catalytic injections of cash can lead to substantial change.

Insofar as MICs are more likely to share common problems with aid contributors (for example, youth unemployment, environmental threats or change in the energy patterns), cooperation with MICs requires a more horizontal, networked activity, bringing together the capabilities and expertise of the various actors, including those coming from the South. Official agencies should relinquish (over time) their former role as service providers, in order to become mediators, to identify problems, talk to those involved, create the necessary conditions to lay down a network of common activity, and define incentives (including financial incentives) to ensure the efficiency of coordinated action. We identify five key roles of this kind of incentivising financial cooperation.

3.1.1 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. Sometimes incentives have been perverse, especially when large amounts of support may have disincentivised progressive policies in recipient countries, or when conditions attached to aid have promoted the wrong policies. But equally often the role of the international community has been to incentivise progressive policies. There are many

issues of importance in which external funds or political pressure can make a difference, whether in human rights, domestic resource mobilisation, better accounting or supporting policies against social inequities.

It is wrong to argue that small is insignificant. There are many examples of small amounts of money being used to encourage very significant change. For example, while ODA makes up a tiny proportion of Colombia's economy, it has often worked to promote positive outcomes in strategic areas. A revealing note in the pre-Busan Colombia case study of the Paris Declaration evaluation of by Wood et al (2011) claims that "in certain fields – such as the environment, institutional strengthening, and productive system support, as well as problems related to the struggle against inequality, internal displacement and human rights violations – the selective use of aid financing, expertise and shared experience was a 'determining factor in achieving better development results'." Other examples include the way international cooperation has helped to disseminate information about successful experiments, and provide start-up funding, such as when donors, particularly the World Bank, backed the diffusion of the conditional cash transfer programmes started in Mexico.

Often, the importance of cooperation as incentive increases in inverse proportion to the relative scale of the investment. In Low Aid countries, it will be the all-important aspect for agencies to consider. In fact, the negative consequences of aid on governance, which are well documented, are far less likely to occur in Low Aid contexts as they are related to dependence, meaning that the chances of achieving good "value for money" are somewhat enhanced.

3.1.2 Supporting non-governmental actors

As countries grow economically and the development problem gradually shifts from absolute lack of resources to the poor distribution of resources, the advocacy and accountability roles of civil society (understood broadly to include e.g. the media, trade unions, the church, think tanks), and the work of parliaments, become even more important. One problem is that there are often only limited national sources of funds for national civil society – the role of international funds can be crucial to the survival and development of a healthy civil society capable of shifting the balance of power towards the poor and marginalised. A major difficulty here is the relationship between external funders and non-governmental actors, many of which frequently criticise the government – in fact, that is often precisely the point of funding them. While this is certainly a tension, it is one

that the international community has handled delicately over the years, and should continue to do so.

3.1.3 Leveraging and adding value to private finance

Given its limited weight on the GDP of recipients further up the income scale, the effectiveness of development cooperation will often depend crucially on its leverage i.e. its ability to mobilise additional capacities and resources. 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, either by leading the way and proving profitability, or sharing some of the risk. That is the purpose, for example, of the Development Finance Institutions that are in charge of managing instruments related to equity and quasi-equity investment, loans and guarantees. Their consolidated portfolio is close to \$36 billion (\$6.5 billion in new projects in 2012) but they mobilize resources, mostly coming from the private sector, that could multiply that amount four or five times (EDFI, 2012). The involvement of public actors often means that social and environmental standards will be somewhat higher than were only private actors to be involved.

3.1.4 Capacity development (individual and institutional)

The focus of much south-south cooperation, and the objective of around 20% of ODA, is capacity development, whether of individuals or institutions. While it is likely that needs change as countries develop, we are aware of no evidence or logic to imply that there is a *reduced* need for capacity development, just an evolving one. In fact, knowledge sharing is a normal part of relationships between the very richest countries, implying that this area of work remains important right to the top of the income scale. However, technical cooperation should overcome some of its typical limitations, putting more emphasis on the development of local capacities instead of being a mere transplant of donor capacities. This implies cooperation aimed at strengthening institutional capacities, less dependent on expatriate technical staff and more sensitive toward knowledge applicability under local conditions.

3.1.5 Risk coverage, including environmental disasters and financial shocks

This role for development cooperation is undisputed. Some MICs are among the countries most exposed to natural disasters, an aspect of geography unlikely to change as wealth increases. Development cooperation should take into account this problem, supporting national and

international mechanisms of prevention and strengthening resilience of communities at risk. One example is donor support to the Caribbean Catastrophe Risk Insurance Facility, an initiative promoted by the governments of the region with the support of the World Bank in order to provide short-term liquidity to facilitate recovery efforts after hurricanes or earthquakes.

Meanwhile, MICs are more likely to be at risk of financial shocks than LICs, as they are generally more integrated into global financial markets. Again, resources need to be available to act as an insurance mechanism through financial crises, which have the capacity to hit their development prospects severely and suddenly (for example, Indonesia regressed to LIC status in the late 1990s following the East Asian crisis).

Development cooperation can also back innovative initiatives in economic and social policies which governments may be reluctant to fund on account of risk. Because foreign money is accountable to entities outside the immediate political arena of the recipient state, governments are sometimes able to use more flexibly than they are able with their own money, which is scrutinised more closely by parliament. While accountability issues are among the most complex area of development cooperation, this additional flexibility can, in the best of circumstances, allow countries to take risks that they would otherwise have avoided, leading to higher returns or important lessons learned.

3.2 Development cooperation and MIC gaps: Critical support for development budgets

In the above examples, in which development cooperation is called upon to help respond to MIC traps, the quality (characteristics) of the money is more important than its quantity. But, as we have seen, many MICs have significant gaps in public budgets to reduce/end poverty and achieve 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 remain crucial in many MICs. But there are two objections. First, the perception that MICs can raise the required resources without recourse to aid or development cooperation. And, 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.

3.2.1 Are other sources of finance available?

The assertion, increasingly common, that MICs can pay for their own development depends very much on how “development” is defined, that is to say, on the ambition of the international community. Some MICs have enough room for a perceptible improvement in their taxation system, but others face serious problems. Many of the “new middle classes” are still in the \$2-\$13 range themselves (Ravallion, 2012) meaning that MICs have a relatively small taxable population. For example, just 5% of Indonesia’s population lives above \$10/day PPP according to the national socio-economic survey (Sumner and Edward, 2014). Other factors also hinder the creation of a sound taxation system, including the strength of the informal economy, the large number of very small companies, the weaknesses of institutions and tax administrations, a shortage of tax statistics and the limited development of the financial system, not to mention illicit and untaxed capital flows which are substantial for MICs (Cotarelli, 2011; Keen, 2012; Cobham, 2014). All these factors are particularly limiting in the case of MICs as long as they require moving to a more complex taxation system, with more presence of direct taxation.

In such contexts, domestic taxation is not necessarily sufficient to deal even with the cost of ending \$1.25 or \$2 poverty, let alone \$10 poverty. There may also be significant limitations in terms of access to private capital markets. Even when countries do have a credit rating (and not all MICs do), it is still the case that even UMICs may find themselves borrowing at 10% rates of interest or more on ten year treasury bonds. In comparison the EU borrows at 1.5%.

Most anti-poverty and infrastructure spending in the developing world is, and will continue to be, financed by domestic budgets supported by a mix of private sector finance, ODA, multilateral development bank loans and, more recently, loans from emerging economies. Private finance will be crucial in filling the renewable energy financing (Greenhill and Ali, 2013, suggest it will provide 75% of what is required). But, it is clear that international public finance will also need to play an active role. The climate finance negotiations have already recognised the principle that developed countries should contribute considerable funds to “green” developing country infrastructure, very

much including MICs, to encourage a shift towards low-carbon and climate-resilient technologies.⁴ Other international public goods will also have to be paid for by developed countries.

3.2.2 Is there a danger of moral hazard?

There is always a moral hazard danger when external funds fill gaps in spending that should be filled domestically (Svensson, 2000, among others). This danger exists in all countries, not just MICs, and has to be managed by external funders. Nevertheless, we are unaware of any convincing evidence that aid at low levels relative to the size of GDP can significantly slow progress to a more equitable use of resources – on the contrary, in many instances, when spent judiciously, it may further the pressure for change (Alonso, Garcimartín and Martín, 2012). Furthermore, the moral decisions weigh both ways; a decision by the international community to pull resources on the basis of moral hazard, thus leaving the poorest communities to fend for themselves as national politics works itself out, would be a bold one, given the lack of evidence in this complex area. Instead, we recommend efforts to direct aid to areas where moral hazard is less likely, new areas of spending unlikely to be funded otherwise, such as international public goods.

In this brief report we have only been able to outline the roles development cooperation policy can play to support development in MICs. The point we wish to emphasise is that there are an important array of possibilities open to those who wish to support such development. In a bidding war for scarce resources, the very poorest countries will likely emerge as priorities for funding because the situation of those countries is more desperate. It will be up to the international community, particularly the wealthiest countries, how much of the financing gaps in MICs it chooses to help fill with additional international public finance. Such 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.

⁴ A leading scholar has recently called for the \$100bn pledged in Copenhagen to come exclusively from public funds, because the profit opportunities from investment in adaptation are extremely limited. <http://www.developmentprogress.org/blog/2014/02/04/can-private-sector-finance-support-adaptation>

In short, MICs can make good use of international public funds, whether to respond to traps (quality of funding) or gaps (quantity) to complement domestic finance (public and private) and international private finance. Whether such funds are provided is one of the major choices facing the international community in this era of development.

4. 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: it should also back their efforts to participate more intensely in the development agenda regionally and globally. As the world becomes ever more heterogeneous, with a new cadre of countries taking a more prominent role in the international realm, countries' commitments and efforts should adapt to a new distribution of wealth and capacities. The simplistic split between "developed" and "developing" countries should be replaced with a more complex and gradual distribution of responsibilities at the international level. In accordance with this vision, traditional donors should back MIC efforts to participate in cooperative action against common problems in four particular dimensions: south-south cooperation (SSC); contribution to international public goods; regional cooperation and integration; and policy coherence and global rules and governance.

4.1 Supporting south-south cooperation

Support for SSC is one way overcoming the dualistic "donors and recipients" conception of the cooperation system, replacing it with a more inclusive vision in which those developing countries (particularly MICs) with enough capacity and resources also take part in international cooperation activities.

The exact volume of SSC is not well known, partly due to deficient registration systems, but according to the OECD-DAC 25 non-DAC countries provided US\$10.6 billion in 2010, more than 8 per cent of total ODA, with Saudi Arabia (US\$3.4 billion), China (US\$2billion), and Turkey (US\$968 million) being the most important contributors (DAC, 2011b). These estimates do not include all SSC contributors, suggesting that total figures would be somewhat higher. Unlike ODA, then, which has decreased from historically high levels in recent years, SSC appears to be increasing year on year.

Although the SSC label hides very different models and cooperation practices it brings significant, and sometimes new, elements into the cooperation system including:

- Greater recipient ownership, based on a philosophy of “horizontality”. SSC may also generate a “double dividend”, supporting the development of technical and institutional capabilities in both recipient and contributor country;
- Learning from other countries that have faced the same problems in similar contexts. In these cases technical assistance provided by MICs may be more appropriate and cheaper than that offered by “traditional” donors;
- Enlarging the range of cooperation models creating a healthy competition among cooperation providers. SSC widens recipients’ room for maneuver and increases their bargaining power in the international arena (Kragelund 2008, Zimmermann and Smith, 2011);
- Helping spread a sense of shared responsibility for addressing international inequalities. This should lead to a less hierarchical system, in which different actors coming from all types of country will operate together in mutual networks.

In view of the above, 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. Specifically, **HIC donors** could support SSC through:

- Helping official agencies and their technical bodies to strengthen their cooperation systems (with technical and financial resources, and sharing experiences)
- Taking part in triangular cooperation, facilitating SSC initiatives by providing additional funds and technical expertise
- Scaling-up successful innovations
- Backing SSC platforms for technical support and the exchange of experiences and supporting regional cooperation initiatives (see below)

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, especially civil society organizations and private sector
- Diversifying modalities of cooperation e.g. beyond bilateral programmes of technical cooperation, contributions to multilateral or multi-country programmes, particularly those related to international public goods and others global issues, and decentralized programmes.

- Establishing learning mechanisms through more intense practices of evaluation and peer reviews.⁵

4.2 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. It requires a certain level of coordinated action at the international level and some MICs are being called upon to play a crucial role in this cooperative effort, given their increasing significance in the world order. For example, MICs are already responsible for 54% of the CO₂ emissions in the world, and rising, and 65% of rainforests, the “lungs” of the planet and stores of biodiversity, are located in MICs.

At the same time, some MICs are among the countries most affected by under-provision of public goods. For example, a large group of MICs (among them islands and coastal countries in the Pacific and Caribbean) could be seriously affected by the effects of climate change – 13 of the 15 countries most exposed to natural risks are MICs (World Risk Report, 2012).

The provision of public goods is not free and some countries will try to avoid the effort, adopting ‘free-rider’ behavior. To encourage developing countries (particularly MICs) to assume a committed role in the provision of international public goods, the international community has to define the right incentives and supporting measures to compensate the costs. International cooperation can play a role:

1. First, the active involvement of **MICs** is required in international initiatives facing up to the most urgent international public bads (environmental threats being the most challenging). MICs should actively share their experiences, and provide technical assistance and financial and in-kind support to those countries of equal or lesser development in areas such as clean technologies, natural resource management, sustainable livelihoods, prevention and resilience against environmental risks and adaptation programmes.

⁵ Latin American countries have begun a promising process with the Secretaría General Iberoamericana (SEGIB), a regional platform reporting and monitoring their SSC initiatives.

2. Second, **all contributors (but particularly HICs)** should integrate vulnerability to environmental and global risks into their allocation criteria of development cooperation flows.
3. Third, **all contributors** should work together in promoting progressive change in patterns of energy production and consumption in favor of renewable energies. A possible option would be to jointly set up and finance an international fund for technology generation and dissemination. One of the fund's objectives might be to provide incentives for creating a public "commons" of green technologies (as advance market commitments).

4.3 A regional perspective

A regional scope is often most appropriate for MICs as they increase their role in the international arena, for three main reasons. First, their contribution to global governance could be more significant at a regional level, which is more prone to create inclusive mechanisms of voice and representation and adapted better to country-specific problems, strengthening the feeling of ownership among the countries involved and allowing a more active participation of small countries. MICs' role in creating these regional responses will be crucial given their weight.

Second, several public goods are regional in scope, such as river basin management, mechanisms for regional macroeconomic coordination, or infrastructure to promote inter-country connectivity. In these cases, regional public goods will tend to be available only if the countries affected are willing to finance their provision and build the relevant institutional framework. Regional initiatives could also advance in building mechanisms for providing global public goods when there is not yet a suitable response at the global level. For example, while financial stability is a global public good that is deficiently provided at international level, there are some interesting regional initiatives in the area of liquidity provision, such as the Latin American Reserve Fund (which covers the Andean area) and the Chiang Mai Initiative in East Asia, both of which are cooperative mechanisms designed to forestall crises. Experience with these initiatives shows that even a mechanism with limited funding and regional scope can have an important impact on national and regional financial stability.

Third, some MICs are very large; in much of the world, a small number of MICs account for between up to a half of a region's population and aggregate output. The stability and economic growth of such economies is therefore a factor of equilibrium and progress in their region. International

cooperation should take these externalities into account in order to guarantee maximum impact in supporting development in surrounding countries:

1. All contributors should work to promote an ambitious plan of infrastructure investment encouraging regional connectivity. Such a plan should be mainly oriented to physical infrastructure (such as roads, railways and other connections), technology (such as broadband) and energy (sharing resources and power).
2. All contributors should support technological cooperation programs promoting the diffusion of new technologies and the strengthening of national innovation.⁶
3. International cooperation should support regional integration processes, encouraging MICs to take a leading role in the process. Such cooperation could include technical support to regional institutions to improve their capacities for driving the integration process, and backing regional programmes, thus strengthening a culture of collaboration.
4. Finally, an interesting example of inter-MIC cooperation can be found in the strengthening of regional (and sub-regional) development banks and bond markets. Although such institutions are to be found in all regions of the developing world, the two most complete networks serve the Arab and Islamic countries (Islamic Development Bank, Arab Fund for Economic and Social Development, Arab Monetary Fund, Arab Bank for Economic Development in Africa, among others) and the Latin America and the Caribbean region (Andean Development Corporation⁷, Central American Bank for Economic Integration or Caribbean Development Bank). More recently, the Asia-Pacific region has seen initiatives to create mechanisms in support of national bond markets, and the issuance of regional bonds. These institutions are limited by the financial restrictions of their membership, which suggests the need for external support (finance, guarantees and risk management) from the international community, including regional financial institutions as well as HICs.

⁶ Some existing experiences in this field show that significant results can be achieved with limited resources. For example, CYTED, a scientific and technological cooperation program based on creating international research groups and deployed in the Iberoamerican area (Spain, Portugal and the Latin American countries), has supported the exchange of researchers and the creation of technological networks.

⁷ The Andean Development Corporation has become the most important development finance institution in Latin America and has achieved an investment-grade rating higher than its individual member countries.

4.4 Policy coherence, global rules and governance

MICs occupy a difficult position in the development range: they are more deeply integrated in international markets than LICs, but they lack the economic soundness and institutional capacity of HICs. As a consequence, they are highly vulnerable to the faults in the developed country policy coherence, as well as to the asymmetries and gaps of existing global rules. An important part of international support for development in MICs should therefore lay in improving policy coherence (such as in terms of trade and intellectual property rights).

In the new international landscape some MICs are negatively affected by externalities caused not only by developed country policies but also by other MICs, particularly the biggest and richest countries in the same region. Therefore, improvements in policy coherence should also be promoted in some MICs. Monitoring policy coherence could be carried out at regional level, as a part of SSC, in order to maintain ownership of the surveillance process.⁸

Without an enabling international environment that better distributes development opportunities among countries and encourages cooperative responses to collective problems, many national development efforts will be fruitless. An effective enabling environment should guarantee the desired balance between preserving enough policy space for national development strategies and providing effective global rules for governing shared problems. Voice and representation should be adapted in some global governance structures to reflect countries' current weight in the international arena, to enable them to engage more fully in modification of global rules and governance structures.

There are many global rules and institutions requiring reform, but one is particularly important for MICs: international tax coordination. MICs are being encouraged to improve their tax systems in order to better mobilize domestic financial resources. But while many MICs have policy space for designing fairer and more efficient tax systems, as well as improving their tax administrations and public finance management systems, such reforms should be accompanied by advances in tax

⁸ The EU has defined an interesting methodology for monitoring policy coherence for development that could be replicated in other areas.

governance at a global level to reduce tax evasion and fraud, the “race to the bottom” on tax policies, and the debilitating effects of tax havens.

5. IMPLICATIONS FOR ALLOCATION AND EFFECTIVENESS

The preceding sections have discussed the question of international development cooperation with MICs in three ways. First we looked at the question of need, and applied our traps and gaps analysis. Then we suggested the most important means of support the international community can give to MICs for their own development. Third, we looked at how international cooperation can help MICs support development and governance beyond their borders. 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 how scarce resources are prioritised, the means of transfer (modalities), and accountability mechanisms?

5.1 Allocation

5.1.1 What is wrong with MICs category?

The World Bank, which devised the LIC/MIC/HIC thresholds based on its operational lending categories, has never published the exact methodology behind them. The Bank's website explains that GNI per capita was considered the best indicator to offer a broad measure of a country's economic capacity, given the high correlation between this variable and other indicators of economic and social development and that the thresholds were initially set on this basis. Thresholds are defined by the GNI per capita (exchange rate conversion) and are updated to incorporate the effects of "international inflation" meaning the inflation rates of the world's richest countries (the weighted average of the Euro Zone, Japan, the U.K., and the U.S.).

It has become commonplace to recognise that the income per capita threshold at which LICs graduate to MIC status is somewhat arbitrary and this remains the main criticism of the category. More generally, GNI per capita is not a sufficient measure, by itself, to grasp countries' development capacities and challenges, as evidenced by the great diversity among MICs. Furthermore, the income-based classification rests on debatable technical options. The use of exchange rate as a conversion factor (instead of PPP) is questionable; country classification would change significantly, and not in a linear way, if PPP conversion were adopted. It is unclear whether the use of 'international inflation' rates for the world's richest countries is an appropriate way to assess thresholds over time for the world's poorer countries; as a minimum, the "international inflation"

calculation ought now to include some MICs themselves, notably, China and other economically significant ‘emerging economies’. Finally, because it is based on absolute thresholds sustained over time, the trend of growth in the world economy has meant that the number of LICs and LMICs has necessarily decreased over time, and the number of UMICs and HICs has increased.

For these reasons, and others, the LIC/MIC/HIC thresholds require a substantial revisiting, and indeed two major reviews are already underway:

- The World Bank itself is set to publish a review later in 2014.
- The UN Committee for Development Policy has included this subject as a chapter in their forthcoming report for the ECOSOC.⁹

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. Few bilateral agencies rely solely on the LIC/MIC threshold for aid allocation and lending terms – they have additional criteria – but basic GNI per capita data (and sometimes even this crude threshold) are major factors in such decisions. This procedure is even more general in the case of multilateral institutions, including some global funds. For example, the concessional windows of the World Bank (IDA), the African Development Bank, the Asian Development Bank, the IMF (poverty reduction and growth trust) and the International Fund for Agricultural Development use an income per capita threshold (close to that between LICs and LMICs) for country eligibility and finance allocation.

Basing aid eligibility and lending terms on an income-based criterion can cause problems:

- i) *appropriateness*: since MICs are characterized by high social and economic heterogeneity, average measures (such as GDP per capita) are not representative of relative development challenges;
- ii) *equity*: because countries at a similar stage of development but on either side of the arbitrary threshold could receive different treatments;

⁹ Currently there is no formal OECD Development Assistance Committee (DAC) review process. However, it is likely to evolve as a focal point for discussions for donors given discussions on development financing.

- iii) *incentives*: because international support measures are removed in association with achievements in the level of country's development, penalizing success;
- iv) *coordination*: because reaching graduation eligibility may trigger simultaneous withdrawal of support, which could affect the stability and progress of a country's development.

5.1.2 An issue-based criteria for aid allocation

Given the shortcomings of the income-based classification, there are some proposals to create an alternative category (see Tezanos and Sumner, 2013, for discussion). However, given the proliferation of country classifications and the likely contentious nature of any new categorisation attempts, 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 are specifically designed to address it, the problems that affect comprehensive or country-based categories (such as MICs) as criteria for aid allocation could be avoided (Alonso, Cortez, Klasen, 2014).

The key will be to identify an objective indicator (or indicators) in order to define the allocation process. Building on the traps and gaps analysis outlined in section 2, a set of issue-based classifications or criteria could be developed for the purpose of development cooperation. By way of example, we suggest three issues that could give rise to different subsets of countries within the MIC group.

Option A: An access to credit constraint

Typically the crossing of the MIC line is seen as evidence that access to private capital will improve. However, such access is at a price. 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 (for Standard & Poor and Moody's 'BBB-' and 'baa3' are the lowest non-speculative grades, see table 2) and thus concessional lending from donors in itself may remain important, particularly for long-run development financing. For example, interest rates on government ten year bonds for the Eurozone were 1.5% and 2.7% for the US (October 2013). In contrast, interest rates on 10 year government bonds stood close to or over 10% in even some of the fastest growing, large MICs such as India,

Nigeria, and Indonesia. Further, some treasuries issue bonds but not with 10 year maturities (e.g. Sri Lanka, Lesotho and Ghana). And Sudan's central bank does not issue bonds due to Sharia law. Concessional, long-term lending could remain useful as an alternative to relatively high rates of interest. An issue-based classification could consider the credit ratings and/or interest rates on 10 year treasury bonds as one way to differentiate between MICs.

Table 2: Selected MICs and credit ratings and rates of interest on 10 year government bonds

	ODA/GNI (2011)	Ratings		Rate of interest on 10 year government bonds
		S&P (2013)	Moody's (2011)	
China	0.0	AA-	Aa3	4.1
Indonesia	0.1	BB+	Baa3	8.2
Lesotho	0.2	BBB-	Baa3	8.7
Sri Lanka	0.8	BB-	-	13.2
Bhutan	1.0	B+	B1	n/a
India	1.6	B-	Caa1	11.5
Vietnam	3.1	BB-	B1	8.8
Ghana	4.7	B	-	n/a
Sudan	9.1	BB-*	-	n/a

Sources: Data processed from World Bank (2013), Economist (2013) and Standard and Poor (2013) and Trading Economics (derived from monetary authorities of each country).

Notes * = Fitch rating equivalent to S & P rating of 'B'. Bhutan and Lao not rated. Sudan rated by C by Dagong credit ratings agency based in China.

Option B: Space for redistributive policies (and the taxable population)

MICs have very different fiscal space for funding redistributive policies against inequality and poverty. One way to approach this issue is to analyze the transfer of income required of the fifth quintile (the richest one) to raise all poor people above the poverty line. Taxation systems mainly rest on this quintile, so the higher the ratio, the more unlikely that country will be able to eliminate poverty through its own fiscal policy. On average, LICs show the highest ratios. On the other hand, MICs show very different ratios, not necessarily linked with GNI per capita (see table 3). More precisely, there is a group of MICs (mainly LMICs) which also have very high ratios. In these cases, development cooperation can complement local resources to fight poverty. An issue-based

classification could use an indicator of domestic fiscal space in order to identify these subsets of MICs.

Table 3: Examples of LMICs with high and low ratios (income required for raising poor people above the \$2 poverty line over fifth quintile income)

<i>Country</i>	<i>High ratio (%)</i>	<i>Country</i>	<i>Low ratio (%)</i>
Zambia	46.00	Albania	0.01
Ghana	13.25	Egypt	0.15
Lao PDR	12.16	Morocco	0.18
Congo Rep.	11.73	Paraguay	0.20
India	8.78	El Salvador	0.29

Source: Data processed from World Development Indicators (World Bank)

Option C: Environmental vulnerability

Within the MICs group there are countries that suffer severe environmental threats. Such is the case of small islands or costal countries with large parts of their territory in low coastal zones, countries frequently affected by natural disasters (floods, droughts, earthquakes) or countries highly dependent on agricultural production that could be affected by sudden shocks (external prices, climatic conditions). A way to approach these threats is through the Economic Vulnerability Index (EVI), an indicator used in the definition of LDCs. Development cooperation might take this indicator into account in order to identify those countries more severely affected by environmental vulnerabilities (including the effects of climate change). There are also many MIC countries that provide opportunities to invest in climate-compatible growth. Such opportunities should be identified and public monies allocated – much of the early years of the climate finance era has been dedicated to such work.

5.2 Effectiveness

In recent years, and particularly since the onset of the Paris Agenda for Aid Effectiveness in 2005, it has been impossible (rightly) to separate a needs analysis from an effectiveness analysis; the push for “more” is accompanied by the demand for “better”. The Paris Agenda focused the attention of the major aid donors on its now-ubiquitous five principles: ownership; alignment; harmonisation; managing for results; and mutual accountability.

Despite strong endorsement for the process and principles from a wide range of development actors, there have also been concerns that they are overly focused on “traditional” relationships between western donors on the one hand and low-income, fairly aid dependent, countries on the other. Thus, the concerns of the MICs, both as continued recipients and as emerging donors (or “re-emerging” in many cases, see Mawdsley 2012) may not have been given enough space.

5.2.1 Moves towards inclusivity

As the Paris process morphed into the Global Partnership for Effective Development Cooperation at Busan in 2011, there was a clear attempt to expand the purview of the process beyond “traditional” rich country/poor country dynamics and to include the exciting innovations taking place in and between MICs. While the core principles remained largely intact, there were changes to some of the indicators (just seven of the original 12 remain). Table 4 presents a summary analysis of what is in and out of the Busan Indicators compared with their Paris forebears.

Table 4: How the Paris Aid Effectiveness indicators evolved at Busan in 2011

<i>In both the Paris and Busan</i>	<i>Newly introduced at Busan</i>	<i>In Paris but dropped at Busan</i>
<ul style="list-style-type: none"> • Country results frameworks (with stronger emphasis on coordinated use by donors) • In year-predictability • Aid on budget • Mutual accountability (with stronger emphasis on inclusive approaches) • Strengthening PFM systems • Use of country PFM and procurement systems • Untying aid 	<ul style="list-style-type: none"> • Civil society enabling environment • Private sector enabling environment • Medium term predictability • Application of aid transparency standards • Gender equality in public spending 	<ul style="list-style-type: none"> • Operational development strategies • Coordinated technical cooperation • Parallel project implementation units (PIUs) • Use of programme-based approaches • Joint missions and analysis

Source: Glennie et al, 2012

The inclusion of the new indicators demonstrates two clear learnings from the first five years of the Paris Agenda:

1. That development requires the collaboration of a wide range of actors, as well as a strong and functioning government. Thus the emphasis on the role of civil society and the private sector and also the focus on results, which implies a “whatever works” way of thinking.
2. The promotion of a more flexible use of aid modalities rather than top-down blueprints, illustrated by the de-emphasis of certain modality indicators (e.g. use of programme-based approaches, PIUs and the focus on technical cooperation) in favour of broader issues of transparency and accountability.

While both represent progress towards a richer understanding of effectiveness there are still issues that need working out in the forthcoming High Level Meeting in Mexico in April 2014 if MICs are to see the process as more relevant to their own situation.

5.2.2 Specific MIC issues in effectiveness

The five Paris/Busan principles are highly relevant to all types of cooperation. All cooperation should align with country-led strategies in a way that complements the work of other external actors, is oriented towards concrete outcomes and can be held accountable by the intended beneficiaries. In many ways, SSC has some way to go to improve its results analysis and accountability, while it may trump traditional aid when it comes to respecting ownership. In theory, then, the Paris/Busan foundations are well-placed for useful debate and learning between traditional and emerging practices.

However, there are some points of contention that make the Busan principles less useful in MIC settings. With regard to MICs as recipients, as a country’s relative financial capacity increases it is not only development priorities that may evolve. So too, generally, do two factors critical to the success of external cooperation: political power in negotiations with external actors; and institutional capacity to deliver development programmes. For example, the focus on “using country systems”, one of the mainstays of the Paris-Accra-Busan process, might be managed in a more flexible way because it could be less appropriate for countries receiving limited amounts of aid. This means that different modalities may become appropriate to achieve agreed results as effectively as possible. In some countries, project approaches are positively preferred, as they require less paperwork, and can play exactly the role of incentives outside the system that can be most effective

in such contexts.¹⁰ In particular, the pressure for budget support, allowing recipients maximum flexibility over how aid is spent, may be less useful in Low Aid contexts, where tight targeting of funds may be more appropriate. In large countries where particular regions remain poor, an increased focus on regional and city development may be appropriate.

With regard to MICs as contributors, the concept of untying aid, a key element of the Paris agreements and critical to improving aid effectiveness, is anathema in most south-south cooperation which is built upon the theory of mutual benefit. The untying of aid or the various programming instruments for cooperation would appear to go against the very advantages that new development partners can bring to the aid system – namely, the provision of their own development experience in a direct and rapid way (mainly through technical assistance). The main argument for untying aid, namely that it increases value for money, is also far less relevant when the tied services (or sometimes goods) come from countries where labour is less expensive.

5.2.3 A negotiated way forward

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 to the experience accumulated by traditional donors.

It will be difficult for the GPEDC to maintain its original force as a powerful tool in the hands of recipient countries demanding improvements, while at the same time opening its vision to a broader set of contributors and recipients. It can only be done through negotiation. All the indications are that only by substantially restarting negotiations of the indicators, this time in an all-inclusive fashion (which probably means making it a formal UN process), will key MIC countries actively engage in the process (as opposed to signing the document without the intention of engaging).

It is vital that recipients of aid and cooperation, particularly LICs, make their position clear, as they have in the past, that they *do* wish to see non-OECD providers bound by agreed principles, even if they are not precisely the same as those agreed at Busan. As long as inclusive principles are not the

¹⁰ Personal communication to the authors.

object of concrete pressure, they will not emerge – the OECD countries have relatively little political persuasion in this.

Already most MIC recipients are adapting the Busan indicators to their own circumstances. If negotiations do open up on more appropriate indicators some will be identical to Busan indicators, others will be different. It is possible that a sliding scale of indicators could be built, with some aid effectiveness priorities more appropriate in some contexts than others. Such a process could lead to the launch of 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.

CONCLUSION

Middle income countries 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 conclusion, we would reiterate five points:

First, 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.

Second, 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.

Third, 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.

Fourth, the income per capita threshold at which LICs graduate to MIC status is insufficient and arbitrary. 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 could be avoided.

Fifth, while moves to open up the debate on aid effectiveness to better include MIC concerns are welcome, further work is needed to support a more horizontal type of cooperation. This will require a substantial review of the process as well as discussions of substance.

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 a 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.

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