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## Supporting LDCs' Transformation: How can ODA Contribute to the Istanbul Programme of Action in the Post-2015 Era?\*

*José Antonio Alonso\*\**

### ABSTRACT

Many intergovernmental processes, including the Istanbul Programme of Action, the post-2015 Development Agenda and the Addis Ababa Action Agenda, call for a significant increase in ODA toward LDCs. However, even if the commitments were fulfilled, their effectiveness could be minimal if no significant changes are made in the way in which donors allocate and provide ODA. LDCs are among countries with higher levels of aid-dependency, proliferation of donors and aid fragmentation. The purpose of this paper is to discuss the role that ODA can play in the development process of LDCs and the way in which aid should be allocated among countries.

**Keywords:** International aid, aid effectiveness, aid dependency, aid allocation, Least Developed Countries, donor proliferation, development cooperation

**JEL Classification:** JEL: F02, F35, F53, O19

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\*\* José Antonio Alonso is professor of Applied Economics at the Complutense University (Madrid) and member of the UN Committee for Development Policy (more information, see [www.alonsojoseantonio.com](http://www.alonsojoseantonio.com)).

Comments should be addressed to the author by e-mail: [j.alonso@ccee.ucm.es](mailto:j.alonso@ccee.ucm.es).

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UNITED NATIONS  
Department of Economic and Social Affairs  
UN Secretariat, 405 East 42nd Street  
New York, N.Y. 10017, USA  
e-mail: [undesa@un.org](mailto:undesa@un.org)  
<http://www.un.org/en/development/desa/papers/>

## Acronyms

<b>CDP</b>	Committee for Development Policy	<b>LMICs</b>	Lower-Middle Income Countries
<b>CGIAR</b>	Consultative Group on International Agricultural Research	<b>MDGs</b>	Millennium Development Goals
<b>DAC</b>	Development Assistance Committee	<b>NARS</b>	National Agricultural Research Systems
<b>DFQF</b>	Duty-Free, Quota-Free	<b>ODA</b>	Official Development Assistance
<b>EVI</b>	Economic Vulnerability Index	<b>OECD</b>	Organization for Economic Cooperation and Development
<b>FDI</b>	Foreign Direct Investment	<b>PPP</b>	Power Purchasing Parity
<b>GNI</b>	Gross National Income	<b>OWG</b>	Open Working Group on Sustainable Development Goals
<b>HAI</b>	Human Assets Index	<b>R&amp;D</b>	Research and Development
<b>ICESDF</b>	Intergovernmental Committee of Experts on Sustainable Development Financing	<b>SDGs</b>	Sustainable Development Goals
<b>IPG</b>	International Public Goods	<b>SSC</b>	South-South Cooperation
<b>IPoA</b>	Istanbul Plan of Action	<b>TOSSD</b>	Total Official Support for Sustainable Development
<b>LDCs</b>	Least Developed Countries	<b>UMICs</b>	Upper-Middle Income Countries
<b>LICs</b>	Low-Income Countries		



# Supporting LDCs' Transformation: How can ODA Contribute to the Istanbul Programme of Action in the Post-2015 Era?

## 1 Introduction

Since the inception of the least developed country (LDC) category, only four countries (Botswana, Cape Verde, Maldives and Samoa) have graduated from the list, with two more (Equatorial Guinea and Vanuatu) being earmarked to graduate in 2017. During the same period, 28 countries were added to the category either immediately following independence, or after their development situation deteriorated. The small number of graduated and graduating countries has been a longstanding concern of the international community, including the Committee for Development Policy (CDP).

Already in 1971, the Committee for Development Planning, the predecessor of the CDP, identified the lack of financial resources as an important impediment to development in the LDCs. The low levels of per capita income limit the capacity of these countries for mobilizing domestic resources, through national savings or tax collection in favour of developmental purposes. At the same time, private international flows – such as FDI, portfolio investment or loans – are only marginally oriented to LDCs and they are too selective in their destination, and highly unstable. As a consequence, international official flows – particularly official development assistance (ODA) and other ODA-like resources – are playing a crucial role in filling the shortfall in resources required for poverty alleviation and sustainable development in these countries. To illustrate, ODA still represents over 70 per cent of total external finance despite some progress in increased availability of private funds.<sup>1</sup>

<sup>1</sup> See Targeting ODA Towards Countries in Greatest Needs, DCD/DAC(2014)20 available at [www.oecd.org/general/searchresults/?q=TARGETING%20ODA%20TOWARDS%20COUNTRIES%20IN%20GREATEST%20NEED](http://www.oecd.org/general/searchresults/?q=TARGETING%20ODA%20TOWARDS%20COUNTRIES%20IN%20GREATEST%20NEED)

In this regard, the Istanbul Programme for Action (IPoA) has identified the need for a more determined effort by the donor community to fulfil and, where possible, enhance their ODA commitments to LDCs. To achieve improved progress towards graduation, LDCs will need to be granted improved preferential treatment in accessing ODA and alternative sources of financing. This objective is also present in the document of the Post-2015 Development Agenda that will likely be approved in the UN Summit in September 2015,<sup>2</sup> as well as in the document for the Third Conference on Financing for Development that has been agreed in Addis Ababa in July.<sup>3</sup> In both cases, donors are encouraged to fulfill their commitments on total ODA (0.7 percent of their GNI) and on the part of resources that should be allocated in LDCs (0.15-0.20 percent of their GNI).

As is well known, these commitments are not new, which reasonably arise the question about why this time will be different. Even if the commitments were fulfilled, their effectiveness could notably be reduced if there are not significant changes in the way in which donors allocate and provide ODA. LDCs are among countries with higher levels of aid-dependency, proliferation of donors and aid fragmentation, all of which can limit the effectiveness of aid, particularly if corrective actions are not adopted. Additionally, if donors (particularly bilateral ones) do not allocate their aid in accordance with recipient countries' constraints, fairer and effective distribution of resources could not be achieved. Finally, even if assignment of resources between productive and social sectors

<sup>2</sup> See the final draft "Transforming our World: the 2030 Agenda for Global Action": [https://sustainabledevelopment.un.org/content/documents/7603Final%20draft%20outcome%20document%20UN%20Sept%20Summit%20w%20letter\\_08072015.pdf](https://sustainabledevelopment.un.org/content/documents/7603Final%20draft%20outcome%20document%20UN%20Sept%20Summit%20w%20letter_08072015.pdf).

<sup>3</sup> See the Addis Ababa Action Agenda: [http://www.un.org/ga/search/view\\_doc.asp?symbol=A/CONF.227/L.1](http://www.un.org/ga/search/view_doc.asp?symbol=A/CONF.227/L.1)

has become more balanced in recent years, there is a concern that international aid is out focus on some important elements for supporting a transformative strategy in LDCs.

The purpose of this paper is to discuss the role that ODA can play in the development process of LDCs, with the particular focus on the issues mentioned above. This paper is considered to be very timely to the four on-going important international agendas – the IPoA, the Sustainable Development Goals (New York), the Financing for Development Agenda (Addis Ababa) and the climate change accords (Paris)-, all of which stress the need for giving LDCs a clearer priority in the process of ODA (and other ODA-like resources) allocation. The paper is organized around eight sections, including this introduction. Section 2 reviews the way in which commitments regarding LDCs are adopted in the main intergovernmental processes in course; section 3 examines the main changes that have taken place in the international financial landscape; section 4 analyzes the evolution of ODA and the changes in the way of ODA is registered; section 5 discusses the way in which ODA is allocated, suggesting some new criteria in favour of LDCs; section 6 examines some of the problems that affect the level of aid effectiveness in LDCs; section 7 suggests some avenues for improving the transformative capacity of ODA; and, final section 8 presents some conclusions.

## 2 Recent intergovernmental processes related to LDCs, ODA and finance mechanisms

The outcomes of the previous United Nations conferences on the LDCs – the Millennium Declaration, the Monterrey Consensus of the International Conference on Financing for Development, the Plan of Implementation of the World Summit on Sustainable Development (Johannesburg Plan of Implementation), the 2005 World Summit Outcome, the Doha Declaration on Financing for Development and the outcome document of the High-level

Plenary Meeting of the General Assembly on the MDGs – reaffirmed that LDCs deserve particular attention and well targeted support measures to eradicate poverty, accelerate economic growth, achieve sustainable development and overcome their vulnerabilities.

In 2011, the *IPoA* recognized that some international support measures generated only limited results, as they were insufficient in scope and scale to achieve the goals and objectives of the Brussels Programme of Action, and to meet the specific needs of the LDCs. In some cases, there were implementation difficulties of agreements and a lack of policy coherence and consistency. As such, the IPoA called for strengthening international support measures in terms of higher priority and specific targeting of LDCs.<sup>4</sup>

With the aim of enabling half the number of LDCs to meet the criteria for graduation by 2020, the IPoA proposes that international support measures should, *inter alia*, focus on ensuring financial resources (including ODA) and their effective use for LDCs' development. It also advocates the promotion of policy coherence and consistency with regards to decisions concerning the international economic, financial and trading systems, with the aim of increasing the quantity, quality and effectiveness of LDC-focused international support measures and mechanisms. Accordingly, the implementation of the Programme of Action should be integrated into all relevant international processes (paragraph 29.b).

The IPoA recognized that there is a clear need for much more determined efforts by developed countries to fulfil and, where possible, enhance ODA commitments to LDCs. In this context, donor countries have continued to commit to the target of 0.15-0.20 per cent of their GNI as ODA to LDCs and, *inter alia*, to aligning the allocation of ODA to LDCs' priorities with particular focus on productive capacity development to achieve sustained, inclusive

<sup>4</sup> Fourth United Nations Conference on the Least Developed Countries, Programme of Action for the Least Developed Countries for the Decade 2011-2020, A/CONF.219/3/Rev.1, 23 May 2011.

and equitable economic growth and sustainable development.

In 2012, the United Nations Conference on Sustainable Development established two committees tasked with presenting results on the post 2015 development agenda to the General Assembly by September 2014: the *Open Working Group (OWG)* and the *Intergovernmental Committee of Experts on Sustainable Development Financing (ICESDF)*. The General Assembly initiated negotiations on the post-2015 development agenda which is to be adopted in September 2015.

The OWG was tasked with proposing the Sustainable Development Goals (SDGs) to replace the MDGs (to be expired in 2015), and set the global agenda on economic, social and environmental development for the next 15 years. The General Assembly adopted the report of the OWG in September 2014 and decided that the proposals contained in the report shall be the basis for integrating SDGs into the post-2015 development agenda, along with other inputs considered by the intergovernmental negotiating process.<sup>5</sup> Finally, the preparatory document for the United Nations Summit in September 2015 has integrated the SDGs agreed by the OWG with minor modifications in some targets.<sup>6</sup>

The proposed SDGs comprise 17 Goals, each accompanied by targets which will be further elaborated through indicators and measurable outcomes. Goal 17 refers to “[s]trengthening the means of implementation and revitalizing the global partnership for sustainable development” and contains a number of financing-related targets, including one reiterating developed countries’ commitment to provide 0.15 to 0.20 per cent of GNI to LDCs (target 17.2) and a non-specific target to ‘mobilize additional financial resources for developing countries from

multiple resources” (target 17.3). Target 17.9 calls for enhanced international support for implementing effective and targeted capacity-building in developing countries to support national plans to implement all the sustainable development goals, including through North-South, South-South and triangular cooperation.<sup>7</sup>

The report of the Intergovernmental Committee of Experts on Sustainable Development Financing (ICESDF) was tasked to present the range of financial sources and modalities that can support the sustainable development objectives.<sup>8</sup> It also refers to the third international Conference on Financing for Development (FFD) as an opportunity to bring together all stakeholders and define new commitments on mobilizing the resources and means of support required for making the SDGs a reality. The Intergovernmental Committee acknowledged that UN Member States should honour their commitments in full and further effort is needed to maintain and increase ODA allocated to LDCs.

This proposal has been incorporated in the outcome document of the FFD, Addis Ababa, in 13-16 July 2015.<sup>9</sup> The document acknowledges the critical role that ODA plays in developing countries, including LDCs, with limited capacity to raise resources domestically; it urges all developed countries that have not yet done so to implement by 2020 their commitments to allocate 0.7 per cent of GNI in ODA to developing countries, with 0.15 to 0.20 per cent of GNI to LDCs. It also encourages all donor countries to establish, by the end of 2015, indicative timetables to illustrate how they will reach these commitments (paragraph 53). Additionally, the document encourages the targeting of ODA to countries (such as LDCs) where the need is greatest, in accordance

5 See <http://sustainabledevelopment.un.org/index.php?menu=1300> and [http://sustainabledevelopment.un.org/content/documents/4518SDGs\\_FINAL\\_Proposal%20of%20OWG\\_19%20July%20at%201320hrsver3.pdf](http://sustainabledevelopment.un.org/content/documents/4518SDGs_FINAL_Proposal%20of%20OWG_19%20July%20at%201320hrsver3.pdf)

6 See: [https://sustainabledevelopment.un.org/content/documents/7603Final%20draft%20outcome%20document%20UN%20Sept%20Summit%20w%20letter\\_08072015.pdf](https://sustainabledevelopment.un.org/content/documents/7603Final%20draft%20outcome%20document%20UN%20Sept%20Summit%20w%20letter_08072015.pdf)

7 General Assembly A/68/970, Report of the Open Working Group of the General Assembly on Sustainable Development Goals, 12 August 2014.

8 General Assembly A/69/315, Report of the Intergovernmental Committee of Experts on Sustainable Development Financing, 15 August 2014.

9 See: [http://www.un.org/ga/search/view\\_doc.asp?symbol=A/CONF.227/L.1](http://www.un.org/ga/search/view_doc.asp?symbol=A/CONF.227/L.1)

with their national priorities and, given the decline in the share of ODA to the poorest in last few years, urges all developed countries to allocate at least 50 per cent of net ODA to LDCs (paragraph 52).

Beside these processes, a new UN Conference on Climate Change will be held in Paris in December 2015. This will be the 21<sup>st</sup> annual session of the Conference of the Parties to the UN Framework Convention on Climate Change and the 11<sup>th</sup> session of the Meeting of the Parties to the Kyoto Protocol. While the specific content of the proposed agreements is to be defined, one of the objectives of the Conference is to mobilize \$100 billion a year by developed countries from 2020, in order to enable developing countries to combat climate change. LDCs and other developing countries in need will be main recipients of this fund that will be partly pass through the Green Climate Fund.

At the same time, the OECD has promoted a process of reviewing concepts and way of registering ODA and other related flows. The OECD/DAC High Level Meeting of December 2012 gave a mandate to its Members to review new ways for measuring external development finance, recognizing the need for exploring alternatives to the traditional concepts in view of the rapidly changing development framework. The DAC set out to modernize the measurement of ODA and to better capture official support for sustainable development. In this context, new agreements were reached at the high-level DAC meeting in December 2014, as well as other proposals have been tabled –such as the new concept of Total Official Support for Sustainable Development (TOSSD)- for further discussion in the near future.

All these processes underline that we are in a crucial moment: the agendas adopted during this year will condition the future of the global development policy. And in all of them, the strengthening the support to LDCs through more active and effective ODA (in addition to other means of support), appears as a component of the renewed agreements. Thus, it is crucial to ask about the role that ODA can play in the development processes of LDCs.

### 3 Financing for development landscape: some LDCs' specificities

Over the last two decades, the financing for development landscape has undergone significant changes. After a decade of stagnant aid, donors drove an upward trend of aid that has been maintained up to now, with some minor setbacks; in fact, ODA has increased 66 per cent in real terms since 2000. But, international private flows to developing countries have grown at a much faster rate and, as a consequence, there has been a notable shift in the structure of international financing of developing countries, with private finance gaining in importance at the expense of public funding.

During the same period, there has been a dramatic widening in the array of actors and instruments that operate in the financing for development landscape. New providers of official development cooperation have joined, through South-South cooperation (SSC), the activity of traditional donors grouped in the OECD-DAC. Together with the emergence of new official donors, other actors, most of who coming from the private sector, have been increasingly involved in activities supporting development. As a consequence, the range of mechanisms and agents for supporting and financing development is much broader today than in the past.

Even if this process involves higher transaction costs and coordination problems, the enlargement of available supporting mechanisms and agents is not generally perceived as a burden by recipient countries. In fact, most of them positively perceive the greater range of options because it widens their room of manoeuvre and increases the availability of support better tailored to their specific needs (DAC/OECD, 2014c, Greenhill et al., 2013).

All these mechanisms will be needed for supporting the post-2015 development agenda. The final list of sustainable development goals (SDGs) and targets is to be made in September 2015, but it is already clear that the objectives the international community will

set are vastly more ambitious than those embodied in the MDGs. While eradicating extreme poverty will remain the primary objective, new fields and more ambitious objectives will also be part of the new agenda. Given its enlargement, the post-2015 development agenda will require the support of a renewed global partnership for development to mobilize unprecedented resources and political engagement. Therefore, both private and public financing from domestic and international sources will be necessary, and both need to be effectively exploited. As the ICESDF acknowledges, “there is no one simple policy option.”<sup>10</sup> Instead, *a basket of policy measures and means of support should be available for countries to choose the most appropriate policy combinations in each case.* In accordance with the spirit of the Monterrey Consensus, the international community should take into account all forms of financing and other means of support and implementation, including public, private, national and international in a holistic manner.

However, it would be a *mistake to assume that we are dealing with substitutive sources of support.* Each one has its own characteristics, which make them particularly appropriate for some actions but unsuitable for others. For example, public resources are crucial when the goal is to support an equitable distribution in access to the good or service provided, when the resources should be channeled with a certain degree of stability and predictability, and, when they should be managed transparently and accountable for citizens. On the other hand, private resources can be important to rapidly mobilize large volumes of resources for activities with profitable returns, and where market stimulus provides appropriate incentives. Therefore, one should not aim at compensating a shortage of some types of sources (e.g. official aid) with a higher presence of another type of flows (e.g. private), but rather at combining the most appropriate form of means of support and source of financing for each case.

There are peculiarities in the role that different sources of financing for development can play in the case of LDCs. The capacity of these countries for mobilizing domestic resources, even if not inexistent, is clearly limited. Their saving rates tend to be low and the economic environment is frequently not suitable for generating investments (due to the low quality of institutions, high exposure to external shocks, fragmented societies and, in some cases, risk of conflicts). Given the deficiencies of their institutions and the narrowness of their taxable base, room for improving tax collection in the very short time is limited, too. The average tax ratio (over GDP) in LDCs is close to 15 per cent, lower than that of lower-middle income countries (LMIC) (19 per cent) and upper middle income countries (UMICs) (24 per cent). However, these averages mask very different national situations, even among countries with similar levels of GDP per capita. For example, the tax revenue ratios of three LDCs with similar GDP per capita (in PPP), Sierra Leone, Uganda and Senegal are 9, 14 and 20 per cent, respectively. All of this suggests that there is room for increasing tax collection in some LDCs, but this improvement is highly country-specific.

Improving LDCs' capacity for mobilizing their domestic resource and enlarging their tax collection requires countries to overcome several and intertwined shortcomings. Among them are the presence of a large informal sector, the dominance of agricultural activities that are difficult to tax, the large number of very small companies, the weaknesses of public institutions and tax administrations, a shortage of tax statistics and the limited development of the financial system. But, the most limiting factor is the low level of taxable population in these countries. In LDCs, more than 98 per cent of the population are living under \$10 a day. Furthermore, the international environment does not facilitate the task of building sound tax systems in LDCs, either. For instance, the lack of appropriate international tax cooperation is encouraging tax competition among countries, tax evasion through transfer pricing by multinational corporations and untaxed capital

<sup>10</sup> See [http://www.un.org/ga/search/view\\_doc.asp?symbol=A/69/315&Lang=E](http://www.un.org/ga/search/view_doc.asp?symbol=A/69/315&Lang=E)

flows towards tax heavens. Given that LDCs suffer the severe constraints that significantly limit their capacity to mobilize domestic resources in order to finance an effective transition towards inclusive and sustainable strategies of development, international financial flows to these countries become a crucial factor for complementarily financing for developmental purposes.

LDCs' capacity for attracting private international capital flows is also limited. For example, for the period 2008-2012, FDI inflows per capita amounted to \$43 in LMICs and \$201 in UMICs, as compared to \$23 in LDCs (\$19 in the case of LICs). Per capita remittances received were \$73, \$49 and \$30 in LMICs, UMICs and LDCs, respectively. Official international capital flows are a much more important source of external finance for LDCs (and LICs) than for LMICs and UMICs. In fact, net aid per capita received by LDCs amounted to \$50 (\$48 in LICs), while it was close to \$15 and \$7 in LMICs and UMICs. *In sum, the evolution of ODA, its allocation and effectiveness are crucial for supporting the post-2015 development agenda in LDCs and for making the objectives of the IPoA a reality.*

A significant mobilization of financial resources for developing countries is essential for the post-2015 development agenda to be properly implemented. However, if we want to make the SDGs a reality, it is equally important that the international community supports activities that aim at *enhancing and developing technical and institutional capacities in developing countries, through the development of skills, technological cooperation and the sharing of knowledge and experiences*. At the same time, it is also important to promote changes in policies and rules in order to improve policy coherence at the national and international levels. The post-2015 development agenda will not be met without *an enabling international context* that takes into account the diversity of conditions of developing countries, and guarantees an *adequate provision of those public goods* required for the development process.

## 4 An overview of aid to LDCs

### 4.1 Recent trends

After a decade of stagnation, ODA began a period of a sustained upward trend in the 2000s, which was maintained, with some minor setbacks, up to 2014. The effects of the global crisis were felt in terms of less intensive growth and some occasional setback in the aid figures, but the volume of ODA to developing countries was maintained between \$120 and \$135 billion in the last six years (\$135.1 billion in 2014). The ratio of ODA over GDP followed the same trajectory, going from 0.22 percent in 2000 to 0.29 percent in 2014.

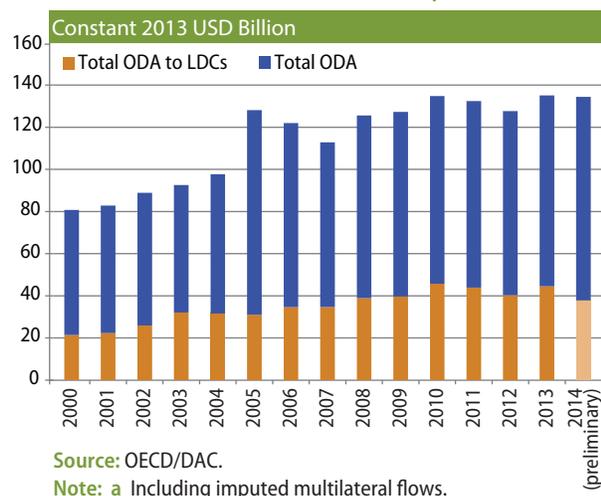
Accompanying this process, there has been a more selective focus on targeting resources to the poorest countries. In fact, LDCs witnessed an increase in their share in located ODA from DAC member countries from about 36 per cent in 2000 to 49 percent in 2013<sup>11</sup>. The share is considerably lower (close to one third) if total ODA (including amounts unspecified by country) is considered (figure 1).

After 2010, the share of ODA to LDCs slightly declined in some years, in part as a consequence of the concessional loans –mainly oriented to MICs- have increased in bilateral ODA (figure 1). It is likely that this trend continues in the near future, bearing in mind the difficulties OECD donors have to increase grants (in the context of tight public budgets) and the new role that reimbursable (and other market-like) modalities can play in the development cooperation system. These modalities that generate debt or demand private sector's engagement are not always appropriate in the case of LDCs.

The relative weight of LDCs in ODA allocation is very different among donors (figure 2). In aggregate terms, the ratio of ODA to LDCs over donors' GNI has slightly gone up from 0.06 in 2003 to 0.10 per cent in 2013. In spite of that, only nine donors fulfilled the international target of 0.15-0.20 per cent of GNI devoted to LDCs in 2013. Six countries

<sup>11</sup> Close to 30 percent of ODA is unspecified by country because it finances general activities or global programmes that cannot easily assigned to any specific country.

Figure 1  
ODA towards LDCs and total ODA, 2000-2014<sup>a</sup>

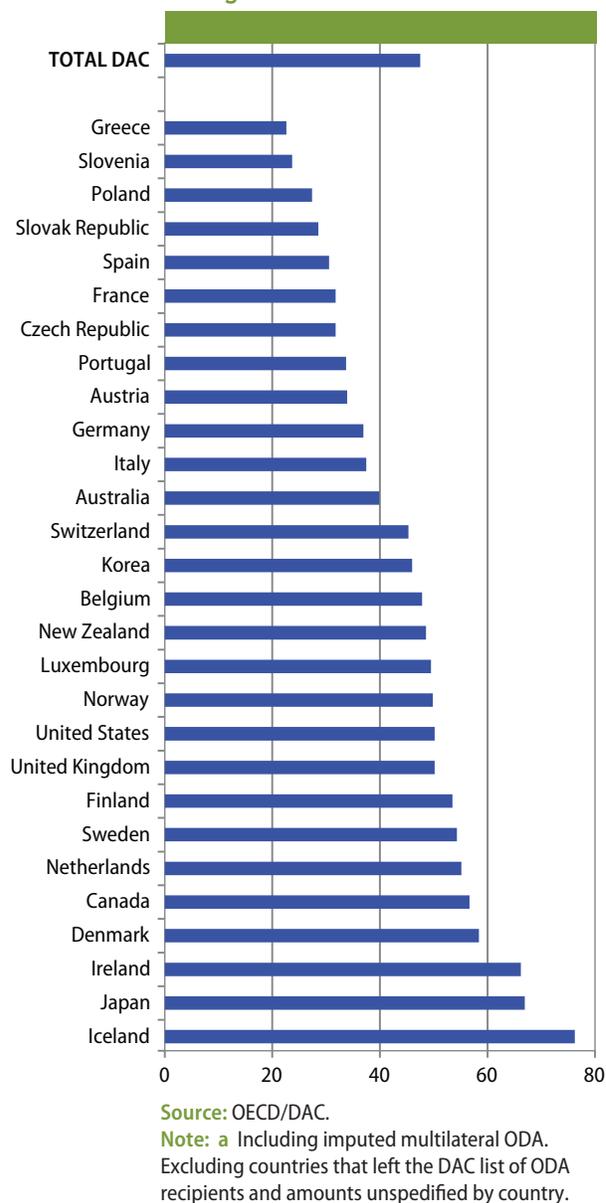


exceeded the 0.20 ratio: Luxembourg (0.38), Sweden (0.31), Norway (0.30), Denmark (0.27), United Kingdom (0.24) and Ireland (0.23); and other three countries exceeded the 0.15 ratio: Finland (0.19), the Netherlands (0.17) and Belgium.

In order to achieve the 0.15 – 0.20 percent of GNI to ODA, DAC donors would need to disburse \$67 - 90 billion a year, as net ODA towards LDCs (instead of \$42 billion allocated as an average between 2012 and 2013).<sup>12</sup> In fact, in that biennium, on average, there was a \$25 billion gap a year in donors' delivery of the 0.15 ratio on ODA towards LDCs (in case of the 0.20 ratio, the gap rises to \$47 billion). Filling the gap and taking on higher targets are in line with i) the IPoA's proposed action that donor countries should review their ODA commitments in 2015 and consider further enhancing the resources for LDCs (Section G, para 116.2.a.v); ii) the final draft of the outcome document to adopt Post-2015 Development Agenda related to strengthening the means of implementing and revitalizing the global partnership for sustainable development (paragraphs 17.1 to 17.5); and iii) the outcome document of the Addis Ababa Action Plan from the Third Conference on Financing for Development (paragraphs 51 to 53).

<sup>12</sup> Istanbul Programme of Action for the LDCs (2011-2020), Monitoring Deliverables, Tracking Progress - Analytical Perspectives. CPD, FERDI, The Commonwealth Secretariat, OECD Development Centre, ICTSD, 2014.

Figure 2  
Percentage share of ODA to LDCs in total ODA from DAC member countries, average between 2012 and 2013<sup>a</sup>



## 4.2 From ODA to new measures of development support

Along with an expanding list of globally agreed objectives, the post-2015 era will play host to an expanding and changing group of actors and modalities of development support. While MDG 8 could be characterised, broadly speaking, as actions which “developed” countries needed to take to support

“developing” countries, such clear-cut definitions are no longer a reflection of the reality. Many countries are already both contributing and receiving development cooperation, with now a more complex web of interactions and mutual solidarity and interests than the traditional donor/recipient relationship. Besides that, new actors from the private sector, directly or through foundations, are increasingly supporting international aid programmes, besides promoting other activities such as philanthropy or social impact investment that have positive developmental effects without necessarily being ODA. With these new actors, the development cooperation system has also increased the range of its available instruments.

All these changes oblige the international community to review the concepts, measures and reporting systems. The DAC has begun a process of both reviewing ODA measurement and setting a complementary and wider concept of “total official support for sustainable development” (TOSSD). In the first case, the main purpose is to define ODA in a more precise way, counting grant equivalent in concessional credits (instead of the total face value) and removing “in-donor” costs. In the second case, the objective is to capture flows (not necessarily based on direct budgetary efforts) that are relevant for development and mobilized with the help of official interventions.<sup>13</sup>

Up to now, the main agreement adopted is regarding the way in which concessional loans should be counted as ODA. According to the current criteria, to be recognized as concessional and reportable ODA, a loan must have a grant element of at least 25 per cent and be “concessional in character”. In order to calculate the grant element, a discount rate is fixed at 10 per cent. Loans are counted in DAC statistics on a cash-flow basis (positive when disbursed and negative when repaid) and in accordance with the face value of the loan. This procedure is clearly far from satisfactory because: i) the fixed discount rate of 10 per cent is too high in accordance with prevailing market conditions; ii) it is not reasonable that two

loans with the same face value, but with different levels of concessionality, are registered as equivalent figures of ODA; iii) there are discrepancies on the interpretation of the “concessional in character”, which has led some donors to register market-raised funds with no explicit official subsidy as ODA.

In order to overcome these inconsistencies, DAC decided to create a new procedure based on a grant equivalent system, in which the grant equivalent is calculated with different discount rates in accordance with countries’ adjusted rates of risk with three different levels for i) LDCs and LICs, ii) LMICs, and iii) UMICs. Additionally, three thresholds were introduced in order to guarantee that there is a minimum level of concessionality (higher for poorer countries) for loans to be registered as ODA. Finally, donors must use the debt sustainability frameworks defined by the IMF and the World Bank in order to avoid countries from falling into excessive indebtedness (Box 1).<sup>14</sup>

This agreement will become effective after 2015, although both methods (the current and the new) will be applied up to and including 2018. Some simulations with the new criteria of registering ODA reveal that the changes may have only limited impact on total ODA, although they can affect some donors more than others. The effect will mainly depend on the level of reimbursements received by the donor from previous loans, the share of ODA that is usually channeled through reimbursable instruments and the level of concessionality of the loans. Given that ODA to LDCs is mainly in the form of grants and, in a very small share, of highly concessional loans, it is not likely that the new procedure will result in significant changes. In the future, the agreement that the higher discount rate is applied to loans to LDCs and LICs may give an incentive for donors in allocating more resources to these groups of countries. Donors could compensate the higher levels of risk of loans to poorer countries with either higher interest rates or, alternatively, higher grant equivalent (and registered ODA).

<sup>13</sup> See <http://www.oecd.org/dac/financing-development.htm>.

<sup>14</sup> (DCD/DAC (2014a))

## BOX 1

**New ways for reporting ODA<sup>a</sup>**

The new procedure is based on four basic elements:

- Firstly, replacing the cash flow based system with a grant equivalent system for the purpose of registering ODA. This homogenizes the way in which grants and loans are registered. As a result, more concessional loans will register higher levels of ODA than less concessional loans with similar face value.
- Secondly, concessionality will be assessed based on discount rates differentiated by recipient groups. This is based on the assumption that lending to poorer or more vulnerable countries involves greater donor effort and recipient benefits than lending to richer and stable countries. The way the differentiated rates are applied is not totally in accordance with market conditions: rates will consist of a base factor, which will be the IMF rate (currently 5 per cent), and an adjustment factor of 1 per cent for UMICs, 2 per cent LMICs and 4 per cent for LDCs and other LICs. Given that the new system would value the risk of default on loans upfront, the eventual forgiveness of these loans would not be reported as ODA.
- Thirdly, it is to establish thresholds on the level of grant element to ensure that loans to poorer countries are provided at higher levels of concessionality than those given to richer countries. Accordingly, only loans with a grant element of at least 45 per cent will be reported as ODA in the case of LDCs and other LICs. This threshold is 15 per cent in the case of LMICs and 10 per cent in the case of UMICs.
- Finally, given the impact that loans have on recipient countries' external debt, DAC members agreed that loans whose terms are not consistent with the IMF Debt Limits Policy and the World Bank's Non-Concessional Borrowing Policy will not be reportable as ODA.

As a way of illustration of the new procedure of reporting ODA, it could be useful to reproduce an example. Let us suppose, for an example, that country A lends \$3.5 million to upper-middle income country Y. The terms of the loan include a repayment in 10 years, a grace period of 2 years and an annual interest rate of 4 per cent. Under the present system (reference interest rate of 10 per cent), the loan meets the minimum grant element of 25 per cent (25.0968 per cent), qualifies as ODA, and has a grant equivalent to \$878,388. Under the new system, the reference rate falls to 6 per cent (5 per cent IMF reference rate + 1 per cent as adjustment factor). The same loan now has a grant element of 9.5678 per cent, which is below the minimum required, and can no longer be considered as ODA.

Country A would need to offer more favourable terms for this loan to meet the minimum grant requirement and be treated as ODA. For instance, lowering the lending rate to 3.75 per cent raises the loan's grant element to 10.7638 per cent. The loan can be treated as ODA and generates a grant equivalent of \$376,733.

**Note: a** For the new procedure, see <http://esango.un.org/ldcportal/web/16736/when-should-concessional-loans-be-reported-as-oda-?groupId=19804>.

The new concept of TOSSD, now subject to discussion within the DAC, will probably undergo more changes (DAC/OECD, 2014b). The new measure aims to capture the array of official development finance being provided beyond ODA, regardless of the type of financial instruments used and their terms (or levels of concessionality). Some DAC members are of

the view that this is a way to provide a more accurate measure of donors' contributions to address global challenges and enablers of development. The new measure tries to: i) cover finance that originates from official sources and mechanisms, but clearly distinguish between official support and flows mobilized by this support; ii) include both concessional and

non-concessional financing and capture all financial flows (including those generating reflows to provider countries); iii) be calculated on gross cash-flow basis; and iv) cover activities promoting and enabling sustainable development (including contributions to international public goods when they are aligned with developing countries' priorities). According to the DAC Secretariat, this new measure should be distinct from ODA, with the latter remaining the main measure of donor effort.

Although the definition of TOSSD has so far not been agreed, the proposal has already raised some controversy. Some consider this new measure as a way for donors to divert attention from the possibly slow increase in their ODA in the near future. Others caution for the potential confusion of combining different sources of funding (ranging from ODA to for-profit mechanisms and from instruments for funding international public goods and those oriented to funding development actions) into one single measure.

It is reasonable that donors search for new concepts and methods of measuring to better grasp the current state of the development cooperation system, where a broader array of actors (public and private) and instruments (financial and non-financial) are now operating. But, the new concepts should be coherent with the very nature of development cooperation policy, which is different from other areas of the financing for development. As Alonso and Glennie (2015) suggest, development cooperation could be defined as those international interventions and activities (public and private) that: i) specifically intend to support development ii) operate through actions that would not be promoted (or at least not in the same way) by the market alone; iii) differentiate in favour of developing countries, particularly the poorest ones, in order to broaden their opportunities of progress; and iv) are based on cooperative relationships that aim to enhance developing country ownership. The new concepts should be part of the development cooperation.

## 5 Criteria for allocating aid

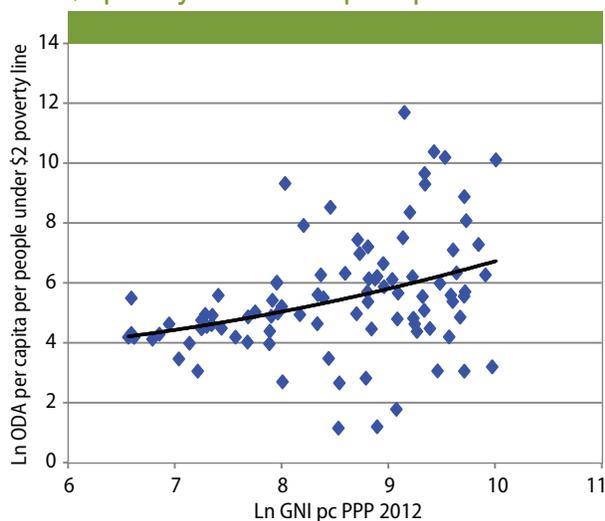
### 5.1 The limited role of countries' needs

The SDGs and the IPoA's objectives may not be achieved unless donors: i) significantly increase their resources mobilized as ODA (or ODA-like flows); and ii) change the criteria used for allocating their means of development support. In fact, the patterns of aid allocation reveal that donors are reluctant to link, in a consistent way, their aid-allocation criteria to developing countries' needs and constraints. Other criteria such as those related to historical relations or donors' political and economic interests seem to have a visible weight in the process of aid allocation, as many empirical studies show (for example, see Alesina and Dollar, 2000, Collier and Dollar, 2002 and Neumayer, 2003). The following three empirical evidences illustrate the point.

Firstly, donors do not seem to allocate ODA in accordance with recipient countries' level of poverty. Figure 3 shows the relation between ODA per capita for people living on less than \$2 a day and countries GNI per capita (in PPP). Given the distributive purpose of ODA, a negative relationship should be expected between ODA per capita and recipient countries' GNI per capita: that is, the higher the GNI per capita, the lower ODA that each person living on less than \$2 a day receives. Data, however, shows otherwise – the higher the per-capita GNI, the higher ODA per capita received by each poor person, indicating that donors do not allocate more ODA to countries with poorer populations and lower levels of development.

Secondly, aid allocation patterns do not seem to respond to countries' capacity for mobilizing domestic resources through taxation. As a proxy for how difficult it is for governments to eradicate poverty by income transfers and taxation - call it here "fiscal effort for eliminating poverty"-, we could calculate how much income must be transferred out from the people belonging to the top (richest) decile in the income distribution in order to eradicate income

Figure 3  
ODA per capita per people living under \$2 poverty line and GNI per capita<sup>a</sup>

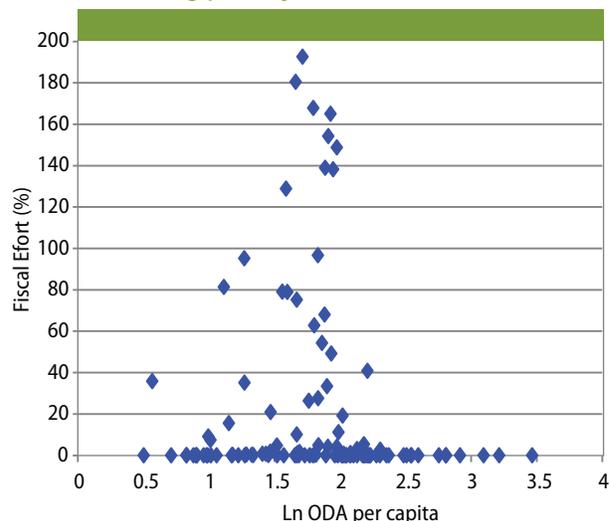


Source: World Development Indicators (World Bank).  
Note: a ODA: average over the period 2010; GNI: 2012.

poverty (defined by \$2 a day), and show the amount as percentage of total income of people belonging to the top decile. The higher the amount necessary to eradicate poverty in relation to total income of the rich, the more difficult for the fiscal authorities to apply the required taxation to this segment of population (Alonso, 2015).<sup>15</sup> If ODA were oriented to support countries' fiscal effort for eliminating poverty, one would expect a positive relation between the fiscal effort required for eliminating poverty and ODA per capita. However, there is hardly any correlation, given the high levels of heterogeneity and dispersion among developing countries (figure 4). For example, there are LDCs with high levels of ODA per capita, but with low levels of transfer required (such as Mauritania, Comoros or Bhutan); and there are countries with high levels of required transfers and low ODA per capita (such as Madagascar or Burundi).

<sup>15</sup> As fiscal efforts usually rest on this decile, that ratio could be understood as an approach to the redistributive effort, through the taxation system, required for eliminating poverty (being the ratio dependent on the national GDP per capita, the level of inequality, the percentage of poor people and the poverty gap)

Figure 4  
ODA per capita and fiscal effort for eliminating poverty<sup>a</sup>



Source: World Development Indicators (World Bank).  
Note: a ODA per capita: average over the period 2010 - 2013; Fiscal effort for eliminating poverty: Percentage of the income of the richest decile required for eliminating poverty (\$2 poverty line).

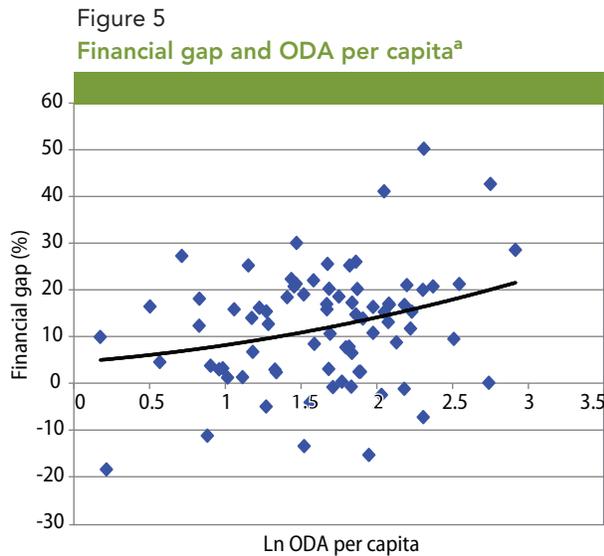
Finally, aid does not seem to be allocated according to countries' ability to access alternative financial sources. Countries finance their investment mainly through their own savings and the international savings they are able to capture. The more dynamic developing countries – defined as those that have achieved an average rate of economic growth higher than 5 percent in the period 2000-2012 -- have shown a rate of savings plus FDI close to 36 percent of their respective GDP – call it the *notional objective for financing*.<sup>16</sup> This paper defines the gap between the notional objective and national savings plus FDI measured as ratio to GDP, as *countries' needs for official international financing*. If ODA is expected to address this financing gap, a positive relation between ODA per capita and the financing gap should be expected. Figure 5 below shows that is indeed the

<sup>16</sup> We do not consider portfolio investment because are less relevant in quantitative terms and more instable. On the other hand, remittances are not taken into account because are included in the measure of gross domestic savings. This measure is only an approach and ignores the possibility of crowding out effects among different sources.

case, but the correlation is very low, with high levels of dispersion.

## 5.2 Allocating aid: some proposals

The analysis above shows that donors do not allo-



cate aid in accordance with sound criteria related to recipient countries' needs and capacities. The presence of other factors in their decisions (such as donors' political or economic interests) diverts the resources from where they are most needed, hindering the effectiveness of aid. In order to achieve more transparency and efficiency, it is important that the donors define and adopt sound criteria in the process of aid allocation, even if these criteria are applied with some flexibility. The following suggests possible criteria that could be part of the decision process.

### a. LDC criteria

The LDC category identifies countries that suffer from severe structural constraints for building sustained strategies for social transformation and economic progress. A group of criteria and indicators are defined and used for identifying those countries

affected by such constraints. These indicators have been refined by the CDP over time, being now defined by the GNI per capita and two compound indexes: the Human Asset Index (HAI) and the Economic Vulnerability Index (EVI). These indicators should be applied by donors for allocating ODA (and other ODA-like flows), if the needs and constraints of the recipient are to be considered. In line with earlier suggestions by the CDP to better align development assistance with country needs and avoid abrupt changes in ODA allocation when countries graduate from the LDC category, the General Assembly invited development partners to consider the LDC criteria and indicators as part of their criteria for allocating ODA.<sup>17</sup> The LDC Ministerial Declaration of September 2014 and the General Assembly resolution on the follow up to the Fourth UN conference on LDCs reiterated that the allocation of ODA should take into account the structural handicaps and constraints of LDCs. The inclusion of structural vulnerability in the criteria for aid allocation would make the allocation of ODA more stable, predictable and less pro-cyclical (Guillaumont, 2015).

In terms of volume, earlier work by the CDP points out that countries with lower GNI per capita and HAI generally receive more ODA, whereas there is no such correlation between the level of ODA and EVI. Given the substantial ODA flows and the fact that few LDCs managed to graduate in the past 30 years, this suggests either that the nature of the problems of LDCs were so severe that even large aid flows could not make a difference or, probably more likely, that aid to LDCs has not been as effective as it could have been.

### b. Space for domestic resource mobilization

*A second criterion for aid allocation could be related to a country's tax capacity for funding redistributive policies to raise poor segments of the population above the poverty line.* There are different ways to approach the tax capacity for eliminating poverty. Ravallion (2009) estimates tax capacity based on the marginal

<sup>17</sup> General Assembly resolution A/67/221.

tax rate that should be applied to the rich population in order to finance poverty eradication. To this end, he defines “rich population” as the segment of the population that is above the poverty line (that is, someone who would not be considered poor based on any standards). Next, he estimates the tax rate that should be applied to such stratum in order to lift the entire poor population above the \$1.25 poverty line. He calls this ratio the “marginal tax rate”. Given that the redistribution policies are defined within the national perimeter (as part of the “social contract” on which a society is based), perhaps it is more relevant to identify the “relative riches”, in accordance with national parameters, rather than using the “international rich population” as a benchmark. In that case, another possible procedure for approaching tax capacity is to estimate the transfer of income that the richest decile has to do for raising poor people above the poverty line at national level (Alonso, 2015). The ratio between the required transfer and the income of that decile approaches the space for funding redistributive policies (which we call here the fiscal effort for eliminating poverty).

### c. Alternative sources of funding

*Another important criterion to consider is a recipient country's capacity for accessing alternative international sources of financing.* Recent declining trends in ODA and the needs for new financial resources arising from the SDGs indicate the increasing importance of countries' ability to access to a range of other sources of financing. A way to measure the availability of international funding could be the credit rating that a country has in international markets, or the risk adjusted rate by international institutions (e.g. OECD). An alternative approach could be to measure the gap between a notional desirable ratio of available resources for funding investment (adapted to country circumstances) and the effective resources (domestic and international) mobilized by the country.

### d. Defining a minimum floor

If donors consistently apply the aforementioned criteria, most of their ODA would be directed to the poorest countries and, particularly, to LDCs. But, that does not guarantee that donors fulfill the international target of dedicating between 0.15-0.20 of their GNI to LDCs. In order to fulfill the target, most donors should also increase their ODA budgets. For this reason, it is important to underline the need that traditional donors as well as emerging donors in consideration to do so define a credible path for increasing their development cooperation budgets and, in the case of traditional donors, the objective should be to reach the objective of 0.7 percent of GNI.

*Meanwhile, donors should publicly commit themselves to a minimum floor of their ODA budget dedicated to LDCs.* This is what the revised draft of the Addis Ababa Accord suggests, when it urges “all developed countries to allocate at least 50 per cent of net ODA to LDCs” (paragraph 52). For example, if all donors in the biennium 2012/2013 committed to dedicate at least 50 percent of their (located) ODA to LDCs, the resources mobilized to this group of countries would have been \$48 billion,<sup>18</sup> instead of the actual level of \$42 billion. This is not a significant difference in quantitative terms (which facilitates the adoption of the proposal), but it sends a pragmatic message calling on donors to change their criteria of aid allocation and giving more priority to the poorest countries. *The new providers of development cooperation could join this initiative and define their own minimum floor of ODA to LDCs in accordance with their respective conditions.*

## 6 Aid effectiveness

In addition to increasing the volume of resources channeled as ODA to promote positive changes in LDCs, there is an urgent need for enhancing the impact and effectiveness of these resources. As

<sup>18</sup> The increase of ODA would be much bigger if donors dedicate 50% of their total (located and not located) ODA to LDCs.

various studies have revealed, concerns regarding the aid effectiveness are well documented and affect many countries. When examining the link between aid and growth, the results are largely inconclusive with some studies finding positive effects (e.g. Arndt, Jones, and Tarp, 2010, and; Clemens et al., 2012), while others find negative or no effects (e.g. Rajan and Subramanian, 2008; Nowak-Lehmann et al. 2012, and; Doucouliagos and Paldam, 2011). Although the impact of aid on low-income countries appears to be more positive (e.g. Dreher, Nunnenkamp and Thiele, 2008, and; Galiani et al. 2014), the results of empirical research are far from conclusive.

In the case of LDCs, there are several factors impeding an improvement in aid effectiveness. Some of these LDC-specific factors are: i) aid dependency is larger than in other recipient countries; ii) capacity shortcomings are severer in an environment of fragmented and loosely coordinated aid; iii) many LDCs are fragile states with poor governance, risks of conflict and related problems; iv) these countries are particularly economically vulnerable and thus suffer more under volatile and poorly managed aid. Two of these factors, the limited coordination of donors and high levels of aid dependency, seem to be crucial and should be corrected by donors, because the two factors are mutually reinforcing and result in a vicious circle.

## 6.1 Lack of coordination

LDCs typically have relatively low levels of institutional capacity for implementing projects and coordinating international providers of support, as well as high levels of donors' proliferation and aid fragmentation. Data for 2011 show that, on average, the number of donors in LDCs is similar to "Other LICs" (35 in LDCs and 36 for other LICs), but much higher than that of LMICs or UMICs (29 and 27, respectively). At the same time, the number of non-significant donors<sup>19</sup> is higher in LDCs (22) than

in the three other groups (19, 17 and 14, respectively). As compared with the countries in other income groups, LDCs experience the highest fragmentation ratio<sup>20</sup> of aid (63 per cent). Despite the agreements reached by donors in the Paris Declaration, this ratio has increased over the last five years.

The agenda on aid effectiveness (i.e. the Paris Agenda and its follow-up processes) is of particular relevance to LDCs, especially the principles related to the need of more harmonization among donors, clearer alignment of donors' activities with priorities and procedures of recipient countries and improvements in ownership of the development process by the recipient country. This issue has become increasingly important as the aid landscape has changed dramatically in recent years, with both new bilateral donors (such as Brazil, China, India and Turkey) as well as big non-governmental players (such as the Gates Foundation, the various Global Funds, etc.). In this environment, all the problems of the current aid system could become more pronounced. As such, there is an urgent need for engaging the new players into a dialogue around coordination and development cooperation effectiveness.

The EU has a particular responsibility in this process because it includes most of the main donors. It developed various mechanisms for a better coordination among European donors (as defined in the European Consensus on Development (2005) and the Code of Conduct on Complementarity and the Division of Labour in Development Policy (2007)). But these mechanisms have not yet shown a visible impact.

## 6.2 Aid dependency

As compared with other developing countries, LDCs have experienced relatively high levels of aid (as a share of GNI). LDCs as a group have received the largest share of aid in GNI for decades. A considerable number of LDCs is dependent on aid, with aid

<sup>19</sup> The DAC defines a "significant" donor by one of these two criteria: i) the donor provides a higher share of aid to the partner country than the donor's overall share of global

aid; ii) the donor is among the largest donors that cumulatively account for at least 90% of the partner country's aid.

<sup>20</sup> The fragmentation ratio measures the number of non-significant donors compared to the overall number of donors.

flows making up significant shares of government revenues, and even larger shares of public investments. As shown in table 1, share of aid in LDCs' GNI consistently averaged above 10 per cent over the past 25 years, around 1 per cent of GNI for all developing regions.

However, the level of aid dependency varies significantly among LDCs. The average ratio of ODA

Table 1

### Aid dependency of LDCs and its subgroup as percentage ratio of ODA to GNI, 1990, 2000 and 2012

	1990	2000	2012
All LDCs	19.2	13.2	12.1
African LDCs	21.3	12.7	10.9
Non-African LDCs	17.6	14.5	15.2
War-Affected LDCs	18.5	16.9	23.9

Source: World Development Indicators (World Bank).

Note: a Unweighted averages and not including all countries.

over recipients' GNI for the decade 2003-2012 is 15 percent, but this ratio varies between close to 1 percent in the cases of Angola or Equatorial Guinea and up to about 80 percent in the extreme case of Liberia. Table 2 groups countries in accordance with the ratio of ODA to countries' GNI. There are some countries with very high ratios (sometimes referred to as "donor darlings"), such as Afghanistan, Burundi, Liberia, Malawi or Mozambique and others with very modest ratios ("donor orphans"), such as Yemen, Bangladesh or Sudan.

Classifying countries by levels of ODA per capita is another way of measuring aid dependency. The average ratio in the latest three years for which data are available (2010-2012) was \$184 per capita a year. However, the ratio varies among countries, ranging between \$2,594 in Tuvalu and \$7 in Myanmar. Table 3 groups countries in accordance with the level of per capita ODA received. ODA reaches its highest ratios in small countries, with a population less than 1 million people, indicating that there is a minimum

Table 2

### Aid dependency of least developed countries as percentage ratio of ODA to GNI (average 2003-2012)

20% <	15% < < 20%	10% < < 15%	5% < < 10%	< 5%
Liberia	Congo, Dem. Rep.	Timor-Leste	Bhutan	Sudan
Solomon Islands	Sierra Leone	Niger	Lao PDR	Yemen, Rep.
Afghanistan	Rwanda	Ethiopia	Benin	Bangladesh
Tuvalu	Kiribati	Vanuatu	Comoros	Angola
Burundi	Guinea-Bissau	Uganda	Togo	Equatorial Guinea
Sao Tome and Principe	Haiti	Tanzania	Senegal	
Malawi	Eritrea	Gambia, The	Cambodia	
Mozambique		Mali	Guinea	
		Burkina Faso	Lesotho	
		Mauritania	Chad	
		Madagascar	Nepal	
		Central African Republic		
		Zambia		

Source: The author, based on World Development Indicators.

Table 3

**ODA per capita, average 2010-2012 (Current dollars)**

500 <	100 < < 500	50 < < 100	25 < < 50	< 25
Tuvalu	Vanuatu	Rwanda	Uganda	Eritrea
Solomon Islands	Sao Tome and Principe	Comoros	Niger	Guinea
Kiribati	Timor-Leste	Somalia	Chad	Madagascar
	Afghanistan	Mozambique	Ethiopia	Angola
	Liberia	Mali	Sudan	Bangladesh
	Haiti	Senegal	Nepal	Myanmar
	Bhutan	Sierra Leone	Yemen, Rep.	
	Djibouti	Gambia, The	Eritrea	
	Lesotho	Zambia	Guinea	
	Mauritania	Burkina Faso		
		Guinea-Bissau		
		Benin		
		Malawi		
		Lao PDR		
		Congo, Dem. Rep.		
		Togo		
		Burundi		
		Tanzania		
		Equatorial Guinea		
		Central African Rep.		
		Cambodia		

**Source:** The author, based on World Development Indicators.

threshold (in terms of fixed and sunken costs) that aid has to overcome in all programme countries.

There is an ample array of empirical studies that have shown the negative effects of high levels of aid dependency on aid quality, damaging institutions and governance or reducing international competitiveness in the recipient country (see, for example, Moss et al., 2008, Rajan and Subramanian, 2008, and Alonso et. al., 2012). Thus, high aid dependency in LDCs requires for the donor to make a balanced consideration; while the LDC category was created for the donor to increase aid to these countries, the donor is required, at the same time, to take into account the fact that the LDC category includes a significant number of countries with already high

levels of aid dependency. Not always “more” is synonymous with “better”.

Clearly, the reduction of ODA flows is not an efficient or fair response to this problem. For some LDCs, ODA (and other ODA-like) flows is a source of financing for much needed social services and, under the current circumstances, difficult to replace. The process of reducing aid dependency requires a more complex response, based on complementary measures. Particularly, it is necessary to: i) be more cautious about plans to increase aid without considering its potential adverse effects on the country; ii) establish plans to gradually reduce aid where feasible while seeking and backing alternative sources for financing a country’s development; iii) pay greater

attention to existing routes for mobilizing domestic resources and improving public administration, which involves not only domestic reforms (e.g. strengthening tax systems), but also international changes (e.g. tackling tax evasion and capital flight); and iv) finally, dedicate more resources towards the provision of crucial international public goods (IPGs) related to developmental objectives (such as agricultural R&D, see section 7.2) because this is a way not to exacerbate the national problems derived from aid dependency.

## 7 Improving the transformative capacity of aid

### 7.1 Matching needs and cooperation modalities

The range of development cooperation modalities and instruments has widened in the last two decades. At the same time, the heterogeneity of LDCs has also significantly increased. LDCs share many common features and, on average, have poorer outcomes in terms of income, human capital and structural vulnerability than the average of other developing countries. These outcomes may, however, reflect different circumstances at the country level. The group is currently composed by 31 low-income countries, 15 lower-middle and two upper-middle countries, as well as one high-income country. Among the 48 LDCs, 8 are small island developing states (SIDS), 16 are land-locked economies, 24 are categorized as fragile states by the OECD and 44 are IDA eligible. Their population sizes vary from tiny Tuvalu to populated Bangladesh. Economic structures also differ greatly across LDCs: 6 are fuel exporters and another 6 manufacturing exporters (largely textiles and garments). Ten countries are mineral exporters, 8 agricultural exporters and 10 service exporters (classified according to which export category accounts for at least 45 per cent of exports of goods and services). This heterogeneity affects countries' need for international support and should be reflected in designing strategies for effective assistance.

Therefore, it is important to match, in a suitable way, countries' needs and the content and modalities of aid. For doing that, there is a need to identify key areas of the structural impediments that deserve international support, create clusters of LDCs according to the main impediment affecting them, and identify the development cooperation modalities suitable for tackling the issues affecting each sub-group of countries.<sup>21</sup> This approach allows for clusters of countries with more homogeneous shortcomings, which demand similar responses. It is important that these issues mainly focus on long-term structural weaknesses that are, at least partially, beyond governments' immediate ability to address. In this manner, perverse incentives (moral hazard) that are usually associated with aid when used as a substitute for recipients' domestic effort could be restricted or eliminated.

Six main areas related to structural impediments that deserve international support, with the aforementioned characteristics, are instructed below: all of them relating to long-term structural impediments (Alonso and Glennie, 2015). Additionally, they allow, in a general way, to identify distinctive lines of action for development cooperation. The six selected areas of structural impediments and related development cooperation responses are as follows (see also Box 2).

- *Human capital assets*: Basic structural weakness in countries' human capital provisions related to education and health parameters and measured by HAI, which is one of the criteria used to define LDCs. Given the nature of the deficiencies that affect basic social sectors, development cooperation responses should be provided via official grants, together with highly concessional loans through bilateral or multilateral channels. Budget support, basket funds and development project modalities are also appropriate means of support.

<sup>21</sup> This problem is carefully analyzed in Alonso et al., (2014).

## BOX 2

## Defining clusters within LDCs

The groups of countries listed below are identified by using available and widely used indicators of structural impediments (which may suffer from some shortcomings in terms of country coverage or reliability). The groups were tentatively defined by including a similar number of countries to facilitate comparisons. The analysis does not intend to define any new groupings nor abrupt threshold for allocating international support among countries, but only identifies those countries with severe deficiencies under each of the proposed impediments

*Human Capital Assets:* HAI is one of the criteria used to define LDCs. HAI is a composed index with four elements: two related to health and nutrition (the percentage of population that is undernourished and the rate of mortality for children aged five years) and two related education (the gross secondary school enrolment ratio and the adult literacy rate). Main LDCs affected: Afghanistan, Angola, Bangladesh, Benin, Bhutan, Burkina Faso, Burundi, Cambodia, Central African Republic, Chad, Comoros, Congo, RD Congo, Djibouti, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Haiti, Lao PDR, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nepal, Niger, Rwanda, Senegal, Sierra Leone, Somalia, Sudan, Timor-Leste, Togo, Uganda, Tanzania, Yemen and Zambia

*Economic Vulnerability:* EVI is also one of the criteria used to define LDCs. EVI is a composite index with seven indicators: population size; remoteness; merchandise export concentration; share of agriculture, forestry and fisheries in GDP; homelessness due to natural disasters; instability of agricultural production; and instability of exports of goods and services. Main LDCs affected: Afghanistan, Angola, Belize, Bhutan, Burundi, Cambodia, Chad, Comoros, Djibouti, Eritrea, Gambia, Guinea-Bissau, Haiti, Kiribati, Lesotho, Liberia, Malawi, Mauritania, Mozambique, Myanmar, Niger, Rwanda, Samoa, Sao Tome and Principe, Sierra Leone, Solomon Islands, Somalia, Sudan, Timor-Leste, Tonga, Tuvalu, Vanuatu and Zambia.

*Knowledge and Innovation Capacities:* Knowledge and innovation is composed by three components with three indicators each: education (average years of schooling; secondary enrolment; tertiary enrolment); innovation (royalty payments; patent count; journal articles); ICT (telephone; computers; the Internet users). Main LDCs affected: Angola, Bangladesh, Benin, Burkina Faso,

Cambodia, Djibouti, Eritrea, Ethiopia, Guinea, Lao PDR, Lesotho, Madagascar, Malawi, Mali, Mauritania, Mozambique, Myanmar, Nepal, Rwanda, Senegal, Sierra Leone, Sudan, Tanzania, Uganda, Yemen and Zambia.

*Quality of Governance:* The six dimensions are included: i) controlling of corruption; ii) Government effectiveness; iii) political stability and absence of violence; iv) regulatory quality; v) rule of law; and vi) voice and accountability. Main LDCs affected: Afghanistan, Angola, Bangladesh, Burundi, Cambodia, Central African R., Chad, Comoros, RD Congo, Djibouti, Eritrea, Ethiopia, Guinea, Guinea Bissau, Haiti, Lao PDR, Liberia, Madagascar, Mali, Mauritania, Myanmar, Nepal, Sierra Leone, Somalia, Sudan, Timor-Leste, Togo, and Yemen.

*Infrastructure Quality:* There is no standard indicator that provides complete information on the infrastructure development of developing countries. However, the World Economic Forum, based on opinion polls, has defined a measure on the quality and development of countries' port infrastructure. Main LDCs affected: Angola, Bangladesh, Bhutan, Burkina Faso, Burundi, Chad, Ethiopia, Guinea, Haiti,, Lao PDR, Lesotho, Liberia, Madagascar, Malawi, Mauritania, Mozambique, Myanmar, Nepal, Rwanda, Sierra Leone, Tanzania, Timor-Leste, Uganda, Yemen and Zambia

*Environmental Vulnerability:* The World Risk Index is composed by four dimensions: exposure towards natural disasters, susceptibility depending on likelihood of suffering harm, coping capacities and adaptive capacities. This type of vulnerability is understood as the susceptibility to risks, lack of coping capacities and lack of adaptive capacities against environmental degradation and natural disasters. Main LDCs affected: Afghanistan, Bangladesh, Benin, Burkina Faso, Burundi, Chad, Djibouti, Gambia, Guinea, Guinea-Bissau, Haiti, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Senegal, Sierra Leone, Solomon Islands, Sudan, Togo and Vanuatu.

*A note of caution:* the clusters of countries by the main structural impediments are conditioned by the availability of data. For example, the reason why Somalia is not among the countries with low "infrastructure quality" is not because its infrastructure is good, but because the lack of data on this subject. Therefore, if this approach is to be adopted, previously donors should support an improvement on available data on these areas.

- *Economic vulnerability*: Structural weaknesses associated to the risk posed to a country's exposure to exogenous shocks. In this case, the objective is to promote a greater productive diversification and a reduction in countries' vulnerabilities towards external shocks. Official grants and concessional loans are important, but technical cooperation and some market-like instruments could also be useful. Multilateral cooperation could contribute to reduce countries' vulnerabilities to external shocks and to support the productive diversification process through preferential measures like duty-free and quota-free (DFQF) access to developed countries' markets or by financing infrastructure projects.
  - *Knowledge and innovation capacities*: Countries' ability to generate, adopt and diffuse knowledge. Countries with this type of deficiencies have to strengthen their efforts in developing their education, science and technological systems. Technical cooperation is appropriate, particularly in the areas of technological innovation systems. Multilateral aid could also be relevant through the support of knowledge capacity and technological transfer; public-private partnerships between research entities and industrial enterprises with the participation of similar entities from developed countries and market-like instruments might have an important role in supporting innovation.
  - *Quality of Governance*: countries' quality of governance, as an average of the six indicators that compose the Worldwide Governance Index (World Bank). Such countries need to advance the quality of their institutions and to improve public policy and its relation with citizens' demands. Under these conditions, financial cooperation is not as important as technical cooperation, the exchange of experiences, institution-building activities and policy dialogue. Both bilateral donors and multilateral institutions can have a role in this area, even if we know that improving governance conditions is almost always a complicated and lengthy process.
  - *Infrastructure quality*: Quantity and quality of infrastructure provision. Development cooperation should focus its efforts on supporting countries to build a sustainable infrastructure required for development progress. Concessional and non-concessional loans, through both bilateral and multilateral channels, are the most appropriate mechanisms. Public-private partnerships, with the participation of developed country entities, could also be a useful way of assistance.
  - *Environmental vulnerability*: Tries to take into account countries' vulnerability against natural disasters. For this group of countries, development cooperation should focus on risks mitigation measures and on supporting the establishment of mechanisms to increase countries' resilience. Virtually all development cooperation modalities could make positive contribution in this area, including innovative finance mechanisms as well as those related to climate finance.
- The definition of clusters of countries affected by the same issues is a way to tackle LDCs heterogeneity and improve the suitability and effectiveness of the development cooperation responses. Even if general preferences and means of support are common for the whole category, donors should assess how to organize LDCs into more homogeneous groups of countries in order to give them more appropriate development cooperation responses.

## 7.2 Investing in strategic international public goods: agricultural R&D

Both historical analyses and empirical research confirm the crucial role that the agricultural sector has played in the process of countries rising up the income ladder. First, significant increases in agricultural productivity have been a common starting point of strategies for successful dynamic structural transformation of the economy. In more general terms, it has also been found that, in low and lower-middle income countries, agricultural growth reduces urban poverty, as a rise in agricultural wages and incomes increases the reservation

wage of unskilled workers in cities. Second, many of the world's poor continue to live in rural areas and, directly or indirectly, depend on agriculture for their livelihoods. Helping smallholder farmers and their dependents by increasing productivity would have immediate impacts on reducing poverty and hunger. Third, agriculture is also a sector with large and relatively inexpensive potential for climate change mitigation. Therefore, improvements in agricultural productivity are important not just for raising overall economic growth, but also for reduction in poverty and improvement in livelihoods of rural and urban populations. For LDCs, it is important to invest in tropical agricultural R&D and extension in order to ensure that R&D outputs reach the mass of rural households. In most LDCs, where the majority of the population still lives in the rural area, improvements in agricultural productivity are necessary for greater production (food security, export) and higher incomes.

There is an existing and growing global divide in terms of funding for agricultural R&D. Before the 1990s, in particular, from the 1960s through the 1980s, the Consultative Group on International Agricultural Research (CGIAR) played a leading role in Agricultural R&D. From the 1990s onwards, private companies have become an increasingly important source of Agricultural R&D. As companies are driven by profit motives, the emphasis in terms of crops, technologies and regions is not geared to the concern of LDCs.

Private R&D in LDCs is often oriented towards export crops. For example, in Zambia, the decline in funding for agriculture R&D that started in the 1990s accelerated during 2001-2008, a period of privatization and liberalization. Decline in spending has adversely affected research capacity (in terms of manpower). Private-public partnerships have emerged, but benefited commercial farmers, instead of resource-poor farmers.

Another trend is the growing divide among developing countries. Some of the large developing countries, such as India and China, have developed

strong National Agricultural Research Systems (NARS), but most developing countries, particularly LDCs, have not significantly increased expenditure on R&D. There is also a widening gap in terms of research intensity, leading to a larger gap in scientific knowledge across countries. Moreover, the global inequality in spending on agriculture R&D is likely to have worsened after the food and financial crises of 2008.

There are economies of scale in R&D that smaller countries cannot exploit if investing separately in a research project. In this regard, multilateral and bilateral funding for NARS of LDCs should be encouraged. For example, there is a new Arab world initiative for financing food security, a regional partnership, with funds from Arab donors. LDC countries such as Sudan and Yemen are part of this regional partnership, and their domestic research institutes along with CGIAR research centres and other international donors are involved. Research done in larger developing countries or developed countries could be modified and used to enhance productivity in LDCs. New South-South partnerships can be explored, as well.

Taking into consideration all these trends, donors (and some emerging countries) should dedicate a higher percentage of ODA towards expenditure on agricultural R&D and extension as relevant to LDCs. Public sector agricultural research, globally, regionally and nationally, should be strengthened through traditional and other sources of funding and partnerships. Moreover, donors should increase their support to CGIAR, alongside with searching for new partnerships with an emphasis on funding for improvements in agricultural productivity.

## 8 Conclusions

We could summarize our analysis in the following five main messages:

1. The adoption of a new development agenda after the MDGs era will have wide-ranging

implications for the development cooperation system. The final list of sustainable development goals (SDGs) is to be adopted in September 2015, but it is already clear that the objectives set out by the international community are vastly more ambitious than the MDGs. At the same time, the objectives of IPoA are equally ambitious to the extent that it sets a target of enabling half the number of LDCs to meet the criteria for graduation by 2020. As a consequence, a renewed global partnership for development to mobilize unprecedented resources and political engagement is of critical importance. And, more importantly, new and more effective financial (and non-financial) resources oriented to LDCs will be needed for making the IPoA a reality.

At the same time, there has been a significant expansion of the financing for development landscape over the last two decades. New sources of financing and modalities of support (official and private, national and international) have emerged. All of them can be useful for supporting the post-2015 agenda and the IPoA. However, it would be a mistake to assume that we are dealing with substitutive sources of support. Each one has its own characteristics, which make them particularly suitable for some actions and unsuitable for others. In this vein, the role of development cooperation, financial and otherwise, will remain critical because of its unique characteristics. ODA (and other ODA-like flows), even with carrying less relative weight than before, is (and will remain) an important component of the international financing for development.

LDCs suffer particular constraints that affect their capacity for significantly improving domestic resources mobilization in favour of developmental purposes. At the same time, some international private flows –such as FDI, portfolio investment or loans- are only marginally oriented to LDCs and they are too selective in their destination and highly instable. As a consequence, international official flows (particularly, ODA and other ODA-like resources) are more

relevant in LDCs as a way for filling the shortfall in resources required for poverty alleviation and sustainable development.

Given the crucial role of ODA in the financing for development of LDCs, donors should define credible paths of gradually achieving the committed objectives of: i) dedicating 0.7 per cent of their GNI to ODA; and ii) allocating between 0.15 and 0.20 per cent of their GNI to LDCs through effective development programmes adapted to countries' priorities. In the process of reaching these objectives, donors should define public commitments around a minimum floor of their ODA budget dedicated to LDCs (e.g. 50 percent of their ODA dedicated to LDCs). This should be considered as a transitional phase for giving more priority to the poorest countries. The new providers of development cooperation could join this initiative and define their own minimum floor of ODA (or ODA-like flows) to LDCs, in accordance with their respective conditions.

2. Donors don't always allocate aid in accordance with sound criteria related to recipient countries' needs and capacities. The presence of other factors in the decision making (such as donors' political or economic interests) divert resources from where they are most needed, hindering the effectiveness of aid. Therefore, it is important that the providers define and adopt sound criteria in their process of aid allocation, even if these criteria are applied with some flexibility, based on countries' structural deficits and their capacities for mobilizing alternative (domestic or international) financing flows.

Development cooperation providers should improve their criteria of allocating resources and means of support, taking into account recipient countries' constraints and capacities. We suggest three possible criteria that should be part of the decision process:

- a. Donors should apply the LDC criteria in their process of aid allocation. The inclusion of structural vulnerability in the criteria for aid

- allocation would make the allocation of ODA more stable, predictable and less pro-cyclical
- b. For appropriate aid allocation, donors should take into account the country's tax capacity for funding redistributive policies, which is clearly conditioned by the dimension of the taxable population and their income concentration.
  - c. Finally, an important additional criterion to be considered is a country's capacity for accessing alternative international sources of financing.
3. LDCs are among the developing countries that have low levels of institutional capacity for implementing projects and coordinating international providers of support. These countries also suffer from high levels of proliferation of donors and aid fragmentation. In order to overcome these problems, donors should be encouraged to improve the level of compliance to the principles agreed in the Paris Declaration. Particularly, there is a need for strengthening recipient countries' ownership and aligning activities with local priorities and procedures. Besides that, the donor coordination in partner countries should be strengthened in order to enhance partner country ownership and delegation and division of labor among donors.
 

LDCs are also among developing countries with high levels of aid as a percentage of GDP. Studies have shown the negative effects of high levels of aid dependency on the aid quality, institutions and governance in the recipient country and international competitiveness in the global market. However, the reduction of ODA flows is neither an efficient nor a fair response to this problem. For some LDCs, ODA (and other ODA-like) flows is a source for financing much needed social services and is currently difficult to replace. Therefore, it is important that donors and new providers of development cooperation look for other ways to address the issue of aid dependency. Among other responses, donors should; i) be cautious about plans to increase aid without considering its potential effects on the country; ii) establish plans to gradually downsize aid where feasible, while seeking and backing alternative sources for financing a country's development; iii) pay greater attention to existing options for mobilizing domestic resources and improving public administration, which involves not only domestic reforms (e.g. strengthening tax systems), but also international changes (e.g. tackling tax evasion and capital flight); and iv) dedicate more resources towards the provision of crucial IPGs with developmental effect on LDCs.
  4. In order to improve the effectiveness of aid, there is a need to better tailor the content and modalities of development cooperation to country's specific conditions. Even if general preferences and means of support are common for the whole category, donors should assess how to organize LDCs into more homogeneous groups of countries in order to provide them with more targeted development cooperation responses. In doing so, there is a need to identify key areas related to structural impediments that deserve international support, create clusters of LDCs according to the main impediment affecting them, and identify the development cooperation modalities suitable for tackling the issues affecting each cluster of countries.
  5. Given the strategic role that the agricultural sector plays in countries' development progress, donors should pay more attention to supporting improvements in productivity, particularly funding efforts in agricultural R&D, both at the national and international level. This is an international public good (IPG) with a significant potential impact on the development progress of most of LDCs. Public sector agricultural research, at the global, regional and national levels should be strengthened through traditional and other sources of funding and partnerships. Moreover, donors should increase their support to CGIAR, alongside with searching for new partnerships with an emphasis on funding for improvements in agricultural productivity.

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