The “Middle Income” conundrum

The need for and effectiveness of international assistance in “Middle Income” countries

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DRAFT, SUBJECT TO FURTHER REVIEW

COMMENTS WELCOME

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Abstract

This background paper responds to specific questions as to the usefulness of the Middle Income country (MIC) category for aid allocation and effectiveness. It is in two parts. First, I argue that an objective needs analysis, as opposed to a prioritising exercise, would show the need for high levels of foreign assistance in most MICs, given continuing poverty and structural transformation requirements, made even more expensive by local and global environmental considerations. Second, I show that classifying countries by aid-receipt rather than income/capita provides a useful way in to analysing the role and effectiveness of aid in MICs. The vast majority of the world's poorest people have long lived in countries where aid is a very small part of the economy (Very Low Aid and Low Aid countries). Aid plays a different role depending on its size relative to the economy, and effectiveness debates should reflect that.

Note on terminology

I use the term "aid" here to refer broadly to international public finance flows, not just Official Development Assistance (ODA) as defined by the OECD. However, the statistics are for ODA – other sources are not yet good enough to introduce.

Contents

1/ Need. *What is the role of the international community in supporting MICs?*

> **"There is basically no role for international development cooperation in middle income countries."**
>
> *Paul Collier, author of "The Bottom Billion"*

As economies grow the role and relative importance of international public finance evolves. If growth is relatively balanced household incomes will improve and domestic revenue collection will likely increase. Meanwhile private investment from abroad will be attracted by better opportunities and improving infrastructure.

This correct generalisation has led the international community to a point whereby when countries pass a certain income/capita threshold it is assumed official foreign assistance should decline over time and eventually end entirely. Countries described as "middle income", it is argued, no longer need such support.

However, this assessment of need is flawed. International public financial flows, and development cooperation more broadly, remain an important complement to domestic and foreign private sources of development finance to help respond to a) the very high levels of material poverty which remain in many MICs and b) the investments in infrastructure and structural transformation to embed progress, especially if such progress is to be environmentally sustainable. Prioritising scarce resources towards the very poorest countries should not be mistaken for needs analysis of slightly wealthier ones.

Poverty

> **"The idea that South Sudan is a Middle Income country is a joke."**
>
> *Tisa Sabuni Aggrey, Economic Advisor to the President of the Republic of South Sudan.*[2]

The actual words "Middle Income" are proving unhelpful in communicating development realities to busy lawmakers, journalists and the public at large (see Glennie 2013). They imply that such countries are no longer poor, but this is true only if we draw an unacceptably low bar for poverty. For example:

- Guatemala, an established Middle Income country, has the third-highest rate of chronic malnutrition in the world, at 54%.

[2] Now Minister of Finance and Economic Planning. Remarks on hearing that South Sudan was so classified, at the CAPE Conference, November 2012, London. http://www.odi.org.uk/events/2972-aid-development-cooperation-cape

- More than one third of the world's malnourished children live in India, where prevalence is double that of sub-Saharan Africa. India has been a Middle Income country since 2007.

- Meanwhile South Sudan emerged onto the international scene as a Middle Income country in 2011, despite facing grave poverty. In 2012 it was Low Income again, as oil exports fell.

Some make the case that these countries have the means to deal with poverty, if they were only to allocate resources better, and it is true that there is inequality is severe in many MICs. But there are two problems with this argument.

First, the international development community is in danger of placing too much stall with an exaggeratedly stingy definition of poverty, intended to identify the most destitute people on the planet not to stipulate an acceptable standard of living. Even if MICs had the wherewithal to deal with $1.25/day poverty, thresholds nearer $5 or $10/day would better imply resilience against the possibility of falling back into extreme destitution (Sumner, 2013).

Second, the political feasibility of redistributing wealth and income is over-estimated in such scenarios. India, for example, like many developing countries (whether Low or Middle Income) has a Gini coefficient on a par with most developed countries (and significantly below that of the United States); while desirable, there is no reason to expect radical redistribution.

In some instances international interference, especially in the form of financial assistance, may lessen political pressure for pro-poor changes. But as aid diminishes as a proportion of the economy, it is less likely to dissuade redistributive measures (it is not big enough to have such an effect) but could promote such measures, through good example and targeted interventions (see next section where we discuss aid in Low Aid Countries) i.e. it is too context-specific a concern for generalisations.

Sustainability

"Development only really begins when extreme poverty is eradicated."

Adolf Kloke-Lesch, former managing director at GIZ, Germany

Despite the important focus of the international community on the poorest and most marginalised communities, there is more to development than poverty reduction. Continued economic growth and indeed structural transformation (i.e. moving beyond agriculture and resource extraction towards manufacturing and technological innovation) will be required for countries to maintain spending on infrastructure, social investments and other public goods. This has long been recognised by foreign assistance programmes – the tight focus on direct-targeting of poverty only became conventional in the 1990s.

A number of countries have expressed concern that passing an arbitrary income/capita line has jeopardised their ability to access international public finance despite the fact that they are still unable to access significant amounts of private capital because their economies are still developing.[3]

Estimates for infrastructure needs in developing countries are huge, with one study suggesting that "the incremental investment spending across emerging markets and developing countries is estimated at around $1 trillion a year more than what is currently spent", with electricity, water and transport accounting for the bulk of this (Bhattacharya et al, 2012). Most of this spending will, inevitably, take place in MICs and while much of this money will be raised domestically or from the private markets, international public finance will continue to have an important role to play, given its particular qualities.

The need for continued support for structural transformation is even greater in a world in which sustainable development is becoming vital for global survival, with a heavier burden of responsibility on already industrialised countries. In fact, the need for "green" rather than dirty growth has changed the game on the need for international public funds. If industrialised countries are serious about asking poorer countries to keep global CO_2 emissions to a minimum, in a context where they are struggling to reduce their own emissions, they will need to pay other countries for this costly environmental service, a principle established in the COP meetings on climate change.

These investments will not all fall into the ODA category, and increasingly the line between private and public financing is blurred in the international realm. The point here is not the precise modalities of international public funding for sustainable development, but the principle that need is *increasing* rather than reducing.

But there is no point in spending scarce public resources, even where there is need, if they don't have an important effect for poverty reduction and sustainable development. Is aid effective in MICs, and how can it be more so? It is to this question that we now turn, introducing the concept of Low/Middle/High Aid Countries to the lexicon.

[3] For example, Cape Verde's Minister of Finance gave a speech expressing this concern at the UN Development Cooperation Forum's Switzerland High-Level Symposium in Montreux, 24-25 October 2013

2/ Effectiveness. *Should we be talking about MICs or LACs?*

> **"The main client base for the Paris Agenda's stipulations on aid effectiveness was stable <u>low income</u> countries".**
>
> *OECD policy adviser, quoted in Glennie et al, 2013*

The question "how can aid be more effective in MICs" is not obviously one that has a logical answer, there being so many types of aid and so many types of MIC – 103 of the 139 countries conventionally described as "developing". The one characteristic binding MICs – a per capita income of over about $1000 – may not be a very relevant one for making aid decisions.

One lens through which to view this problem is the amount of aid a country receives, relative to the size of its economy. In a paper last year Annalisa Prizzon and I categorised countries by their level of aid receipt. Table 1 shows the four categories we settled on (Glennie and Prizzon, 2012).

Table 1: Categorising countries by aid receipt

Country classification	Aid/GNI (%)
Very Low Aid countries (VLAC)	Under 1%
Low Aid countries (LAC)	1.00-1.99%
Middle Aid countries (MAC)	2.00-9.99%
High Aid countries (HAC)	Over 10%

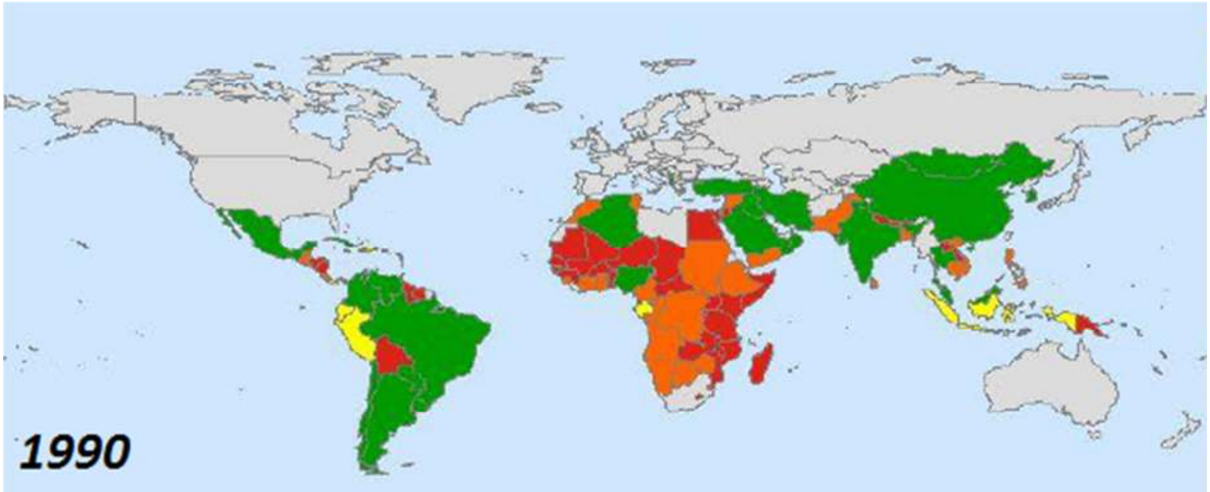
Source: Glennie and Prizzon, 2012. We explain the reasoning behind these cut-off points in the paper.

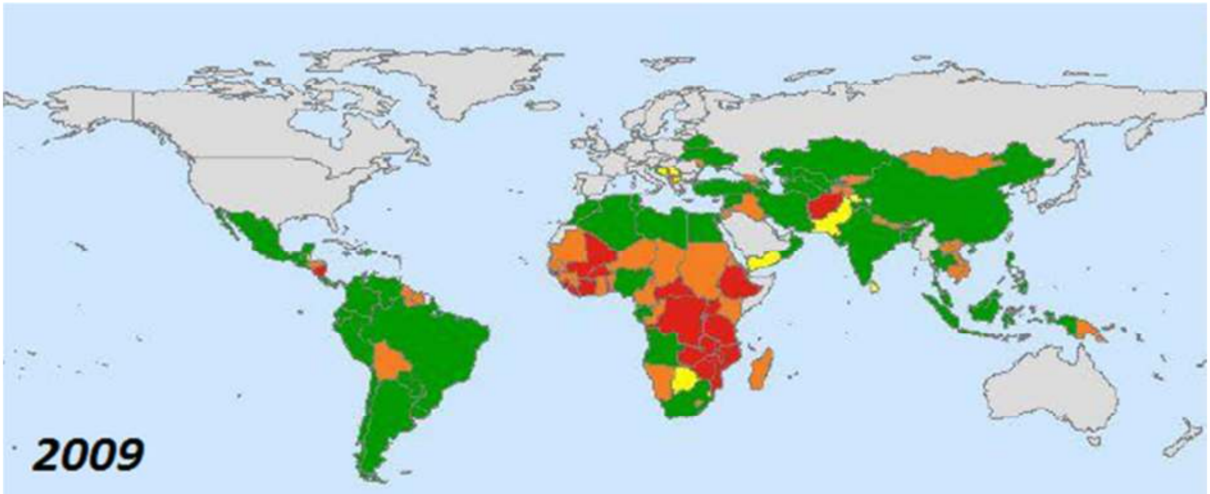
Getting to Low Aid

We argue that as countries are increasingly vocal about their ambitions to reduce aid they should not aim to end it entirely, but to get into the green zone of Very Low Aid, or at least the yellow zone of Low Aid, noting that it is aid dependency rather than aid itself that is problematic. This allows the possibility that as recipient economies grow, aid receipts can continue to increase while aid dependency itself (i.e. aid/GNI) reduces to a more sustainable and healthy level. This is precisely the scenario that may be required in the present era, as needs in MICs continue to expand, and aid becomes a smaller but still important intervention.

As countries higher up the income/capita scale are, on average, less dependent on aid, in country classification terms MICs are more likely to be Very Low Aid countries (VLACs) and Low Aid countries (LACs). As many economies have grown fairly well in the last two decades, the number of High Aid countries (HACs) has reduced, and the number of VLACs has increased. This is shown in the maps in Figure 1 below – there are more green countries in 2009 than in 1990.[4]

Figure 1: Mapping countries by aid receipt: 1990 and 2009





Source: Glennie and Prizzon, 2012.

But what is remarkable for the purposes of the present study is just how many green VLACs there *already were* in 1990. These are countries that have never been aid dependent, or certainly not for several decades, but in which aid has played a very small role (in terms of quantity) in the economy. There are two categories of these long term VLACs worth looking at: long term MICs and very large new MICs.

Table 2 shows a selection of Latin American long-term MICs (i.e. as opposed to the newer MICs of the last couple of decades).[5] All but the last six countries on this list (three Central American countries and three small island states) and Jamaica (whose trajectory appears somewhat exceptional) have been LACs or VLACs since at least the

[4] I have not been able to update this data for this background paper, so I use the data from our 2012 publication, which included aid data until 2009.
[5] Data in Tables 2 and 3 is for average aid/GNI over a ten year period.

1980s i.e. they have received varying, but always Low or Very Low, levels of aid. Such countries are not reducing their dependence on aid – they could never be described as having been dependent – but are maintaining a non-dependent use of aid, presumably to support specific development interventions.

Table 2: Aid receipt classification of Latin America's long term MICs

Country	1980s	1990s	2000s
Mexico	0.06	0.05	0.02
Brazil	0.04	0.03	0.03
Venezuela, RB	0.05	0.06	0.05
Argentina	0.07	0.07	0.06
Chile	0.14	0.17	0.08
Panama	0.69	0.55	0.08
Costa Rica	1.74	0.54	0.12
Uruguay	0.24	0.25	0.13
Dominican Republic	1.06	0.50	0.34
Jamaica	3.10	1.37	0.38
Colombia	0.31	0.35	0.48
Peru	1.09	0.88	0.65
Ecuador	1.13	1.05	0.67
Paraguay	1.26	1.13	0.82
Antigua and Barbuda	1.72	1.05	0.96
El Salvador	4.56	2.71	1.22
Guatemala	1.56	1.50	1.25
Belize	4.96	3.24	1.72
St. Lucia	4.23	3.61	1.81
St. Kitts and Nevis	4.63	3.10	2.71
St. Vincent and the Grenadines	6.87	5.62	3.36

Source: Author's calculations, using data from World Development Indicators

There are also long term LACs and VLACs in Asia (such as Malaysia and Iran) and Africa (South Africa and Algeria) which offer an insight into how foreign financial assistance can be useful at low levels over prolonged periods. It is not clear what has changed in recent years that would make such interventions less useful.

The second set of interesting countries is very large new MICs. Table 3, below, presents all the newly graduated MICs in ascending order of aid/GNI. This group is varied in character, with a preponderance of High and Middle Aid countries. These countries have seen fluctuating average aid levels in recent decades, but broadly speaking, and with notable exceptions such as Ghana and the Solomon Islands, the data supports the notion that as countries progressed to MIC status after the turn of the century their aid dependence has decreased.

Table 3: Aid receipt classification of the newly-graduated MICs

Country	1980s	1990s	2000s	Year of graduation
China	0.35	0.46	0.08	1999
India	0.81	0.59	0.21	2007
Ukraine	n/a	0.00	0.40	2002
Indonesia	1.22	1.16	0.61	2003
Turkmenistan	0.00	0.91	0.69	2000
Nigeria	0.33	0.84	0.73	2008
Uzbekistan	0.00	0.67	1.36	2009
Pakistan	2.86	1.93	1.65	2008
Azerbaijan	n/a	3.52	2.67	2003
Cote d'Ivoire	2.59	8.77	2.68	2008
Yemen, Rep.	n/a	5.84	2.73	2009
Angola	2.02	8.70	2.86	2004
Vietnam	1.97	4.03	3.97	2009
Sudan	7.21	4.35	4.16	2007
Cameroon	2.70	6.62	5.67	2005
Lesotho	14.48	9.67	5.82	2005
Georgia	n/a	5.09	6.12	2003
Moldova	n/a	4.88	6.22	2005
Armenia	n/a	9.99	6.81	2002
Congo, Rep.	4.90	11.97	6.99	2005
Senegal	12.14	11.88	8.89	2009
Ghana	6.32	9.86	11.21	2011
Bhutan	13.61	20.95	11.41	2006
Mongolia	0.13	17.45	12.62	2007
Lao PDR	11.08	17.14	12.74	2011
Mauritania	25.41	18.85	15.73	2011
Zambia	13.59	26.46	17.20	2011
Nicaragua	8.43	30.73	17.89	2005
Sao Tome and Principe	n/a	n/a	24.43	2008
Solomon Islands	24.35	14.64	29.78	2008
Timor-Leste	n/a	n/a	42.37	2007

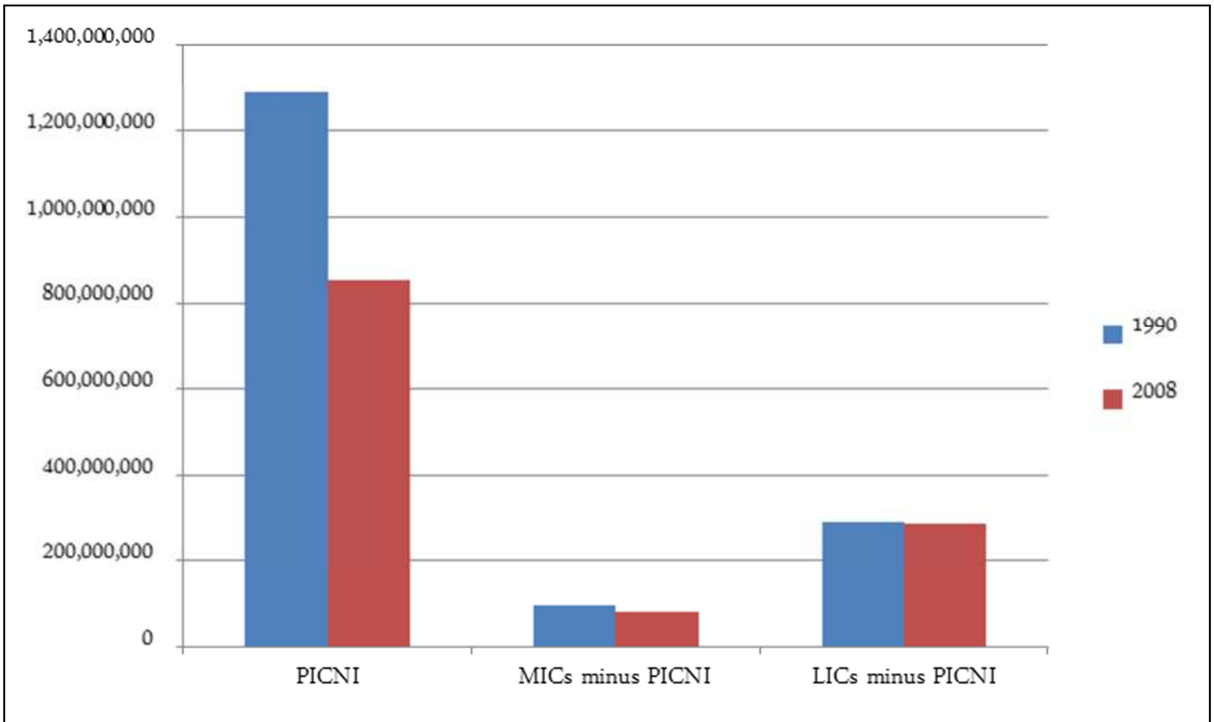
Source: Author's calculations, using data from World Development Indicators

However, what about the VLACs and LACs, the first seven countries in Table 3? While aid levels have also decreased in most of them, this cannot be described as a reduction in aid *dependence* because, like the long term MICs in Latin America, they have never been aid dependent. Rather, they have handled low levels of aid for at least the past three decades. It is not clear what the consequences the "graduation" of these long term LACs and VLACs should be. If aid in small quantities (relative to the size of the economy) has been useful until now, why should it not continue to be so?

Where do poor people live?

These countries are also key to understanding the data on the changing location of poor people. It is well known, thanks to Andy Sumner's important research, that while only about 7% of the world's poorest people lived in MICs in 1990, that figure had reached about 75% in 2008, the "new bottom billion" (Sumner, 2010). However, using the VLAC/LAC/MAC/HAC approach we can avoid drawing the wrong implication from this ubiquitous statistic. As we saw in Table 3 above, among the "graduates" to MIC status during that period were five of the world's six or seven most poor-populous countries: India (home to about 480m poor people today), China (c. 200m), Nigeria (c. 100m), Indonesia (c. 45m), and Pakistan (c. 40m)[6]. These account for the entirety of the shift of poor people from LICs to MICs, as Sumner himself acknowledges. If we remove these "PICNI" countries from the equation, we see that there has been no shift whatsoever in the whereabouts of poor people – the same proportion live in MICs now as did two decades ago – see Figure 2.

Figure 2: Where poor people live – the PICNI effect

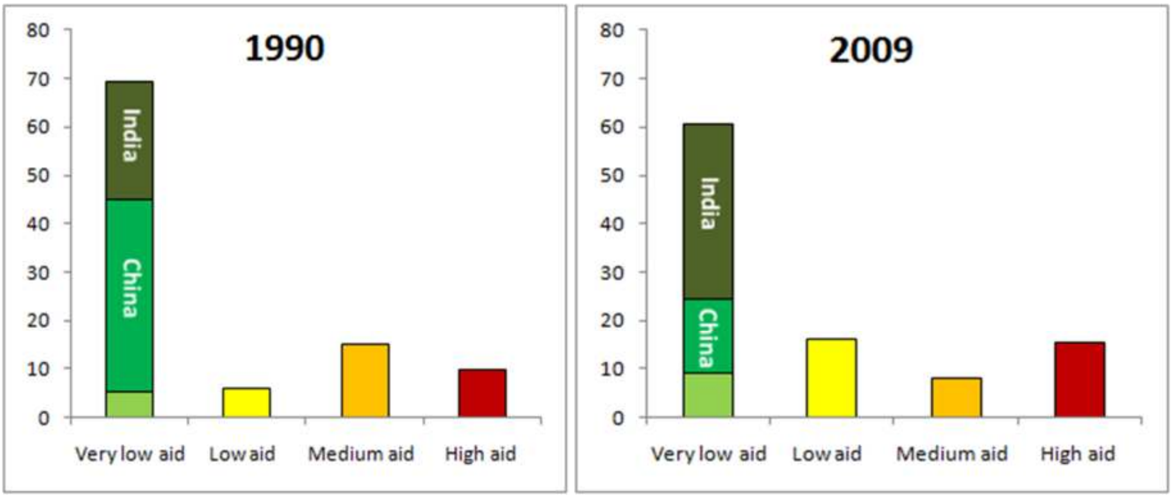


Source: Author's calculations, using data from World Development Indicators

[6] Bangladesh is also in the top six, with around 75mn poor people, and is still a LIC. DR Congo has about the same number of poor people as Pakistan.

While the poor people and MICs analysis has helped frame our understanding of the present development era, it might be something a red herring with regard to aid decisions. Again, however, aid-receipt classification can shed light on this debate. Figure 3 shows the proportion of poor people living in different aid-receipt classifications in 1990 and 2009. Around 75% of the poorest people lived in VLACs or LACs in 2009. However, because the vast majority of these live in India and China, this is almost *exactly the same proportion* as in 1990. In other words, the vast majority of the world's poorest people have *for some decades* lived in countries where aid is a minimal part of the national economy (Glennie, 2012). We return, therefore, to the same question – what has changed today to imply that small amounts of aid can no longer play a useful role in these countries?

Figure 3: Proportion of $1/day poor living in different country classifications, 1990 and 2009



Source: Glennie, 2012

Improving aid effectiveness in (Very) Low Aid countries

> **"What is relevant is not so much the direct effect of the <u>amount</u> of resources channelled by aid, but the role that international cooperation may play in modifying the framework of <u>incentives</u> in which agents operate."**
>
> *Jose Antonio Alonso, Professor of Applied Economics at Universidad Complutense of Madrid*

To answer the question about aid effectiveness in (Very) Low Aid countries we need first to understand the role aid plays in them, and how it may differ significantly from its role in Middle and High Aid countries. In brief, while in MACs and HACs aid fills financing gaps, in LACs and VLACs it is far more likely to play a role incentivising particular behaviours (Alonso 2007).

The Paris Agenda, the most complete attempt to improve aid effectiveness in modern times, was not written with a view to the needs of (V)LACs. For example, Paris was largely a response to the concern in the development aid industry that aid modalities were the undermining "ownership" in recipient countries, but this is less of an issue in countries where aid plays a far smaller role in the economy (Glennie et al, 2012). Is it so important that aid money "use country systems" in (V)LACs, for example, where the distortionary impact of not doing so is marginal, and where an important role for foreign aid is often to challenge the state, including with projects outside of the state's direct remit.

While recognising some important steps forward taken by signatories of the Paris Agenda, the very different set of questions about aid effectiveness in (V)LACs means that there needs to be a very different discussion from the one commonly associated with Paris.

3/ Conclusion

> **"Is it not time for these arcane income thresholds for 'graduating' from 'low-income' status to be laid to rest?"**
> *Martin Ravallion, Director of the World Bank's Development Research Group*

In this paper we have looked briefly at the needs of Middle Income countries, and presented an alternative classification system which, while imperfect and partial, helps to shed some light on the role aid plays and how it could be more effective. It may be that many such classifications are required to assist aid decisions, rather than the simplistic LIC vs MIC dichotomy (and indeed some donors do look at other categories, such as environmental vulnerability).

We have left many questions unanswered and ideas yet to be developed, but are able to share the following summary conclusions:

i. The MICs category is of only marginal usefulness in this debate

The MICs category covers three quarters of the world's developing countries. In simple mathematical terms, it is questionable how useful it is in influencing aid policy decisions. A range of other categorisations may be needed to help the aid community in its allocation and effectiveness decisions. Assessing countries in terms of their historic levels of aid/GNI may be one such useful tool.

ii. Prioritizing scarce resources can be confused with assessing actual need

The "bottom billion" approach to aid allocation, focusing interventions on fragile states and questioning the role of international cooperation in MICs (Collier, 2007), makes sense if funds are strictly limited, although even then there are issues of effectiveness (not only diminishing returns, but also actual harm from aid dependency, see Glennie 2008). But sometimes the need to prioritise is confused with an actual needs analysis i.e. the line between not needing *as much* and not needing *at all*. As well as the debate about how to cut the cake, we need to maintain the debate about the *size* of that cake, and poverty and sustainability needs in MICs need to be recognised. The language of $1/day poverty, while useful, may have skewed our understanding of what constitutes need and poverty.

iii. Aid as a small proportion of GNI can be an important pro-development intervention

As countries move up the income scale, foreign public inflows will become less important in terms of their quantity. Other issues become even more important (to provide an "enabling environment" for poverty reduction and sustainable development). Nevertheless, aid can still be effectively invested in countries well up the income scale, depending on their particular circumstances. Most poor have for some decades lived in countries which rely very little on aid. Unless there is a significant difference between aid at, say 0.4% and 0.2% of GNI, there is no logical reason why levels of aid that were useful in the past cannot remain useful today.

Even if it were true that some countries could theoretically now end poverty (using a generous definition) independently, which it is not for most countries, it is likely also to be the case that they could do so faster and more effectively with international support, financial or otherwise. This implies that cutting assistance to MICs is not a consequence of a correct need analysis, but rather based on the willingness or otherwise of wealthier countries to help linked to a) reduced money in their own exchequers and b) economic competition with emerging economies.

> **"The evaluation [of aid to Colombia] found 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'."**
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> *Evaluation of the Paris Declaration by Wood et al, 2011*

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