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Making Development Financing in LDCs More Conducive to Development

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***Abstract**:*

Making development financing in LDCs more conducive to development should be a priority for the next Programme of Action of the Istanbul Conference. It needs to go beyond the old and emblematic target of ODA to LDCs, which is too far to be reached. The present paper examines four issues.

1) *What ODA and development effectiveness mean in LDCs.*
   It is argued that a) the ODA concept has to be revisited in view of better measuring what is brought to LDCs; b) compared to remittances and FDI, the ODA is still a major source of development finance in LDCs; c) the development effectiveness for LDCs should have a broad meaning, summarized by the chance for an LDC to no longer be so.

2) *How ODA can be a leverage of other sources of development finance in LDCs.*
   This issue is considered with regard to three other flows: migrant remittances, likely to be facilitated by support to the financial sector; FDI, likely to be induced by financing large infrastructures; and tax receipts, likely to increase if aid effects increase the rate of economic growth.

3) *How LDCs' structural features can enhance the effectiveness of development financing. This section first recalls how structural vulnerability, due to the stabilizing effect of aid, makes aid effectiveness higher in LDCs, then reviews various uses of ODA to tackle the structural weaknesses of the LDCs, in particular their structural vulnerability. For that, it considers the possibilities offered by the diversification and regional integration.*

4) *Some orientations for a new paradigm on development assistance, focused on LDCs, and ownership. First the advantages and rationale of using the criteria of LDCs identification are underlined, in particular structural vulnerability, as aid allocation criteria: this principle, already endorsed in several UN documents, would make the allocation more equitable, more effective and more transparent. It would allow the treatment of fragile states preventively and not only curatively. Second how the aid modalities is examined, in particular the share of budget support. It should be adapted to the degree of state fragility. It underlines the need to move towards an outcome-based conditionality in budget support and to avoid parallel institutions to face the weakness of national administrations.*

1. What do ODA and development effectiveness mean in LDCs?

When considering how development financing can be more conducive to development in the Least Developed Countries (LDCs), the first issue is to determine what is and should be the role of official development assistance (ODA). This issue is itself threefold, as it refers to the concept of ODA and its relevance, to the volume of ODA compared to other sources of development finance and to the criteria used to assess its development effectiveness.

1.1. ODA, a debatable concept to be revisited, but still referred to

ODA, as currently measured, is a more than forty year-old concept. It is generally considered as debatable, reflecting neither donors' real efforts, nor real development support brought to receiving countries. In addition, the contributions to global public goods, some of which are of crucial importance for LDCs, are not clearly designed and measured. However the ODA concept is still unanimously used. To have a truly relevant measure of the contribution of the international community to the development of the LDCs a new concept is needed, far away from being agreed upon (see Severino and Ray, 2010). So, as commonly done, we here refer to the usual DAC/OECD concept.

To be recalled, since the first UN Conference on LDCs in 1981, international meetings have regularly reiterated the wish to see the developed countries spending 0.15% of their GNI in ODA to LDCs (within the global goal of 0.7% for the whole ODA). As is well known, observed trends do not allow us to expect a near achievement of the LDC goal, no more than that of the 0.7% goal for the whole ODA. The present percentage (0.9% in 2008) is hardly higher than before the adoption of the goal (0.8% in 1980, with fewer LDCs), although it clearly increased in the last decade after a deep decrease (to 0.5%) between 1990 and 2000.

The debatable content of the ODA measurement and its limited amount with respect to internationally agreed upon goals have led to more and more attention paid to the quality of aid, in addition to its quantity.

1.2. ODA, still a major source of development finance in LDCs

It is frequently alleged that ODA is no longer the major source of external finance for developing economies. On average, this is indeed the case. However for the LDCs, it is not. Again on average (weighted) or globally, ODA to LDCs is higher than remittances or FDI.

Let us consider the remittances. It is true that in many developing countries they are higher than ODA receipts (in 2008 for all developing countries they were four times the volume of ODA). However it is not the case for the LDCs as a whole (where in 2008 remittances were one quarter lower than ODA). And in more than 3/4 of LDCs (31 out of 40 LDCs for which remittances statistics were available) the level of remittances is less than that of ODA. The nine LDCs countries receiving more remittances than ODA are Haiti, Lesotho, Senegal, Sudan, Togo, Bangladesh, Nepal, Samoa and Yemen).

Let us now consider the foreign direct investment (FDI). It is also often argued that FDI has become a major source of development finance. Again this is true for the whole set of developing countries, but not for the whole set of LDCs: in 2008 it was three times the value of ODA for the whole set of developing countries, but 25% lower for the set of LDCs, as remittances. And among LDCs only eight out of fifty LDCs received more FDI than ODA, mostly oil producers or mineral exporters.

Briefly stated, ODA remains for most of the LDCs a major source of development finance, and this is true not only compared to other sources of external finance, but also more meaningfully as a percentage of GDP. The median value of the ratio of ODA to GDP in LDCs, after increasing from 1980 to 1994 has been decreasing, then remaining stable from 2000, slightly above 10%, and clearly above the median ratio of remittances to GDP, which was nevertheless increasing without reaching 4%, or the ratio of FDI to GDP, also increasing without reaching 5%.

1.3. Development effectiveness for LDCs: enhancing chances for an LDC to no longer be so

Effectiveness of ODA as well as of other available resource or policy measure should always be understood with regard to the goal pursued. In macroeconomic literature, aid effectiveness has mainly been considered through its contribution to economic growth, but goals to be regarded are wider, including the various MDGs. In the case of LDCs a major goal of ODA and special measures for LDCs is to push them "out of the trap", in other words to make them capable of moving away from the LDC category. Since LDCs are designed as low income countries suffering from structural handicaps to growth (economic vulnerability and weakness of human capital), effectiveness in LDCs involves both supporting economic growth and contributing to the alleviation of these structural handicaps, so that the economic growth may be sustainable.

The need to specify development effectiveness is even higher for fragile states and post-conflict countries, many of which are LDCs. Effectiveness in such countries cannot be assessed without examining the risk to fail or fail again and the chance to become less "fragile". As we will see, this has strong implications for aid allocation and modalities.

2. How ODA can be a leverage of other sources of development finance in LDCs

With aid resources durably lower than international commitments and what would be needed to achieve MDGs in LDCs, the natural inclination is to search for how more can be obtained from the limited amount available. Leverage effects of aid have thus become an important issue. It might be seen as an opportunist answer to the non-respect of international promises, but also as an attempt to look at external assistance in a dynamic perspective where aid should promote the capacity to grow without it. Let us consider the possibilities of leverage on the two other external sources of LDCs development financing, previously compared to aid, and on the domestic resources levied through taxation.

2.1. Aid and remittances: a risk of substitution?

The relationship between aid and remittances is complex and has not been deeply investigated.

A leverage effect of aid on remittances is a priori unlikely. Actually if aid was, as sometimes alleged, without a clear empirical basis, a means to slower emigration, it could rather be a factor of lower remittances. But an aid aiming at facilitating the transfers from migrants, often strongly reduced by intermediaries, or more generally to improve the financial system, may contribute to an increase of the flow of remittances reaching the targeted beneficiaries. In this way, there may be a leverage effect.

On the opposite and on a cross country basis, there seems to be a negative effect of the remittances on ODA (Kpodar and LeGoff, forthcoming): development partners may consider the needs for foreign resources as lower when remittances are significant. The needs are not, however unambiguously lower: remittances can simply be seen as a counterpart of the loss of value added by the manpower working abroad instead of working locally.

2.2. Aid and FDI: a conditional leverage

The relationship between aid and foreign direct investment (FDI) has been more extensively studied in the literature and suggests several possibilities of leverage. While there seems to be a consensus on whether or not they could be considered as substitutes, the more interesting expected evidence is on a positive effect of aid on FDI channelled into financing infrastructure. However this effect is conditional, in two ways. First it is stronger whent the the policy environment is better. Second, it is sometimes limited to a relationship between ODA and FDI from the same partner (the "vanguard effect" shown in particular for Japan by Kimura and Todo, 2010).

In any event, the search for leverage on private investment (foreign, and domestic as well) supports the view that sector aid allocation should target large infrastructures that cannot be financed by the private sector alone, but can be financed by aid and possibly by public-private partnership. This holds true for large regional infrastructures (transport, energy, irrigation) in particular in the LDCs the size of which is often small. Another way by which external public assistance can positively impact foreign private investments is by lowering the risks they face, in particular in vulnerable countries such as LDCs. For that, attention should be paid to the recommendation of the Eminent Persons for setting up a programme of promotion of FDI, including specific insurance schemes. (United Nations, 2011)

2.3. Aid and tax receipts: possible short term and long term leverages

This has been the most debated relationship. A frequent criticism of ODA has been that it could crowd out fiscal receipts (or lower the "tax effort"). In fact, recent literature does not find robust support to this view (see surveys in Morrissey et al. 2006, Moss et al. 2006, Brun et al. 2008) and even come to an opposite conclusion (Brun et al.). In fact, in the short and medium term, a possible disincentive on the government's (or substitution effect) is compensated both by the indirect effect that the income generated by the disbursements of ODA has on tax receipts (income effect), and by the improvement of the effectiveness in public administration brought about by ODA and technical assistance.

The issue should also be addressed in a dynamic and longer term framework. The level of the tax-GDP ratio is likely to increase when aid enhances growth, since the marginal ratio is generally higher than the average (many studies do not capture this effect since the level of income per capita is generally controlled for). Moreover, the impact of aid on growth can be reinforced by the stronger (private) incentives induced by lower pressure on tax payers, particularly small enterprises, including small farmers, and the risk of discriminatory treatment, so obvious when the state is short on resources (Gunning 2004, Guillaumont and Guillaumont Jeanneney 2010).

Briefly stated, the leverage effect of ODA on tax receipts may be enhanced in LDCs both by a transfer of knowledge in public administration and by the contribution to a higher rate of economic growth.

Besides these two effects a specific reform in aid management could have an immediate effect on tax receipts and could be implemented first in LDCs, including the cancelation of the usual tax exonerations on imported inputs financed by foreign aid: these exonerations not only represent a loss in public revenue, they also induce distortions and administrative burden, particularly detrimental for fragile states (Chambas, 2011).

3. How LDCs structural features can enhance the effectiveness of development financing

The large amout of literature on aid effectiveness most often treats developing countries in an undifferentiated manner. Sometimes it is restricted to low income countries, but hardly ever to LDCs. However the structural features of LDCs are likely to impact the effectiveness of aid, which is a large part of development financing in these countries. And they call for a specific targeting of ODA to overcome the structural handicaps of LDCs. More than other developing countries, LDCs may face a seeming opposition between the need of a big push (supported by aid) to move out of the trap and the limits of the absorptive capacity (of aid) (Guillaumont and Guillaumont Jeanneney, 2010). Are structural features of LDCs limiting their absorptive capacity or increasing the effectiveness of the aid they receive? The answer, as we will see, largely depends on aid modalities.

2.1. Structural vulnerability makes aid effectiveness higher in LDCs: a stabilizing impact

Strong criticisms of development assistance have been formulated for several decades and again more recently, arguing that it is not effective for promoting growth and development. Their analytical basis is generally weak, whatever the recognition that aid modalities can be improved.

Indeed the evidence of a positive impact on growth, drawn from more analytical literature, is still debated as are the major factors influencing aid effectiveness (Arndt, Jones and Tarp, 2010). One lesson from this literature is that the marginal effectiveness of aid (for growth) is higher in countries that are structurally more vulnerable (due to exogenous shocks, either external or climatic, and particularly the instability of exports): the reason is that aid dampens the negative effects of these shocks (Guillaumont and Chauvet 2001, Chauvet and Guillaumont 2004, 2009, Collier and Goderis 2009, Guillaumont Jeanneney and Tapsoba, 2010). In other words, aid enhances resilience.

The real and specific contribution of ODA to LDCs growth is however difficult to assess, because it would need to take into account all the main characteristics of the LDCs as they influence aid effectiveness. It means taking into account not only their structural vulnerability, but also the weakness of human capital. The latter is sometimes considered as lowering absorptive capacity, but this view neglects the fact that the lower the level of human capital, the higher the marginal impact of additions to human capital possibly brought about by aid. In this respect it may be of interest to note that one study found that a lower level of education is a factor of higher aid effectiveness (Gomanae et al.2003), suggesting a higher marginal productivity of the transfer of knowledge associated with aid. Thus the two major LDCs' structural handicaps to growth could increase rather than decrease their absorptive capacity. However such assessments meet the usual limitations of the aid-growth regressions, those of growth regressions in general and those linked to the measurement of aid.

Another and maybe more reliable finding is obtained from the examination of the ex post evaluation of projects. From a set of projects financed by IDA, it appears that the rate of success decreases when the total amount of aid increases, but increases when the export instability is higher and the literacy is lower, so that returns are clearly increasing in LDCs, and decreasing in other developing countries (Guillaumont and Laajal 2006, Guillaumont and Guillaumont Jeanneney, 2010). Such a result favours the idea of a big push for the LDCs.

To make even more significant the specific effectiveness of ODA in LDCs, as vulnerable economies, several considerations should be kept in mind. First the dampening effect of aid is due to its level compared to other exogenous and unstable flows. It holds true for a regular and stable level of aid. Aid does not need to be contra-cyclical to be stabilizing. Of course it can be even more stabilizing if made contra-cyclical. Making aid more contra-cyclical, and predictable as such, involves specific schemes permitting fast disbursements or automatic regulation of amortization, not easy to implement, although highly useful.

2.2. Using aid to tackle the structural weaknesses of LDCs

Assessing the development effectiveness of ODA for LDCs involves looking beyond its impact on the rate of growth and the rate of the success of projects. To promote a sustainable development of LDCs aid has to contribute to the alleviation of their main structural handicaps, weak human capital and high vulnerability.

By enhancing human capital

As for the effect of aid on human capital and poverty, it is agreed that it is channelled to a large extent by its effect on growth, but it also depends on aid modalities, and again on characteristics of receiving countries. Since the instability of income mainly hurts the poor (a given average rate of growth being more pro-poor when the growth is stable), it can be argued that the stabilizing impact of aid makes growth more pro-poor, which suggests an additional specific effect of aid in vulnerable countries such as the LDCs (Guillaumont 2009b). But of course the effect of aid on human capital (health and education) also depends on the sector allocation of aid. This raises two issues.

The first one is fungibility. The sector allocation of ODA may not be translated into the sector allocation of public expenditures, due to the fungibility of public resources. In reality, there is no clear empirical evidence of such a fungibility. In any case, even fungible, aid targeted to the reinforcement of human capital, can still be effective with regard to this target due to its technical content and the transfer of best practices it may induce.

The second and more acute issue is the trade-off between the allocation of aid to social sectors with a view to enhancing human capital and the allocation to productive sectors and economic infrastructure. The present trend in ideas seems now to be for reinforcing the allocation to sectors more directly conducive to growth, in particular to avoid the risk of a loss of competitiveness due to a change in relative prices resulting from increased demand ("Dutch disease" effects).

By reducing structural vulnerability

Using aid resources to tackle the structural vulnerability of the LDCs is an even more complex issue. Structural vulnerability, as designed by the EVI indicator, results from the size of recurrent exogenous shocks (natural and external) and the exposure to these shocks. Its reduction at the LDC country level can mainly be looked for through some components of exposure, such as the concentration of exports, the small size of the economies or the share of agricultural value added in GDP.

A fashioned option is the *diversification* of the productive activities and exports of the LDCs. It can be noted that the concentration of exports of LDCs (as measured by the UNCTAD Hirschman-Herfindal Index at 6 digit level) has been increasing while it was decreasing in other developing economies (Guillaumont 2009, Cariolle and Guillaumont, 2011). Although this increasing trend is only due to the evolution in the few LDCs oil exporters, it is still true that diversification has been slower in LDCs than in other developing countries. How can ODA be used to promote a diversification which really lowers vulnerability, what means a competitive diversification? It is not by an allocation to "diversified" sectors, but by facilitating trade in a non-discriminatory manner. In this perspective "Aid for trade", whatever the ambiguity of the concept, is particularly important for LDCs and can be expanded for them through the Enhanced Integrated Framework.

The other way to lower exposure to shocks and structural vulnerability is *regional integration.* Most often LDCs are small countries and the small size of the population is considered as a factor of vulnerability. A group of small economies linked by a regional arrangement appears as a larger area less vulnerable to exogenous shocks than each one taken separately. For instance, the total group external exports instability is likely to be lower than the average instability of each member exports to all destinations, including other members. Similarly the coefficient of concentration of the group external exports is likely to be higher than the average coefficient of concentration of the exports of the various members taken separately. Both cases evidence the kind of risk sharing brought about by regional integration. When the regional arrangement involves a common monetary and fiscal policy, this deeper integration is a major factor for dampening the impact of exogenous shocks possibly faced by a one member country, including political troubles. As such it is a factor of lower state fragility.

Foreign aid may be particularly useful in LDCs to enhance regional integration. It can finance the transitional losses of duties on intra-trade, the costs of new regional institutions and, even more important, a part of the costs of regional infrastructure, in particular for transportation. It can also offer various kinds of guarantees for the stability of a possible common currency. In spite of frequent declarations in favour of regional integration, it does not seem that it has received the attention it deserves in aid policies. An illustration can be given by the Integrated Framework and Enhanced Integrated Framework, always implemented at the national level, never at the regional one (for instance in the case of the seven LDCs composing the UEMOA, besides one non-LDC).

Finally the relative share of agriculture, which is a component of EVI, draws the attention on a specific aspect of the vulnerability of LDCs: external (world prices) as well as natural (climatic) shocks are particularly affecting agricultural households, which in LDCs generally do not have the means to protect themselves against these shocks. For poor farmers insurance against weather or price shocks is missing, because too costly or too risky, although it is feasible and has economic and social returns. A way by which ODA can productively contribute to lessening the vulnerability of the LDCs is then by supporting domestic insurance schemes, in particular by supplying appropriate guarantees to such schemes.

3.3. Aid modalities can shift the limits of absorptive capacity: promoting ownership

It already appears in what precedes that the limits to absorptive capacity depend on aid modalities. They can be removed for instance by administrative reforms permitting easier, then faster disbursements, by a better balance between the use of aid for productive capacities (or infrastructure) and aid for social services, with a view to avoid Dutch disease effects and adecrease in the marginal productivity of projects, or by technical assistance supporting fiscal reforms which avoid crowding out of tax revenues by ODA…

However the most serious limitation to the absorptive capacity of ODA is institutional. Many LDCs have weak institutions and a significant number are fragile states, by one definition or another. (Actually all have once been classified as "fragile", Guillaumont, 2009). This fragility results to a noticeable extent from the structural handicaps they face, a low level of human capital and a high vulnerability to shocks. As far as large amounts of aid or other development finance are required to push the LDCs "out of the trap", the risk is that the state becomes over-dependent on external financing and more accountable to foreign partners than to the national population or civil society.

In this perspective the issue of ownership is a crucial one. It can be addressed through appropriate aid modalities, as we see below.

4. A new paradigm of development assistance focused on LDCs and based on ownership

During the last decade ideas on development financing have sigificantly changed without being fully translated into practice. They have moved from a view dominated by the external assessment of policy and governance to an approach focused on results and ownership, while donors' practice has remained stuck to the first one. The search for a consistent approach to the development finance for LDCs leads to new rules for aid allocation between countries, and for the conditionality of budget support. In this context, fragile states, instead of being considered as a special case, or an exception to the rule, should be treated in an integrated framework.

4.1. Aid allocation according to the criteria used for LDCs identification: low income and structural handicaps

As recalled above, LDCs are identified using three criteria: income per capita (GNIpc), a low Human Assets Index (HAI) and a high Economic Vulnerability Index (EVI), these last two indices capturing the structural handicaps to growth. We argue that these three criteria can also be used as aid allocation criteria (see Guillaumont 2008, 2009, 2010, Guillaumont, Guillaumont Jeanneney and Ventecachelum, 2009, Guillaumont, Guillaumont Jeanneney and Wagner 2010). Before underlining the rationale of such a widened use, let us note two political advantages of doing so. First it will naturally lead to allocation of more aid to LDCs and all the more so that the countries outreach the criteria to be met for being an LDC.

Second, by substituting a progressive rule of allocation to a discontinuous/ binary (although virtual) preference given to LDCs (through the specific aid target of 0.15-0.20%), it would make the transition of the small graduating countries smoother, their vulnerability being still taken into account in the aid allocation.

Structural vulnerability and human capital weakness versus policy rating

The geographical allocation of aid is not always ruled by clear principles. The only clear rule seemingly applied is the formula used by the main multilateral development banks (MDBs) and known as the PBA ("performance based allocation"). This formula is currently applied with many exceptions by the MDBs, but is still considered by several donors as reflecting principles they endorse. However, as it is presently designed, it reveals various shortcomings, which, by contrast, shed light on the rationale for the proposal to refer to LDC identification criteria.

The first one is the confusion about "performance". Everyone wants developing countries to perform and aid to support their performance. But, for a country, performance means the results or outcomes obtained with respect to its initial situation and the external conditions, whereas PBA performance refers to a country policy rating (CPR) drawn from a subjective "Country Policy and Institutional Assessment" currently designed by the CPIA. If the word "performance" is to be given its genuine meaning, performance should be assessed after taking into account the structural handicaps faced by a country.

Second, ignoring the existence of structural handicaps to growth, as done by the PBA is not equitable. If, as commonly accepted, equity means to equalize opportunities, it involves trying to compensate for the structural obstacles to growth, then taking them into account in aid allocation. On the other hand, retaining the quality of governance and policy as the major criterion of aid allocation penalizes populations already suffering from bad government. They are punished twice! The quality of governance and policy should be taken into account through aid modalities rather than aid volume.

Third, since the policy rating, to which an overwhelming weight is given in the PBA, is a subjective assessment of policies according to uniform norms, it does not fit the principles of alignment and ownership of the Paris Declaration and the Accra Agenda. The indicators of structural handicaps HAI and EVI, which do not involve any assessment of policy, are more consistent with these principles.

Fourth, if the aid allocation criteria aim at capturing the factors of aid effectiveness, they should not ignore the lessons of aid effectiveness literature. As explained above, the vulnerability to exogenous shocks is a major feature of the recipient countries on which aid effectiveness depends. For effectiveness, as well as for equity, structural economic vulnerability should be included among the aid allocation criteria.

Fifth, the allocation of aid according to the country policy rating is not stable, and it is pro-cyclical more often than the opposite, which means it leads to less aid when the countries need more. On the contrary, the two indicators of structural handicaps HAI and EVI are rather stable, and more predictable.

Sixth, due to the difficulty to rigorously implement the PBA, exceptions have been made as important as the rule, undermining its consistency and the transparency of allocation. Exceptions have been introduced by the way of caps, floors and, most important, by a special treatment applied to countries in the most severe situation, such as “fragile states” or “post-conflict states”. As a result the allocation to these countries is higher than to the countries which have a low policy rating, but not low enough to make them eligible to a special treatment. Fragility treatment remains purely curative, not at all preventive.

Relevance and feasibility of a reform

These above reasons for why the present PBA no longer meets the principles of equity, effectiveness and transparency it was initially supposed to meet give a rationale for including the LDC identification criteria among the aid allocation criteria. Including, besides income per capita and possibly country policy rating, the well accepted HAI and EVI indicators, would make the PBA formula more equitable, and more effective for promoting development. Limiting at the same time the exceptions through caps, floors and special windows would also make it more transparent[1]. The reform proposed neither involves giving up the reference to “performance”, nor lowers the weight of performance in aid allocation, if performance is given its genuine meaning: it can simply be seen as correcting the policy and institutional assessment for the exogenous influence of both vulnerability and human capital.

Various simulations made for the IDA and the African Development Fund show that the application of the revised PBA leads to results which avoid the shortcomings of the present formula, and also allowing the decision-makers to treat the cases of fragile states, smallest and largest countries in an integrated and continuous framework

While some donors may remain completely in favour of the present PBA formula, both the international environment and partners minds are changing. The recent crisis has evidenced even more than before the importance of vulnerability. The principle of including structural economic vulnerability among the aid allocation criteria has already been recommended in UN Secretary General Reports to the ECOSOC Development Cooperation Forum in 2008 (United Nations 2008a, §36; United Nations 2008b, pp. 2 and 16), then in 2010 (United Nations 2010, § 48 and 127). It has also been expressed by the Joint Ministerial Forum on Debt Sustainability of the Commonwealth Secretariat and the Organisation Internationale de la Francophonie (2009, §9). More recently it has been reiterated by the Commonwealth Secretariat (2010, pp.10-11), with explicit reference to EVI.

The other ways to address vulnerability do not allow the international community to fully address the issue. As evidenced by past experience, the schemes aimed at providing compensatory finance when a shortfall occurs in export earnings, although needed, take too long to be mobilized and are too conditional, then too discretionary. More important, vulnerability ex ante allocation criterion has a preventive role, whereas compensatory finance, as well as post-conflict windows, are only curative… It could be more cost-effective to prevent collapses and conflicts than to overcome their effects.

Taking into account vulnerability to climate change in allocating resources for adaptation

As far as resources for adaptation to climate change are allocated from institutions or windows distinct from those dedicated to development assistance, the vulnerability to be taken into account is not the same as what is captured in EVI. However, the same principles

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

apply. With regard to equity, transparency and ownership principles there is a rationale for retaining the vulnerability to climate change as a major criterion for the allocation of resources (Guillaumont 2008).

Since EVI is a relevant criterion for the allocation of development assistance, because it is an indicator of structural vulnerability, independent of the present policy, the relevant indicator of vulnerability to climate change should also be so. For that reason, and because any assessment of the expected costs of global warming at the country level is debatable, an index of "physical vulnerability to climate change" has been built relying only on geo-physical components (Guillaumont and Simonet, 2011). It reflects both the risks related to progressive shocks, such as sea level rise and increases in aridity, and the risks of intensification in recurrent shocks related to rainfall and temperature. It appears to be significantly higher in LDCs than in other developing countries. Since, given this "geo-physical vulnerability", the need for resources for adaptation also depends on the poverty of the country and its capacity to manage the adaptation resources, the two other LDCs identification criteria, income per capita and (low) level of human capital, would also be relevant allocation criteria.

If the international resources for adaptation in developing countries were merged with ODA, the rules and proposals as presented above would again be valid, but under the condition that the indicator of vulnerability used as an allocation criterion reflects the vulnerability to climate change more than it is presently the case with EVI. EVI indeed includes important components reflecting the vulnerability to natural shocks (homelessness, instability of agricultural production), which can be progressively influenced by climate change, but, on the whole, it attempts to capture a handicap to medium-term economic growth. Vulnerability to climate change, as designed in the quoted index, tries to capture less a handicap to growth than a risk of changes in geophysical conditions, some of them likely to hamper economic growth, some other doing so less clearly, but all leading to a need of "adaptation".

4.2. Aid modalities differing according to policy and achievements: the room for budget support and outcome-based conditionality

As noted above, the quality of policy and governance of recipient countries should be more a factor of adaptation in aid modalities than a criterion for aid allocation. Two major interrelated choices are to be made. One is between budget support and aid to specific projects or programmes. The other one is between a budget support conditioned by policy measures and budget support conditioned by outcomes. Promotion of ownership and respect of the alignment principle should lead to a preference to outcome-based conditionality, but outcome-based conditionality is not favourable to fragile states. So, the more fragile the state, the lower the share of ODA disbursed through budget support should be. These two points are of particular relevance for LDCs. Let us first resume the rationale of a move from policy-based to outcome based conditionality.

In various papers we have argued in favour of an outcome-based conditionality for budget support, instead of a conditionality based on the adoption of policy changes (Collier et al. 1997, Adam et al. 2004). Outcomes would be measured, as much as possible, in terms of ultimate objectives, such as reduced child mortality or knowledge acquisition by children. This approach "allows for better ownership of reforms, since the choice of instruments would reside with the country; it avoids arbitrary judgement on multiple heterogeneous economic policy measures; and it facilitates gradual and progressive support according to the degree of progress of performance relative to outturns; and by eliminating the scope of discordant conditionality, it supports better coordination between donors" (Adam et al. 2004).

The principle of this proposal has not met strong criticism. But its implementation by a significant number of donors has appeared rather limited, in spite of the Paris Declaration and the Accra Agenda (Petit, 2011). Even the European Union, which has taken the pioneering initiative for a reform in that direction, has gone only half way, as the retained conditions refer to intermediate indicators close to policy instruments. The main hindrances of the full implementation of a outcome-based conditionality are twofold. One is a lack of trust in the capacity and will of the recipient countries, which create a vicious circle since capacities will not develop fully without ownership. The second and probably more important hindrance is the weight of habits within aid agencies. Full outcome-based conditionality would involve a dramatic change of their job, which would then be devoted to monitoring and assessment of the progress of the countries based on a few number of ultimate indicators of development, taking into account the impact of exogenous factors, independent of policy.

4.3. Addressing state fragility in an integrated framework

As noted above, there are many definitions of fragile states, most of them referring to a policy rating (Guillaumont and Guillaumont Jeanneney, 2009). Accordingly, a significant part of LDCs are classified as fragile states (terminology used for instance at the African Development Bank) or post-conflict. And most of them, due to their structural handicaps are at risk to become “fragile”. For that reason and in order to adopt a preventive, not only curative attitude we have argued that the fragile states in the broader meaning should be treated for the allocation of resources in an integrated framework. It means applying the same criteria to all countries, granted that the structural vulnerability is taken into account, since it is evidenced that it is a factor of state fragility. Two caveats should be added. First some exceptional circumstances of fragility and post-conflict may involve a specific policy choice in favour of a country, which is legitimate, if transparent. Second, if an assessment of policy is maintained among the allocation criteria, and is applied both to fragile and non-fragile states, it should include indicators reflecting the *progress* towards more security and more respect of the rules, rather than the corresponding levels.

State fragility, post-conflict situation, low level of policy rating, as well as some donors habits, often lead to transferring foreign resources through other channels than budget support (or in a lower proportion through it). Appropriate channels are not so easy to find. A common practice of donors, considering that the weak administrative capacity is the main source of the difficulties, is to finance specific projects and programmes implemented outside the public administration, while at the same time they are looking for the ways by which the administration can be enhanced. Autonomous agencies are thus set up attracting the best civil servants, with higher wages, possibly after appropriate training, and so avoiding administrative inertia. This short term search for efficiency is often a factor of discouragement within national administration. Moreover these agencies are more accountable to foreign partners than to local authorities. Policy aimed at paying more to a limited number of well-trained civil servants within the administration should be sought in order to strengthen domestic institutions.

The reinforcement of capacities of public administration is indeed a goal of aid in fragile states. The importance given to this goal is reflected in the share of technical assistance within ODA. An increasing level of total aid could then justify a further move in this direction. However, it depends on how this assistance is delivered.

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