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Research Report

Taking into account vulnerability in the global distribution of concessional flows

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Work of the chair in International Architecture of Development Finance

Taking into account vulnerability in the global distribution of concessional flows*

Patrick Guillaumont

Patrick Guillaumont, President of FERDI.

In the run-up to the Paris June Summit, the question of mobilizing new resources to finance development and global public goods seems to receive much more attention than the way in which these new funds, like the old ones, are allocated among countries.

If there is to be a "financial pact", it should be with countries, for whom allocation is crucial. Some priority is to be given to countries that are vulnerable to varying degrees to exogenous shocks, external or natural.

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Why vulnerability matters and should be taken into account in aid policies

Vulnerability is the risk of a country being affected by shocks of exogenous origin. It depends on the likely size of shocks, on the exposure of the country to these shocks, and on its capacity to cope with them, the so-called resilience. Vulnerability may take various forms according to the origin of the shocks (external, natural, policy related)…

The negative impact of these shocks, either linked to the instability of the price of commodities or to the recurrence of droughts or to natural disasters or to conflict has long been established in the literature. Their negative impact has been evidenced on economic growth, but also on various aspects of sustainable development (poverty, inequality, as well as on governance, quality of policy, corruption…).

Shocks and related vulnerability are *felt to be of increasing importance*, in particular with respect to climate change, what motivates the international pressure to see them better taken into account, and also with respect to insecurity.

Three reasons to clearly take vulnerability into account : justice, effectiveness and transparency

First, justice: vulnerability has been seen as a *structural handicap* to growth, which justifies a support from the international community to make countries *opportunities more equal*. It is in this spirit that vulnerability has been introduced as one of the criteria for identifying LDCs.

The second reason is about *aid effectiveness*. It has been shown in the literature that development assistance is marginally more effective in countries facing shocks, because at the macro level it acts ex post as a stabilizer. And ex ante it may or should be seen as a kind of insurance mechanism or safety net, particularly needed in poor and risky countries, threatened to fall in poverty trap. At the microlevel it may be also the role of aid to support relevant insurance schemes in vulnerable countries.

A third reason to clearly take vulnerability into account in the design of aid policies is that it could make this design *more transparent* and avoid the proliferation of exceptions and specific facilities. The countries specificity and needs can be addressed otherwise in the design and management of operations.

How to clearly take vulnerability into account

Vulnerability can be made an operational concept for the repartition of concessional funds by two ways: by the rules of *eligibility* to these funds and by the rules of *allocation* of these funds among countries. Categories are needed for eligibility, criteria for allocation.

There is no satisfactory category to address vulnerability

The Least Developed Countries (LDCs), the only official UN category, relies on three criteria among which vulnerability, the other two being income pc and human capital. But this does not prevent many non-LDCs, especially those graduated or graduating from the category, from being highly vulnerable. The category could be extended to the non-LDCs most vulnerable countries, thus covering the least developed and most vulnerable countries (LDVCs). But it would involve to significantly change LDCs identification rules.

The Multilateral Development Banks (MDBs) have indeed defined the countries eligible to

their concessional windows (IDA, ADF). They have done so on the basis of a group of "low" income pc, to which they have added on an ad hoc basis a complementary list of generally small countries, which partly corresponds to situations of vulnerability.

They have also identified a group of "fragile states", with varying names and content, used as a means of taking a specific form of vulnerability into account, the weakness of the state, by opening a specific window for these countries: FVC (Fragility Violence and Conflict) at IDA, TSF (Transition States Facility) at ADF.

Even applied to other forms of vulnerability (climate) with specific facilities, *creation of new groups is not enough to fairly address vulnerability* in the allocation of funds.

First it raises the question of the respective thresholds of access and exit (any country is either inside or outside), even if it can indeed be answered by intermediate zones or transitory measures. Second adding various sub-categories accentuates the risk of a lack of global consistency, with inequitable effects.

Third and above all, the creation of new groups leaves *unsolved the issue of allocation between countries* (within the groups or sub-groups) as to some trade measures. In short, even if categories are useful for eligibility to specific windows, *continuous criteria of allocation among countries, notably including vulnerability, are clearly needed*.

Wrong reasons of a reluctance to use vulnerability criteria in allocation

However, until now, MDBs have been reluctant to introduce vulnerability into their Performance Based Allocation (PBA) formula (except the Caribbean Bank of Development, a similar exception being that of the European Commission since 2014 for its development funds). *Why this reluctance? Few bad reasons given.*

One is the fear that the introduction of vulnerability criteria will be at the expense of the performance criterion. It should be underlined that the vulnerability considered is an exogeneous vunerability (beyond the present will of the country). Moreover it has been shown that the two criteria may be made perfectly compatible and that the PBA can effectively be transformed in a Performance and Vulnerability Based Allocation (PVBA).[1] [2]

Another is to say that the allocation is often only partially used, due to a low absorptive capacity of recipient countries, the responsibility for which is indeed shared between donors and recipient countries, questioning the operating mode of the MDBs and their risk aversion.

A third reason seems the risk that a display of vulnerability levels affects the notation of countries by agencies. Agencies anyway are quite aware of the vulnerabilities of countries. The fact that these vulnerabilities are taken into account an allocation formula can be seen as showing there is indeed an insurance mechanism at work likely to lower the impact of vulnerability. And most vulnerable countries wish their structural vulnerability to be recognized. It can also be said that being recognized as vulnerable for exogenous reasons is less stigmatizing that being included in a group of "fragile states" (whatever the name they are given).

1. In the formula it can be managed without lowering the share going to the most performant countries.
2. At the same time the vulnerability linked to present policy (the weakness of resilience policy) should be included as a negative factor of performance.

Finally a practical reason seems due to the fear of not being able to establish a robust and consensual indicator of vulnerability, a fear that should disappear with regard to the great deal of work done to design truly exogenous vulnerability indices.

How can vulnerability be measured to be a relevant criterion for aid allocation?

A major process of elaboration is ongoing at the UN at the request of the small islands states to promote a so called "multidimensional vulnerability index" (MVI), which is to be available around the time of the summit after consultation with member countries. (The Commonwealth Secretariat a little earlier produced a similar work, called "Universal Vulnerability Index").

Alongside the usual requirements of a composite index (availability of reliable data and relative simplicity) this composite indicator must and will have 3 specific features.

(i) It has to be *exogenous or structural*, reflecting factors beyond the present control of countries, to be used effectively as a financing criterion (without moral hazard);

(ii) It should be "*universal*", what means relevant for various kinds of vulnerable countries, and not only the Small Island Developing States (SIDS);

(iii) Then it must be *multidimensional*, i.e. it should include an *economic dimension*, which has been identified and analysed for a long time, but also an *environmental dimension*, and more particularly the *vulnerability to climate change*, and finally *a social dimension or exogenous socio-political fragility* (such as revealed by the presence of violence and insecurity at the borders, or the recurrence of epidemics).

There is no need of a specific health dimension of vulnerability, because health-related vulnerability is captured by various ways through the three dimensions noted above.[3]

The index being finalized at the UN will probably meet these principles and could serve as a reference at the Paris Summit.

To be noted, the vulnerability to climate change has been the main driver for the consideration of vulnerability (The Summit was announced at the end of COP27), but it has rapidly been agreed in building a relevant index that it cannot be limited to that dimension.

The allocation criteria (and indicators) should be adapted to the objectives of the various financial instruments

This seems obvious for climate finance.

If it is a question of *mitigation*, the allocation criteria must first aim at *effectiveness*. But credits for mitigation must also provide concessional financing for the additional costs of using low-carbon technologies in LICs, according to income pc and possibly vulnerability criteria.

For the allocation of *adaptation* credits, the vulnerability criterion is particularly important: it must rely on a *physical vulnerability to climate change index*, totally exogenous and capturing the main physical manifestations of climate change in the country, as done by the FERDI

3. Adding a fourth (health) dimension would be both difficult and redundant First, it is difficult to assess the probability of health shocks, as done for the economic and climatic shocks, although the third or social dimension may include a component such as the number of deaths due to the recurrence of epidemics. Second, the economic consequences of health shocks are captured through indicators of economic vulnerability. Third health indicators are to be included as components of the "structural resilience". Indeed the notion of "health vulnerability" is ambiguous: it refers not only to possible consequences of health shocks, as just explained, but also to the health consequences of any kind of shocks (external, or climatic, or socio-political).

PVCCI.

For the compensation of losses and damages, the evaluation of these is almost impossible, as it is difficult to distinguish what is the result of *climate change* (for which the countries of the North are responsible) and what is due to the *climate* in its historical component, and also as it is difficult to distinguish in the losses and damages *what is really exogenous and what is due to the management of risks by the countries and their preparation: a preventive approach is as important as curative action*, which could still lead to allocate (in part) according to the physical vulnerability to climate change.

Recommendations

The final allocation between countries of the new resources mobilized, as well as of the old ones, should be at the heart of a Summit intended to reshape international financing and address vulnerabilities of developing countries. This *involves an international consensus on the rules of eligibility to the concessional resources, and above all on continuous criteria for their allocation among countries.*

In addition to per capita income, which should not be the only differentiation criterion, vulnerability *criteria likely to reflect a structural vulnerability*, independent of current policy are to be taken into account. Vulnerability linked to a bad current policy should, on the contrary, diminish the measure of performance/governance and affect allocation in the opposite direction.

The structural vulnerability criterion *must capture the various forms of vulnerability* that countries face, still independently of their present will, through specific indicators related to economic vulnerability, vulnerability to climate change, social vulnerability, which includes the fragility linked to exogenous insecurity.

To be fully consistent, these allocation principles should apply to all existing and new concessional financing. This *involves significant changes in the allocation formulas of MDBs concessional windows*, where vulnerability has not yet been clearly and transparently integrated. This could condition their legitimacy to manage all or part of the new funds that will have been mobilized. The prospect of a consensus on a new multidimensional vulnerability index (MVI) or at least on the principles of its construction should contribute to promote this consistency.

In order to *inform the international community about current practices* and to monitor the implementation of the principles set out, *an index of the quality of allocation with regard to the multidimensional vulnerability* criterion would be established annually. It could be for each donor (multilateral and bilateral) the weighted average level of the vulnerability indices for each recipient country. This calculation would be part of a new measure of the "selectivity" of concessional flows.

Of course, allocation is not all what matters. Besides allocation among countries (in part) according to vulnerability, MDBs should be invited to focus their operations into *directions leading to risk reduction* in vulnerable countries, and also to report on this matter.

If there should be a global financial pact between countries, the commitments on the amounts mobilized and the instruments implemented would have to be accompanied by commitments on the rules for their distribution between countries.

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