DEVELOPMENT PROGRESS

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From ‘graduation’ to ‘gradation’ in international development finance

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Francisco Sagasti is a senior researcher at FORO Nacional Internacional, Lima, Peru. In this blog, he makes the case for steering clear of using income per capita as the basis for judging development finance needs, proposing a move from graduation to gradation, for all countries, not just poor countries.

Imagine if income support to families in need was determined by the height of the mother. Less than 5’2’’, and the family would receive a monthly grant. Between 5’3’’ and 5’6”, and the family would receive a subsidized loan on top of the grant. A family whose head of household is between 5’7” and 6’0” tall would receive a loan at a regular rate of interest. And if the head of household is more than 6’0” tall, the family would receive no public income support at all. Obviously, this is no way to lift families out of poverty and improve living standards, but this is, in essence what happens when access to development finance instruments is determined on the basis of income *per capita*, rather than the financing needs of a country.

Average income *per capita* is a poor indicator of the capacity to mobilise domestic or external resources. Yet, it is used to define the category of a country – low income, lower middle-income, higher middle-income, high income – that will determine its eligibility for grants and concessional loans, among other financial instruments. As countries move from one category to another, they **graduate** from having access to donations and subsidised loans, and the mix of financial instruments changes accordingly, as does the amount they provide.

Table 1 (below) shows data on the capacity of all countries to access and generate financing that can be used for development purposes, according to the income *per capita* categories defined by the World Bank. Some results may appear odd because of some peculiar country situations during the years examined. There are countries where domestic credit to the private sector exceeds GDP (United States, Republic of Korea, China) or where reserves may exceed GDP in a given year (Hong Kong, Singapore, Libya); and negative direct foreign investment flows reflect outflows and profit repatriation (Finland). Financial intermediation and fiscal sustainability indicators reflect the capacity to mobilise domestic finance, while exports, reserves and Foreign Direct Investment reflect the capacity to mobilise external resources.

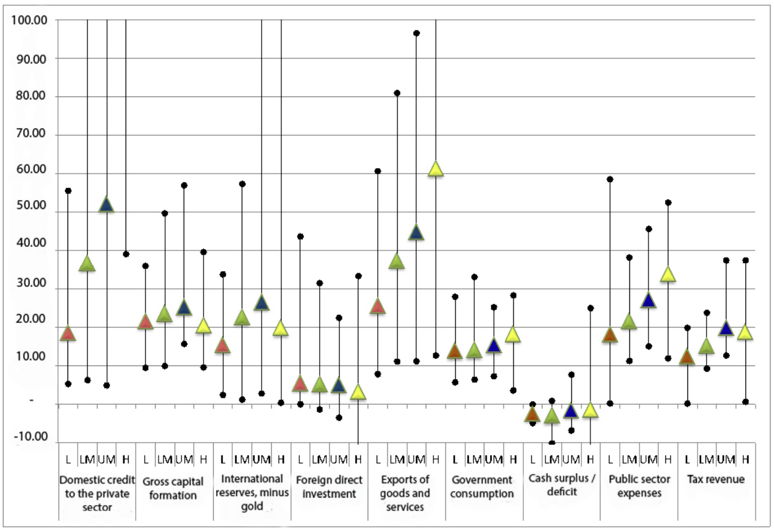
TABLE 1: **Indicators of internal and external resource mobilisation capacity** (average 2009-2011)

Indicators[1] / Type of countries[2]	Financial intermediation and investment		External financial flows			Fiscal sustainability			
	Gross capital formation (% of GDP)	Domestic credit to the private sector (% of GDP)	Exports of goods and services (% of GDP)	International reserves (% of GDP)	Foreign Direct Investment (% of GDP)	Government consumption (% of GDP)	Cash surplus / deficit (% of GDP)	Public sector expenses (% of GDP)	Tax revenue (% of GDP)
Average									
High	20.49	122.57	61.26	19.82	3.21	18.29	-1.43	33.84	18.85
Upper-middle	25.31	52.07	44.81	26.56	5.07	15.39	-1.55	27.22	19.92
Lower-middle	23.57	36.67	37.34	22.66	5.27	14.12	-2.95	21.64	15.21
Low	21.61	18.65	25.62	15.37	5.53	13.91	-2.37	18.12	12.40
Maximum / Minimum value									
High	39.64	282.71	211.48	117.10	33.39	28.36	25.05	52.46	37.47
	9.68	39.08	12.73	0.46	-64.54	3.66	-13.29	12.02	0.70
Upper-middle	56.95	128.02	96.51	162.05	22.54	25.30	7.74	45.61	37.46
	15.78	4.95	11.25	2.89	-3.44	7.36	-6.75	15.10	12.72
Lower-middle	49.66	116.42	80.94	57.28	31.56	33.14	0.97	38.21	23.83
	10.03	6.30	11.18	1.28	-1.30	6.48	-10.08	11.34	9.31
Low	35.99	55.56	60.61	33.84	43.67	27.99	-0.01	58.53	19.90
	9.52	5.33	7.90	2.49	0.07	5.78	-4.84	0.29	0.24

Source: World Development Indicators. Sample: 75 are OECD and non-OECD high-income countries; 55 are upper middle-income, 48 lower middle and 36 are low income.
[1] Average 2009-2011, except fiscal indicators (2009 only). [2] According to the World Bank classification.

The results are clear: **income *per capita* categories do not reflect country capacity to mobilise either domestic or external resources**. The averages are similar for most indicators across the four income categories, and the ranges between the maximum and minimum values overlap significantly (see Figure 1). So country income *per capita* is as useful a benchmark as the height of the head of household. It has little to do with the capacity to mobilise resources.

Figure 1

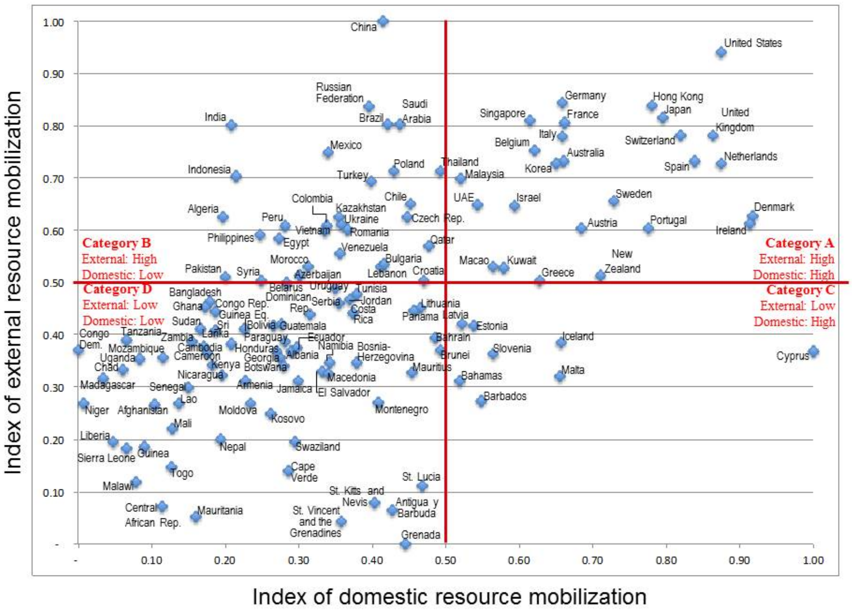


(Click here to download a full size version of figure 1)

A more sensible approach would be to base the choice of instruments and the allocation of development finance on the capacities of a country to mobilise domestic and external resources. Combining the values of the indicators it is possible to construct normalised external and domestic resource mobilisation indexes as shown in Figure 2. The position of a country in each quadrant could guide the choice of financing instruments, and finer distinctions could be made along the two axes to address development financing requirements on a case by case basis.

- Countries in the top left quadrant (with low domestic resources but high external resources), such as India, Algeria and Peru, would benefit from instruments to improve domestic resource mobilisation, including technical assistance and loans to improve the tax system and supplement domestic savings, and measures to develop capital markets.
- Countries in the top right quadrant (with high domestic and external resources), such as UAE and Malaysia, would benefit from insurance and guarantee schemes to attract foreign investors, capacity building for investment promotion, matching loans and grants for public-private partnerships, and help to improve credit ratings.
- The countries in the bottom left quadrant (with low domestic and external resources) include those with extreme needs, such as the Central African Republic and the Democratic Republic of Congo. They need grants, concessional loans, technical assistance and capacity building, among other instruments.
- Countries in the bottom right quadrant (with high domestic resources but low external resources), such as Iceland and Slovenia, rely on international financial markets and stabilisation funds, collective action clauses in bond issues, and support from institutions like the IMF and the European Central Bank (as shown recently in Southern Europe).

Figure 2



(*Click here to download a full size version of figure 2*)

Other reasons to steer clear of income *per capita* as a basis for development finance categories include Martin Ravaillon’s argument that the original graduation threshold from low to middle income came from arcane 1971 World Bank ‘Civil Works Preference’ criteria; José Antonio Alonso highlighting the perverse incentives of thresholds that cut access to development financing instruments; and Andy Sumner showing that most of the world’s poor now live in middle-income countries.

Graduation from development finance instruments as countries cross income *per capita* thresholds should be replaced with **gradual shifts** from one mix of financial instruments to another, tailoring the mix according to the capacity of each country to mobilise external and domestic resources. In short, **we should move from graduation to gradation**. And it is time to abandon obsolete concepts like ‘aid’ and ‘development assistance’, and focus on the fact that all countries, rich and poor, will need different combinations of public and private sources of domestic and external finance to improve and maintain living standards in the coming decades.

With thanks to Fernando Prada for his assistance in processing the data for this blog.

The second and fourth bullet points relating to figure 2 were amended on 17/12/2013 to correct an editing error in their description of the figure.

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