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Accounting for Vulnerability of African Countries in Performance Based Aid Allocation

Patrick Guillaumont and Sylviane Guillaumont-Jeanneney*

Introduction

Like other Multilateral Development Banks, the African Development Bank (AfDB) Group allocates some of its aid through a performance-based allocation (PBA) formula which is primarily based on the quality of economic policies and governance in each beneficiary country. Governance plays a major role in the PBA formula and its weight is equal to more than double that of economic policy¹. During times when many regional member countries of the Bank are facing severe liquidity problems because of the current economic and financial crisis, it is useful to consider whether the PBA penalizes countries which are most in need of resources.

1.2 During the 2006 African Economic Conference, Professor Guillaumont of the Université d'Auvergne argued that

African countries have characteristics which should be better accounted for in the aid allocation process. The AfDB research department has subsequently teamed up with Professor Guillaumont to address this issue. This study is the outcome of this joint work and considers three amendments to the PBA formula used for allocating African Development Fund (ADF) resources:

- (i) Adding an economic vulnerability criterion to the performance criteria,
- (ii) Introducing a human capital indicator in the performance criteria, and
- (iii) Reducing the weight given to population.

The main proposal of the study involves the use of the Economic Vulnerability In-

dex (EVI) which was developed by the United Nations for understanding the economic vulnerability of low-income countries.



¹ For example, in the current formula, if the performance assessment of a country, measured by its Country Performance Assessment (CPA), increases from 3 to 3.5, its allocation would increase by about two-thirds.

The limits of the current aid allocation formula

The predominance of the governance criteria in the PBA is subject to criticism. Its weight is deemed by many to be too high in relation to the characteristics of the Bank's regional member countries (RMCs) for a number of reasons:

- a) The performance measure is subjective.
- b) The uncertainty on the indicator of good policy generates great instability. It contributes to the uncertainty of allocations which, though calculated for a three-year period, are adjusted each year.
- c) The analytical basis for the weight given to governance is questionable.

Aid effectiveness in terms of economic growth is not only a function of economic policy. It also depends on shocks which countries are subject to. Such shocks include terms of trade shocks, notably because of changes in prices of primary commodities, as well as weather shocks or other natural disasters. Economic vulnerability, which depends on geography, history, and international environment, makes it more difficult to design economic policy or for countries to meet their development goals. These shocks, which on the one hand, lead to lower economic growth, do on the other hand, mean higher aid effectiveness². Indeed, in countries which are subject to shocks, aid can help prevent an economic slowdown, as well as the cumulative decline that often follows. Although aid is not always counter-cyclical, it remains stabilizing.

Weaknesses in the PBA formula have resulted in many factors being considered outside the formula. Indeed, the direct application of the formula would lead to less aid being allocated to post-conflict or post-crisis countries while they are the ones which are in particular need of help. Another issue is related to coun-

try size. A small size can be crippling for economic development, especially if the country is landlocked. In addition, it is desirable to avoid the concentration of funds on a few large countries. However, applying thresholds and caps at various stages of the computation generate complications and inconsistencies.



Preliminary lessons



Preliminary results of this study show that introducing the economic vulnerability index in the PBA formula would increase the transparency of aid allocation. In fact, a direct application of the amended formula indicates that fragile states would receive an allocation close to the one based on the PBA formula, including the amount originating from the Fragile States Facility. The introduction of

¹ Guillaumont, P. and L. Chauvet (2001) "Aid and Performance: a Reassessment", *Journal of Development Studies*, 37, 66-92.

the economic vulnerability index in the PBA formula would also favor countries subject to shocks, or likely to suffer from social or political instability.

As economic instability due to external shocks is often the cause of social unrest, civil wars and crises, this amounts to adopting an approach that is not only curative but also preventive in dealing with the needs of fragile states. As amended, the formula would reinforce the sta-

bilizing effect of the African Development Fund by avoiding an excessive reduction of aid flows when countries face difficulties caused by external shocks, such as the current financial crisis, which translates into poorer country performance ratings.

However, it is worth noting that if the endowment of the African Development Fund is held constant, the increased aid allocated to countries with a high eco-

nomie vulnerability index comes at the expense of countries which benefit currently from good performances.

It is now critical that donors share the same views on the desirability of incorporating a measure of economic vulnerability in the aid allocation formula for African countries. Being the first and only development financing institution to have undertaken this exercise, the Bank could assume a leadership role in this issue.



Comments and suggestions can be sent to:

Leonce Ndikumana
Abdul B. Kamara

**Development Research Department
African Development Bank**

BP 323, 1002 Tunis Belvedere, Tunisia – Tel.: +216 71 102 876 – Fax: +216 71 103 779 – E-mail: economic-research@afdb.org – Web: www.afdb.org

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*Patrick Guillaumont and Sylviane Guillaumont-Jeanneney are Professors of Economics at the Centre d'Etudes et de Recherches sur le Développement International (CERDI), CNRS, and Université d'Auvergne (Clermont-Ferrand, France). Désiré Vencatachellum, Lead Economist in the Development Research Department of the African Development Bank, served as Task Manager of this study in the Bank.