Organisation for Economic Co-operation and Development

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Next Steps for Development in Transition

A Background Paper

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Significant development challenges can remain despite progress from one income group classification to the next – and, conversely, some countries achieve progress across non-income development indicators despite lesser progress on incomes. How can international co-operation sustain smooth and successful transitions?

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I. New world economy, new roles

The face of the world economy changed markedly at the turn of the 21st century. During the decade of the 2000s, as many as 83 countries grew at more than double the per-capita rate of the OECD area, compared to only 12 during the 1990s, a transformation dubbed *Shifting Wealth* when it was documented by the Development Centre.[1]

The process of *Shifting Wealth* reached its peak during the 2009 financial crisis, when advanced economies contracted by 3.4% and developing economies achieved 3.5% growth. It has since moderated significantly through slowdowns in China and other large emerging economies. One of the key channels for the diffusion of shifting wealth was the boom in demand for and prices of commodities and energy. Commodity prices returned to levels close to those of the 1980s by 2015,[2] seriously challenging growth prospects in a number of countries.

These changing growth patterns translated into changes in the standing of countries in international income classifications and thereby in international co-operation. In the first half of the 1990s, seven countries that had graduated from eligibility for International Development Association (IDA) concessional lending re-entered IDA.[3] This was the result of a combination of national factors and poor aggregate performance, especially during the 1980s. During the 2000s, 26 countries moved out of the low-income group and 14 countries moved from the middle-income to the high-income group. With the end of the resource boom, Equatorial Guinea and Venezuela, which had achieved high-income status, reverted to middle income in 2015.

In turn, changing growth patterns have altered the international development assistance landscape through the growing importance of ‘new’ and ‘emerging’ donors. ‘New’ donors are largely countries that have relatively new, or recently revived, aid programmes. A large number of ‘new’ donors are recent member states of the European Union (EU)[4], many of which were donors themselves during the Cold War, and then received aid as they made the transition to market economies. These countries have since begun to put in place laws and institutions to co-ordinate their own assistance programs in developing countries. Some non-EU members, notably Israel, Russia and Turkey would also be considered in this group.

‘Emerging’ donors are largely middle income countries and emerging economies that share expertise and financial support with other countries and are the largest providers of South-South Co-operation. Many remain recipients of Official Development Assistance (ODA), albeit in diminishing volumes. The most prominent providers are Brazil, Chile, China, India, Mexico and South Africa, as well as nascent countries such as Colombia, Egypt and Thailand.

[1] OECD (2010) *Perspectives on Global Development 2010: Shifting Wealth*. OECD Publishing. Paris.

[2] OECD (2016) *Perspectives on Global Development 2017: International Migration in a Shifting World*, OECD Publishing, Paris.

[3] The countries were Philippines, Honduras, Nicaragua, Egypt (1991), Zimbabwe (1992), Cameroon, and Congo (1994). Re-entry corresponds to World Bank’s financial years and therefore reflects performance two years prior.

[4] Some - the Czech Republic, Hungary, Poland, Slovenia and the Slovak Republic - are OECD members and participate actively in DAC work.

Box 1. Income classifications and Official Development Assistance (ODA)

The most widely used income classification relies on Gross National Income (GNI) as defined in the System of National Accounts, measured in US dollars using the Atlas conversion factors instead of market exchange rates. Atlas conversion factors are averages of market exchange rates for the year of interest and the two preceding years, where the latter are corrected for inflation differentials between the country and the world. The method therefore reduces the impact of exchange rate volatility on cross-country comparisons. But it does not correct for differences in price levels in measuring standards of living, as, for example, Purchasing Power Parity (PPP) factors do.

As of 2015, the World Bank identified 31 countries as low income, 108 as middle income and 79 as high income.

An income threshold is used to distinguish low- and middle-income countries, set at USD 1 025 (Atlas) in 2015. This threshold corresponds to a former distinction in World Bank operations; it was the threshold below which civil works preference could be awarded to eligible domestic contractors for bids procured under a competitive, international bidding process. It no longer has direct operational implications for countries' access to concessional finance, but it does affect how the countries are presented statistically.

The threshold between the middle-income and the high-income group was set by the World Bank at USD 6 000 (Atlas) in 1987 prices. It has since been updated to account for inflation. It stood at USD 12 475 (Atlas) in 2015. This threshold was chosen to address anomalies in the classification of high-income and industrialised economies. Like the low-income transition, reclassification as high income does not necessarily alter access to development financing, with a number of high-income countries able to access IBRD funding (Fantom and Serajuddin, 2014).

Between low- to middle-income status, the IDA eligibility threshold is the most significant marker. At GNI of USD 1 215 (Atlas) in 2015, this threshold reflects the operational availability of concessional finance from the World Bank, and guides the determination of access to concessional finance for a number of other multilateral financial institutions (the Asian Development Fund, the African Development Bank, the Asian Development Bank and the IMF). Originally, this threshold was USD 250 per capita in 1964. The current level is about 60% of this historical threshold, reflecting demand for IDA funds outpacing their availability.

The Development Assistance Committee's (DAC) list of ODA recipients, designed for statistical purposes, includes all middle-income and low-income countries, except members of the G8 or the European Union (including countries with a firm accession date to the EU). It also includes all countries listed as Less Developed Countries by the United Nations. Updates to the list, which are carried out every three years, eliminate countries that have been above the high-income threshold for three consecutive years.

Sources: IDA (2016), 'Review of IDA's Graduation Policy', IDA Resource Mobilization Department (DFIRM) ; Fantom, N. and U. Serajuddin (2014), 'The World Bank's Classification of Countries by Income', Policy Research Working Paper 7528, and http://www.oecd.org/dac/financing-sustainable-development/Where%20paper.pdf

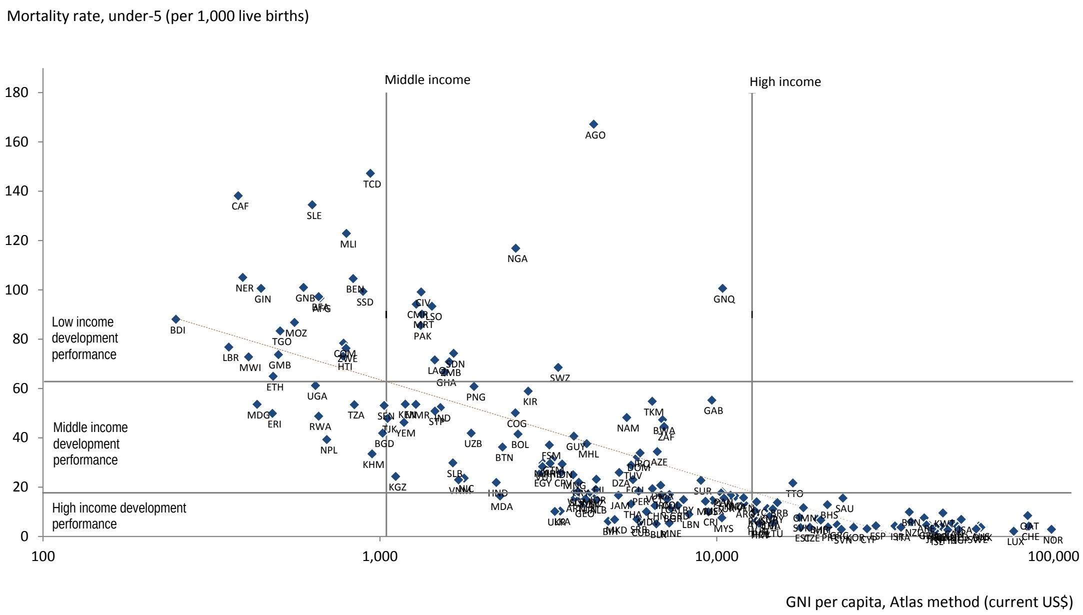
The country classifications that are used to determine eligibility for Official Development Assistance (ODA) and for specific instruments therein rely on aggregate income. Yet, development is much more than increases in per capita national income. Development is a multidimensional process with the ultimate measure being the well-being of citizens. The pace and pattern of economic growth plays an important role in driving other dimensions of development, but certain key outcomes of well-being are loosely or even negatively related to aggregate incomes. As a result, transitions in income groups can be at odds with progress on a number of relevant development indicators.

II. Countries share challenges across income thresholds

Countries across income groups share a number of challenges. Significant development challenges can remain despite progress from one income group classification to the next – and, conversely, some countries achieve progress across non-income development indicators despite lesser progress on incomes. For example, while the majority of countries with high infant mortality rates belong to the low income group, 15% of countries with GNI levels sufficiently high to classify in the middle-income group have higher rates of infant mortality than would be expected in a country at the low-income country and middle-income country thresholds (Figure 1).

Indeed, when looking across a series of development outcomes it is apparent that income groups are not sufficient to characterise the level of the development challenges faced by individual countries. Figure 2 illustrates how classification by GNI income group can diverge from other dimensions of development progress. For each indicator, threshold levels are set according to the relationship between income (measured by GNI per capita) and the indicator. The level is considered to be low if it corresponds to that predicted for a low-income country, middle if it would correspond to that of a middle-income country and high if it would correspond to a high-income country.[5] This is akin to replicating Figure 1 for all indicators and representing the shares of countries in each of the performance levels by income group.

Figure 1. Relationship between child mortality and GNI per capita



Note: Mortality rate, under-5 (per 1,000 live births) and GNI per capita, Atlas method (current US$) averaged over 2011-2015. Income thresholds have been established given 2015 IDA classification.

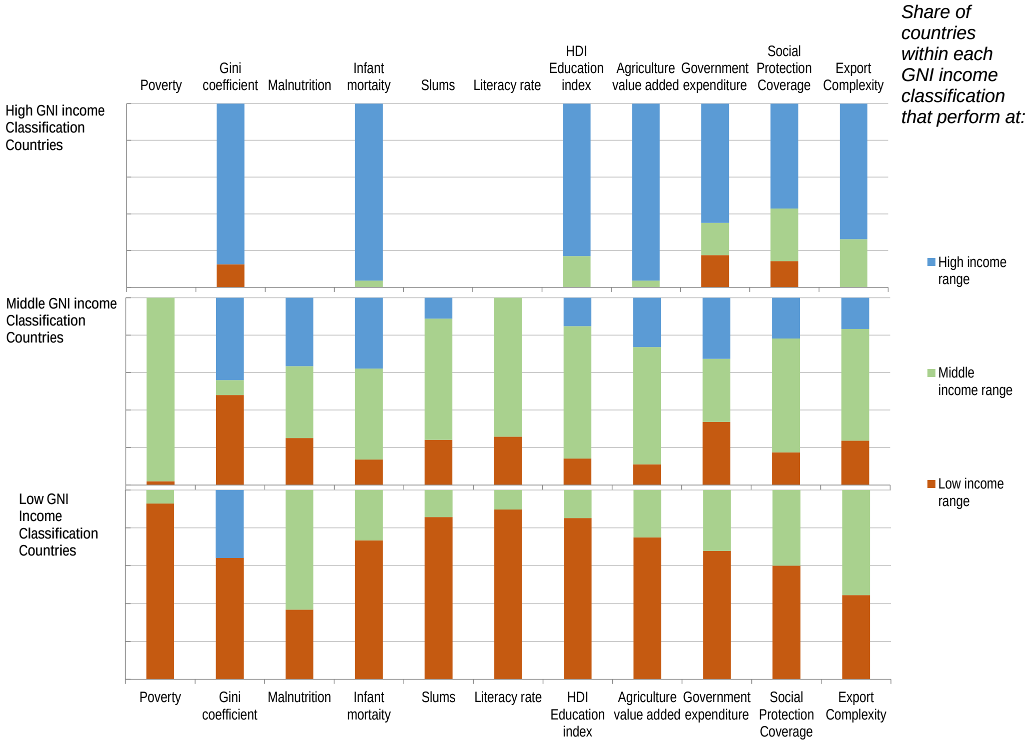
Source: OECD staff calculations based on World Bank (2016), World Development Indicators (database)

[5] Thresholds are set at the levels of the development indicator of interest predicted for the LIC/MIC and MIC/HIC income thresholds on the basis of a regression between the indicator and GNI per capita. The best-fitting or a linear and a logarithmic regression was used for each of the indicators.

Income groups provide a good indication of the prevalence of extreme poverty (at USD 1.90 a day in PPP terms, corresponding to the one-dollar-a-day level). Among middle-income countries, only one middle-income country – the Republic of Congo – has a level of extreme poverty that would correspond to that of low-income countries. This is in line with findings in the literature that economic growth plays a major role in the reduction of extreme income poverty.[6]

In contrast, income groups provide a very poor indication of the level of inequality. Aggregate income and the Gini coefficient, a standard measure of inequality, are not closely correlated. It is therefore not surprising to find that 13% of high-income countries have levels of inequality that could well be found in low-income economies. Moreover, almost half of all middle-income countries have high levels of inequality (with a Gini coefficient above 0.4). This is consistent with findings in the literature that a number of countries transitioning to middle-income status in the past decades have experienced growth with significant inequality increases.[7]

Figure 2. Countries' income grouping can diverge markedly from their progress across other development dimensions



Note: indicators for poverty headcount (at $1.90 a day), malnutrition, population living in slums and the literacy rate are not included for high-income countries as the corresponding range is reduced to one point. In the case of slums, data is not available from comparable sources for most high-income countries.

Source: OECD staff calculations based on World Bank (2016), World Development Indicators (database), World Development Reports, and IMF (2016), World Economic Outlook.

[6] Dollar. D. and A. Kraay (2002) "Growth is Good for the Poor", *Journal of Economic Growth*, Vol 7, Issue 3.

[7] Sumner, A. (2016) "Growth, precarity, structural change, and the limitations of the special case", WIDER working paper 2016/34.

Among key social outcomes, health indicators, as well as indicators for literacy and the quality of the urban environment, also show that many middle-income countries face the same or even more severe challenges than low-income countries. Indeed, in a quarter of middle-income countries, over half the urban population lives in conditions qualified as slums by the United Nations, while a few low-income countries have lower rates of people living in urban slums, such as Senegal (35%) or Zimbabwe (25%).

Finally, a series of indicators examine the degree of economic transformation and the capacity of the state. The Economic Complexity Index, which measures the degree of sophistication of exports, is at levels that would be expected for middle-income countries in a quarter of high-income countries. They involve commodity exporters, including most Persian Gulf oil economies, but also countries like Chile and Uruguay, who have attained high-income status in recent years. The lower sophistication of their export basket can signal an over-exposure to external volatility.

Indicators for the capacity of the state to raise and spend resources are of particular interest. They are intermediate rather than final outcomes, but are critical to the state's capacity to foster the development process and to transform national income into positive development outcomes. Moreover, they are amongst the key discriminating variables found in recent OECD Development Centre work that determines whether countries escaped the middle-income trap in the past.[8] Not only does the data exhibit a wide range of variation in both taxation and expenditure in middle-income economies, but also a number of high-income countries only collect and spend a small share of GDP, below the 27% threshold found for low-income economies (the OECD average was 44% in 2014).

III. Transition and development outcomes

At the time that countries transition to higher income groups, progress across other dimensions of development is often lagging, especially where income performance has been driven largely by resource extraction. Since the early 2000s, 8 countries have graduated from IDA eligible low-income classification. In a number of cases, these countries' progress in GNI per capita has not been reflected in other development dimensions. For example, Angola transitioned to the middle-income category in 2014; however, at that time under-5 mortality rates were, at 162 per 1 000 live births, at the levels of Chad (GNI per capita at USD 980), the share of urban dwellers (55%) in slums was higher than in Nepal (GNI per capita of USD 730), and adult literacy rates (71%) were lower than Rwanda (GNI per capita USD 690). Similarly, child wasting[9] rates in Albania at the time it graduated from IDA eligibility were higher than those of Guinea (GNI per capita USD 310).

This pattern also is evident at the transition from middle- to high-income classification. Oman transitioned to high-income categorisation in 2008; however, at that time, adult literacy rates were, at 87%, at the levels of Peru (GNI per capita USD 2 790), and child wasting rates were, at 7%, at the levels of Kenya (GNI per capita USD 930). Similarly, in Trinidad and Tobago at the time of transition to high income (USD 11 905), under-5 mortality rates were at the levels of Armenia, with a GNI per capita of USD 1 990.

[8] The other key variables are: rule of law, the dependency ratio, quality of education, the polity measure of democracy, gross capital formation, credit market development and export diversification.

[9] Wasting is the proportion of children under five whose weight for height is more than two standard deviations below the median for the international reference population. It is an indicator of malnourishment and/or disease and a strong predictor of child mortality.

IV. Vulnerability and classification reversals

Economic growth that results from a process of structural transformation can give rise to new sources of dynamism. The commodity boom of the early 21st century generated rapid growth in a number of developing countries, but did not always drive structural transformation. In those cases, lack of progress in other development outcomes also signals vulnerability in the sources of income growth themselves, which may not be sustained in the face of external headwinds.

Some countries have crossed income group thresholds through rising terms of trade but without achieving the structural change required to sustain activity and additional growth. In these cases, negative external or internal shocks often lead to the reclassification of income to be reversed, across all income groups.

There have been 44 transitions for low- to middle-income classification and from eligibility for concessional finance since the early 1960s, and several countries have transitioned more than once. 11 countries 'reverse transitioned', with most of these being countries that had transitioned during the 1980s and that were particularly exposed to commodity prices or to political instability.[10]

The transition from middle- to high-income also can be reversed. Between 1990 and 2015, there have been 15 cases of countries returning to middle-income classification; in three cases, countries made the reverse transition at least twice. Many of these countries are small islands states (e.g. Antigua and Barbuda, Aruba, Barbados, American Samoa, Guam), or have economies dominated by petroleum (e.g. Bahrain, Equatorial Guinea, Saudi Arabia, Venezuela) or were where significant external shocks were amplified by domestic weaknesses (Latvia, Malta, Hungary, Korea, Russian Federation).

Given these vulnerabilities and the heterogeneity of countries in the middle income group, financial and non-financial transition support is vital to limit the number of reverse transitions. Countries poised to transition from ODA eligibility in the near and medium term face the loss of ODA-associated financial and non-financial support. A sharp fall in concessional financing, or cessation of such financing that occurs when a country transitions from ODA eligibility, risks slowing the development momentum in the country. This, in turn, can raise the likelihood of a transition reversal and compromise progress towards the Sustainable Development Goals (SDGs).

V. International co-operation to support sustained transition

The challenges of designing and funding appropriate financial and non-financial support mechanisms are considerable and will need to be carefully examined in close consultation with donors and transition countries. There is a range of possible uses of transitional financing, including targeting resources to support projects with systemic or transformational impact on the poorest groups, lagging sub-national areas or the social sectors, supporting fiscal and external sustainability, projects with positive spillover impacts at the regional level and innovation, and piloting new approaches that would lead to leveraging and scale up.

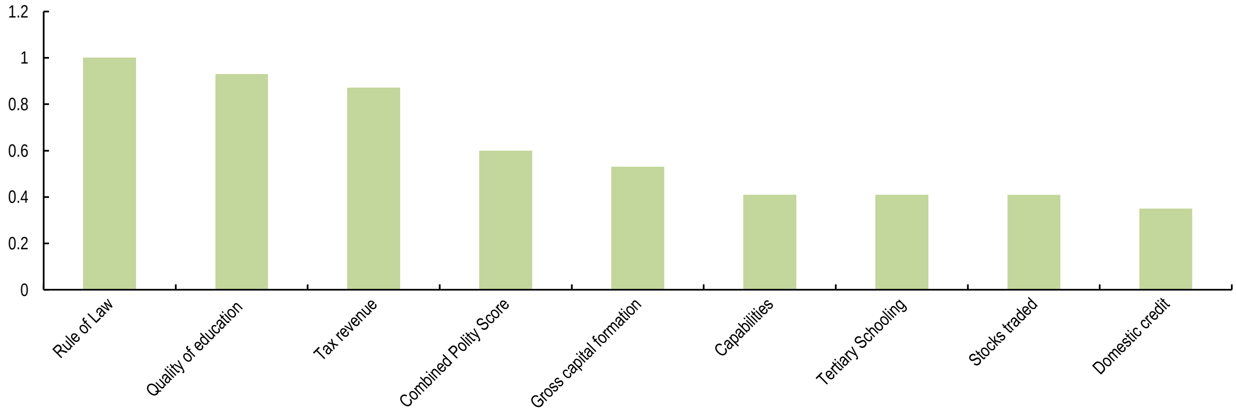
In designing support mechanisms, two important issues should be addressed: the specific needs of countries to transition from middle-income to high-income and what systems are necessary to address the development obstacles that transition countries face.

[10] Sumner (op cit) notes that among a group of 19 countries reaching middle-income status (excluding small islands states and transition economies), only about half of them had large increases in GDP per capita in PPP terms which are identified as those undergoing structural transformation, in opposition to those where GNI levels were driven by in part by terms of trade movements.

Indeed, a number of middle-income countries can face the so-called middle-income trap. The middle- income trap refers to the long-lasting slowdown in growth that many countries endure when they approach middle levels of per capita income.[11] Growth in low-income countries can be said to arise through factor accumulation and the reallocation of labour from low- to high-productivity activities and industries. In contrast, arriving at upper-middle-income and high-income levels usually requires new engines of economic growth based on capital- and skill-intensive manufacturing capabilities and service industries.[12]

The economies that have successfully transitioned from ODA eligibility since 1985[13] have exhibited a number of key policy characteristics (Figure 3), notably strong rule of law, quality education and capabilities to mobilise domestic resources (tax revenue). The nature of these challenges, more related to institutional development than to factor accumulation, differ from the challenges of low-income economies and would require specific attention.

Figure 3. Policy areas associated with successful transition (weighted results using linear discriminant analysis)



Note: Rule of law: As defined in World Bank Worldwide Governance Indicators. Degree of democracy: From the Polity IV Project. Quality of education: Students' performance (Altinok et al, 2014. Tertiary education: % of complete tertiary schooling attained in population. Capabilities: Productive knowledge implied in the country's export structure (Haussmann and Hidalgo, 2009). Tax revenues: Tax intake (% of GDP). Total investment: Gross capital formation (% of GDP). Capital Markets: Stocks traded, total value (% of GDP). Domestic credit: Domestic credit provided by financial sector (% of GDP).
Source: Melguizo A., S. Nieto-Parra, J.R. Perea and J. Perez (2017), "No Sympathy for the Devil: Policy Priorities to overcome the Middle-Income Trap in Latin America", OECD Development Centre working papers (forthcoming).

The increase of new actors and cross-regional modalities is enriching the understanding and practice of development co-operation and has the opportunity to direct the global development architecture towards a more inclusive, effective and horizontal global development agenda. As countries transition from ODA eligibility, new forms of development co-operation are vital to ensure sustainability of

[11] Eichengreen, Park and Shin, 2011; Felipe, Abdon and Kumar, 2012; Zhuang, Vandenberg and Huang, 2012; Aiyar et al., 2013

[12] Kharas and Kohli (2011), "What Is the Middle Income Trap, Why do Countries Fall into It, and How Can It Be Avoided?", Global Journal of Emerging Market Economies, 2011, vol. 3, issue 3, pages 281-289

[13] Israel (1986), Singapore (1988), Ireland (1990), Spain (1990), the Republic of Korea (1995), Portugal (1996), Greece (2000), Chile (2005), Kuwait (2005), Qatar (2005), Uruguay (2012), Malaysia (2014), and Poland (2014).

transition. Triangular and South-South co-operation arrangements are two important pillars to help countries navigate the transition from ODA eligibility.

Triangular co-operation can support win-win-win situations in which all partners (traditional donors and developing countries) learn, contribute and share responsibilities. The OECD defines triangular co-operation as an arrangement under which donor and international organisations support and complement specific South-South co-operation programs or projects by providing technical, financial, and material assistance. To be effective, triangular arrangements need: strong partner countries' engagement and shared ownership among all partners; efficient management of transaction costs that tend to be high in this type of co-operation and; good use of complementary strengths in first-hand knowledge, expertise and resources.

Similarly, greater South-South co-operation can bring valuable support to middle-income and transition countries. However, in overcoming the underlying institutional and technical challenges faced by some Southern countries, South-South co-operation can benefit from the lessons learnt from traditional development co-operation. Greater mutual accountability as well as transparent, regular and efficient information and results management would help to align co-operation to national systems and development plans.

Clear rules for granting access to transitional support will need to be defined. But, the diversity of situations of middle-income countries and that of possible upcoming transition countries in particular calls for a case-by-case approach. Peer learning vehicles can support countries to adopt and modify solutions enacted by other countries at a similar level of development. The OECD Development Centre's Multi-dimensional Country Reviews' Mutual Learning Group (MDCR-MLG), for example, offers peer to peer learning and implementation support on the critical development challenges facing countries, where experts, policy makers and practitioners come together from across the OECD Development Centre member base to share successful strategies and provide support to countries that wish to implement similar strategies.