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INNOVATIVE FINANCE FOR DEVELOPMENT - INSTRUMENTS OF SOCIAL INTEGRATION AND RESPONSIBILITY IN LOWER-MIDDLE-INCOME COUNTRIES (LMICs)

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Innovative finance for development – Instruments of social integration and responsibility in lower-middle-income countries (LMICs)

Tamás Novák[1]

Abstract[2]

Existing proposals for transforming the system of development assistance and especially in relation to middle income countries are manifold. The idea of cutting assistance to middle income countries gained ground parallel with the questioning of the rationale to use only per capita income as an eligibility criterion for assistance. LMICs[3] have much in common with LDCs but the operation and structure of their domestic economy and politics may be significantly different. My proposal is not to disregard middle income countries as potential targets of development assistance as a whole; rather my study argues that focus should be placed on lower-middle-income economies. The LMIC strategy would be different from the one that targets the least developed countries. I tend to coin this policy with the term of "convergence assistance" – an innovative allocation and spending mechanism. Convergence means the reduction of internal disparities and the elimination of the dual structure of these economies. Against this backdrop successful adaptation of development banking models of developing and advanced economies can support the establishment of an economic incentive system based on efficiency requirements coupled with concentration, expertise, the knowledge of the local market and people. By incorporating the best practices of microfinance institutions from the developing world and those of the institutions with the objective of economic inclusion in advanced countries, a development bank may be a good choice in LMICs. This institution ideally may function as a window for all development or convergence financing independently from their origin and nature. The proposal is not meant to prefer LMICs to LDCs but a pilot project is more likely to be feasible in their case.

JEL: F35; G23; P41

Keywords: Development assistance, innovative finance, middle income countries, development institutions

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[2] An earlier version of this paper was submitted for the GDN Next Horizons Essay Contest 2014 in partnership with the Bill & Melinda Gates Foundation on The Future of Development Assistance - See more at: http://www.gdn.int/html/page11.php?MID=3&SID=24&SSID=80#sthash.7bQybSxE.dpuf (15 September 2014)

[3] The World Bank revises the classification of the world's economies based on estimates of gross national income (GNI) per capita for the previous year regularly. As of 1 July 2014, the World Bank income classifications by GNI per capita are as follows: Low income: 1,045 USD or less; Lower middle income: 1,045 USD to 4,125 USD.

Introduction

During the cold war donor countries determined the volume and allocation of their development assistance in line with their foreign policy and ideological aims.[4] Development objectives were subordinate to these interests, the logic of which was based on global competition for influence between the main parties of the cold war period.[5] At that time impact on economic growth or the efficiency of the allocated assistance was not among the priorities. After the cold war, international assistance policies went through a deep transformation. With the collapse of the Soviet Union the importance of developing countries for donor countries declined considerably because the competition for influence in the third world between "big powers" faded away with the demise of the USSR. In the nineties development assistance lost most of its importance in the foreign policy of several large countries most notably the US. After 2001 an important change took place, as major donors began to increase their level of assistance in order to manage global security challenges in more efficient ways and prevent the intensification of international terrorism.[6] This objective was supposed to be achieved by concerted efforts to decrease poverty and improve economic performance in several fragile states. This common interest of the developed world helped to increase the volume of development assistance while placing much greater emphasis on efficiency than before.[7] This attitude brought development assistance closer to its original objective, i.e. to provide basic needs for the poor and achieve higher living standards. As a result of the economic and financial crisis of 2008, development assistance started to decrease.[8]

The situation has been changing again due to the newly emerging geopolitical environment, the rapid economic growth of various states that – as a result – have

[4] For example, the Marshall Plan (European Recovery Program) was clearly an effective foreign policy instrument for the USA to stabilize European countries and also create an alliance with them while serving its economic interests by creating new markets (Kissinger 1994: pp. 446-472.)

[5] Morgenthau (1962): p.307.

[6] Severino-Ray (2009): pp.3-4.

[7] This change in attitude received strong impetus by the Paris Declaration on Aid Effectiveness in 2005.

[8] Although ODA (Official Development Assistance) increased again in 2013, doubts may be raised about its quality. The share of funds that never even reach developing countries can be very high. Different estimates show that in recent years on average around 20% of ODA from DAC (Development Assistance Committee) has never reached the recipient countries (Riddell 2014: p. 14). There is a great deal of uncertainty concerning the reliability of data and it is almost impossible to establish the share that directly contributes to development prospects in recipient countries.

become coined as middle-income countries (for example China, India, Brazil). Many of them aspire to gain greater influence over international political and economic issues. Some of them are becoming important players in the provision of development assistance. In their foreign policy they do not distinguish among the different financial instruments, which include aid, export-credits or foreign direct investments (mostly state supported) etc. In most cases these countries do not impose strict conditions to be fulfilled (neither political nor economic) in exchange of the transfer of the funds. They are now challenging the current international economic and political system on the basis of their increasing importance in global issues. These challenges affect the global power relations, the Breton Woods system,[9] economic cooperation, the future of development assistance, its international framework, the interests of recipient countries and the new donors from large emerging nations. The changing framework seems to indicate that the former structure and type of development cooperation is coming to its end.[10] In addition, the economic and financial crisis of 2008 hit advanced regions much harder than the rest of the world, which undermined the economic and ideological principles pursued by the most developed countries whose attractiveness in terms of economic and political success has, in turn, been considerably weakened.

The mainstream approach today is that development assistance is to be channelled into countries that are indeed in need of this support. The yearly volume of ODA is around 140 billion USD from members of the Development Assistance Committee. This sum is insufficient to make a real difference in terms of developmental impact in a large number of widely divergent countries including LDCs (Least Developed Countries) and MICs (Middle Income Countries) alike. From this perspective it makes sense to allocate the available resources to LDCs only. This policy shift is evident, for example, in the case of the new EU donor policy framed in the past few years.[11]

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[9] See for example: Barry Eichengreen: Banking on the BRICS, Project syndicate. August 13, 2014. http://www.project-syndicate.org/commentary/barry-eichengreen-is-bullish-on-the-group-s-new-development-bank--but-not-on-its-contingent-reserve-arrangement

[10] Detailed analysis of the challenges and difficulties of continuing the earlier policies is for example in: Severino–Ray (2010): pp.16-28.

[11] The beneficiaries of EU assistance policy are among the poorest countries. Council conclusion 'Increasing the Impact of EU Development Policy: an Agenda for Change' 3166th FOREIGN AFFAIRS Council meeting Brussels, 14 May 2012 http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/EN/foraff/130243.pdf.

But the issue of stronger differentiation between LDC's and MICS were analyzed earlier. For example: Anderson–Grim–Montes (2004)

My proposal is not to disregard middle income countries as potential targets of development assistance as a whole; rather my study argues that focus should be placed on lower-middle-income economies. Their economic development is often based on unsubstantiated footing with the exception of some of the very large countries. The size and domestic savings of a large number of countries in this group are insufficient to serve as a protective net for their economies when the conditions of the international environment deteriorate. The problems of managing income differentiation and social exclusion are among the most crucial issues that should be resolved in order to achieve a stable, sustainable social and economic development. The lower-middle-income economies comprise approximately fifty countries with a total population of 2.56 billion. Instead of withdrawing assistance altogether, a new form of multilateral, concentrated approach may be a better solution.[12] Continued but restructured assistance can also be justified with the need to avoid the middle-income trap, which has been proven by several scholarly papers and analyses from international organizations.[13] This consideration is reinforced by MIC-traps (Middle Income Countries) and MIC-gaps identified specifically in support of the idea of continued assistance in middle-income countries.[14] (The term "middle-income trap" is used to describe the situation where a developing economy convergence comes to a halt once its per capita income reaches a middle-income level. Several analyses from the World Bank provide empirical evidence that the "middle-income trap" exists and that developing countries do get stuck at some low-level equilibrium. To change this situation generally the adjustment of the development model is required.) From another perspective the fundamental reasons of continued assistance of this group of countries include fragility, poverty and global community interests.

The LMIC strategy would be different from the one that targets the least developed countries. I tend to define this policy with the term of "convergence assistance". Convergence means the reduction of internal income and regional disparities and the

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[12] Sumner (2013): p.25.
[13] "Avoiding the middle-income trap is, therefore, a question of how to grow fast enough so as to cross the lower-middle-income segment…. why some countries get stuck in the middle-income trap: the role played by the changing structure of the economy (from low-productivity activities into high-productivity activities), the types of products exported (not all products have the same consequences for growth and development), and the diversification of the economy." (Felipe–Abdon–Kumar 2012: pp. 4-5.)
[14] See for example: Alonso–Glennie–Sumner (2014): pp. 40-41.

elimination of the structural problems of these economies (for example: economic and social disintegration and duality; unfavourable export pattern; the difficulties with upgrading the small and traditional economic sector into modern, competitive economic activities; shortcomings and regional disparities of infrastructure). The key content of convergence assistance regarding lower middle income countries is a double strategy that can manage the two biggest challenges of their development: social inclusion and upgrading (in a broad sense).

The Rationale of "Convergence Assistance"

The notion that "Welfare must be paid by nationally collected money and aid can only be used to jump start a system which thereafter must be self-sufficient" seems to becoming the mainstream approach.[15] The idea is to question the rationale of development assistance in countries that have reached a certain development threshold. The situation in LMICs differs widely in terms of political stability and economic development. As concerns the system of objectives of convergence assistance based on the above review and in order to secure the sustainable convergence in LMICs, the following points may be identified for consideration:

1. *Concentration of poor people*. This problem is similar to those in the least developed countries because the development level of several regions (or city suburbs) is not much different from the ones prevailing in low income countries. The solution to this problem could be particularly difficult to implement in large countries with unfavourable geographical conditions.
2. *Security policy concerns*. These are similar to the concepts that were developed after the millennium and resulted in the significant increase of development assistance especially in war or civil war-torn countries. Despite the not particularly evident success of higher volume of assistance, the support of economic development and the raising of living standards are still justifiable objectives.

[15] See Erik Solheim's presentation at the Seminar hosted by the Swedish Institute, 20th of March 2013 http://www.ui.se/play/#oDY_f0oZsd6y5JNX34EygA

3. *Global collective action problems* (climate change, epidemics, financial instability and conflict).[16] The negative or unexpected developments in these fields can deepen poverty problems. The negative spillover effects such as financial destabilization, outbreaks or environmental contamination that stem from complex globalization are especially dangerous, which can result in severe damage and will require close coordination between donors and recipients.
4. *Ideological causes*. After the relaxation of ideological issues in the wake of the cold war, this question is on the agenda again and one cannot afford to ignore this perspective.[17] It is not possible to avoid the discussion on this topic since there has been a multi-faceted global competition where the interests of advanced countries are widely different from the majority of the rapidly developing emerging countries.[18] These include the attitude towards democracy, the economic system, global influence, foreign policy, the roles played in international organizations[19] etc. The spreading of democratic values has stopped or weakened in many parts of the world and the attractiveness of non-democratic models is increasing.[20]

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[16] In fact there is a two way channel: the most recent financial crisis that swept around the world began in the most advanced countries. In addition, the average level of public indebtedness in middle income countries is lower than in advanced regions. There are also explanations which stress that without the cooperation of donor and recipient countries these problems cannot be solved although it would be in the best interests of both parties.

[17] One perspective relates to human rights, see for example: D'Hollander–Marx–Wouters (2014): p.6.

[18] The importance of this global competition is clearly reflected in the negotiation of the Transatlantic Trade and Investment Partnership (TTIP). See for example: Hamilton (2014). In addition in the field of development assistance "Dynamic middle-income countries such as China, India, Indonesia, Turkey and Brazil are increasingly providing relevant development cooperation services and rapidly expanding their budgets for South-South cooperation, including African nations…India, China and Brazil in particular have recently made it clear that they have no desire to align themselves with the rules and standards that they see as still being defined by the OECD countries." (Klingebiel 2014: p.2.)

[19] Mohamed A. El-Erian: The Fragmentation of Bretton Woods, Project syndicate. August 15, 2014. http://www.project-syndicate.org/commentary/mohamed-a--el-erian-says-that-refusal-to-reform-the-imf-and-the-world-bank-is-making-the-world-more-dangerous

[20] In full agreement with Shafik, I would consider the situation even more challenging. The fragmentation of the development assistance activities in developed world makes the system very costly and provokes smaller than possible impacts on development objectives. The non-coordinated, de-centralized system of development assistance of the developed world makes the leverage of emerging donors much stronger: "Emerging donors will probably continue to blend aid and commercial links…Already many in Africa are attracted to Chinese-style state capitalism…India wants to build a social democracy and welfare state like the Nordic countries but will frame it in terms of universal rights (to work, food, education, and information) given the difficulties of targeting in a nation of over a billion people. Russia will try to spread its economic model to its neighbors using its energy wealth and pipeline network to bind its hinterland together" (Shafik 2011: p.3)

One additional point for analysis relates to the level of dependence on foreign assistance. The dependence on aid at a low level of economic development was very high since it was the only financial source to fund development objectives. Parallel with the steady and high economic growth rates, this dependence has weakened in several countries. The higher development level and the more stable economic structure made it possible to increase the inflow of money from alternative sources (loans, FDI). The expansion of financial channels has devalued the importance of foreign assistance. However, earlier dependence on aid has negative consequences even today in a number of LMICs, because in previous decades foreign assistance was often considered a tool used by donor countries to get access to the domestic market or achieve additional gains for companies in the donor countries guaranteed by the conditions of such assistance. Tied aid, technical assistance and export credits are only just a few of the various forms of assistance from which donor countries had benefited a great deal. Conditionality and the share of tied donor aid were thought to be too high. In the eighties the share of tied aid in total bilateral ODA commitments was between 35-48%. During 1984-2009, tied aid decreased from 41% to 15% (and this form of aid has lost its significance) and total aid increased substantially.[21] Technical assistance was never considered to be real aid since large parts of it were used to finance foreign advisers instead of being used up in the recipient country. The lack of expertise or stable economic and administrative structures in recipient countries capable of managing these funds in an efficient and successful manner partly justified this form of control. But donor countries have always been reluctant to let control out of their hands mostly because of domestic political interests. Whatever reasons underpinned the approach and strategy of the donor countries, the negative perceptions of their attitude are still felt in now middle income countries – which are less dependent on donor aid today than they were several decades ago. Despite the changes that took place after the turn of the millennium, these negative experiences may minimize the acceptance of foreign assistance without sufficient control in the recipient countries.

At the same time there is a clear trend from some of the emerging powers to

[21] According to CRS data (Creditor Reporting System). It is an OECD database containing detailed statistics of individual aid activities.

influence development in middle income countries. The most evident example is China but before its current economic crisis Russia also put an emphasis on this strategy. Although their foreign policy objectives and the instruments they use are but in both countries foreign policy and foreign economic policy objectives are strongly supported by state money and may take the form of development assistance to least developed countries too. This assistance in several cases is coupled with direct investments and loans the consequences of which have to be taken into account when elaborating the new development assistance framework. There is a crowding out effect in a number of countries: instead of applying for aid from advanced countries they tend to look with increasing interest towards aid (and other forms of funding) from emerging markets. Limited or non-existent conditionality of assistance from a number of emerging donor countries further weakens the attractiveness of traditional assistance of DAC members.

If traditional donors are aspiring to maintain their positions in a number of lower middle income countries, they will also need to consider this perspective. Without fundamental changes in the philosophical makeup of assistance, emerging countries will gain strong economic and political positions in a number of smaller lower-middle-income countries. When choosing from among LMICs to be assisted, a country by country approach is advisable since this country group consists of very diverse states in term of their economic strategy, institutional stability and development perspectives. In addition, a previously emphasized principle should also be made reference to. According to the principle, in the case of the most advanced countries the utilization of ODA as a means to gain economic advantages in less developed countries is ethically questionable, but in countries that are in the process of catching up it is much more acceptable due to their lower economic development level. If we apply this previously accepted approach, then advanced countries should follow a completely altruistic or a fundamentally different approach in their donor policies while in the case of middle income donor countries, the objective of earning economic benefits from development assistance seems a justifiable and acceptable strategy.

Dualisation with increasing social stratification

The rapid GDP growth in LMICs (according to World Bank data: per capita GNI in 2000: 586 USD; in 2013: 2068 USD – current USD) coupled with technological development in the communication and information technologies accelerated the increasing income and knowledge polarization in several lower-middle-income countries.[22] Despite the breakneck growth in the past two decades their development path is not at all secure and there are risks that can hinder the continuation of convergence in the future.[23] This fragility that is associated with income differences and knowledge gap within these societies ought to be tackled. This is the next important challenge regarding the sustainable development that would generate real convergence and higher living standards.

As a result lower-middle-income countries face the increasing problem of social and economic dualisation. The internal differentiation and dualisation brought about a situation where large segments of society are not even able to communicate with each other (in a broad sense). The economic and social disintegration develops along three important lines.

1. *Problems similar to those in least developed countries due to exclusion from social, educational and legal economic structures*. The most serious problems are associated with underdeveloped rural or otherwise depressed regions without development perspectives, which generate increasing poverty in regional comparison within the given country.
2. The second problem relates to *unsuccessful adjustment of large segments of the economy to globalization* (international trade, production etc.). It is associated with the difficulties of economic structural change, which increasingly transforms into social problems. The negative perception and implications of international

[22] Between 1950 and 2010 the overall per capita income differences between advanced and developing countries did not decrease, and the gap between the advanced and the poorest countries reached record high levels. See more details on that: Sharma (2012)

[23] In contrast to the conventional belief concerning the economic and financial crisis of 2008, the future of several developing countries today is much less clear. This expectation is supported by economic development experiences as well, according to which it is much easier to reach a medium development level from a very low starting point than to achieve any tangible convergence from the middle-income level. The key problems relate to the middle income trap and the problems with the transition from extensive to intensive growth pattern.

economic integration can be mitigated. And this is an especially important issue in a globalized world where economic crisis could easily threaten macroeconomic stability and thus social stability and the political system. From the 2008 experiences one may draw the conclusion that with globalization advanced countries are creating an immense risk for several emerging countries. Although for some years they seemed to be resistant against the negative trends in the international economic environment, GDP growth has slowed down in the majority of the emerging countries including China, Russia, Turkey or Brazil.

3. *Problems relating to the labour market and employability, difficulties of the young generation*. Demographic trends may threaten economic and social stability because of slower job creation in the face of demographic necessities despite rapid economic expansion. These problems may be further deepened by the risk of the middle income trap in a number of countries.

Concentration and management of development funding in LMICs

A possible solution to these issues could be the concentration of funds available for development purposes in lower-middle-income countries. Concentration of assistance from domestic and foreign sources means the management of the funds by the recipient country.[24] This method also calls for the indirect concentration of development funding from bilateral and multilateral donors, state and non-governmental organizations alike. LMICs are different from LDCs and in most cases they have sufficient capacities to manage donors and multiple channels of assistance in a concentrated way. From the functional perspective, it is really the backbone of the concept: how can the development resources (including aid and subsidized sources) be allocated in lower middle income countries. An additional requirement is to drastically cut high administrative costs that consume large parts of the available funds from advanced countries. Such a system and mechanism may be feasible and efficient in fast growing developing countries where economic sovereignty of the state is guaranteed, state and market systems operate, and a pool of financial resources is available including

[24] The idea of managing all funds by the recipient country – from a different perspective – comes from Pietschmann (2014): p.10.

international aid, supported loans from both domestic and international sources. In countries that have already reached this development phase, an institution that combines the above described features in medium to long term can in principle be the most efficient development policy institution – if the increase of associated costs are avoided and the prudent operation is guaranteed.

It is less and less likely that subnational level of development cooperation could flourish smoothly without strong involvement and control of central governments in recipient countries. First, central governments are becoming the most important players in formulating objectives for development cooperation. The other question concerns government attitude towards NGOs which are important participants in today's development cooperation. Central governments increasingly consider that foreign financing of NGOs is not without foreign political interests and influence.[25] Foreign NGOs are also considered to be the arms of foreign policy. As a result governments are trying to take total control over the NGO sector, an approach that seems to be pursued in a number of countries today. Recent examples include a diverse group of middle income countries such as Russia, Hungary, Egypt, Nicaragua, Bangladesh, China etc. This trend has accelerated in recent years and the circle of countries embarking on this avenue will most probably widen. A similar problem may be observed with respect to subnational authorities, i.e. local governments (which also have lost substantial independence recently in a number of countries).

This trend of centralization and the need for stronger control in LMICs seems to be the *zeitgeist* of our time underpinned by two sets of reason. The first reason is that the continuously strengthening economy in several lower-middle-income countries has expanded the governments' room for manoeuvre in every field including the regulation of the NGO sector along politically motivated lines. The other consideration relates to the perceived successes of countries such as China or Russia in economic management and global political involvement. These countries base their policies strongly on

[25] There is another interesting perspective that may further support this perception. See the article: Eric Lipton, Brooke Wiliams and Nicholas Confessore, Foreign Powers Buy Influence at Think Tanks. September 6, 2014, http://mobile.nytimes.com/2014/09/07/us/politics/foreign-powers-buy-influence-at-think-tanks.html?smprod=nytnow&smid=nytnow-share&_r=2&referrer

centralization too and their economic and political models seem increasingly attractive to several other states aiming to achieve rapid economic convergence (although their development models are of course different). This makes it difficult – or even impossible – to execute development assistance through the NGO-sector or on subnational level in middle income recipient countries. Only in exceptional cases can this channel be efficient or feasible through agreements with the government or special interests towards certain subnational or NGO participants etc.

The issue of coordination and concentration on the part of donors (DAC members) has also attracted much attention in the past decade. This consideration triggered a series of debates and conferences on aid effectiveness and on increasing coordination efforts among donor countries.[26] But in practice not much has been achieved in this respect because of the fear from losing control over assistance by coordinating with other countries. This reluctance is a serious barrier to achieving more efficient utilization of different forms of financial assistance. The unwillingness has been reinforced by the recently growing trend which attaches importance to the diversity of donors and assistance channels.[27] It supports the idea that no further significant coordination or concentration is needed from the donor side. It also has to do with the generally low level of trust both among donors and between donors and recipients. But if the mainstream approach remains unchanged in the case of LMICs, then no bigger impact is expected from traditional assistance. No change – no gain.[28]

Given these circumstances the special concentration of development funds and the institutional system may prove to be a viable solution to the challenges that effective development cooperation faces in select LMICs. Concentration in this instance would mean the setting up of an institution in the recipient country, probably using or

[26] The Paris Declaration and the Accra Agenda for Action led to the adoption of the Code of Conduct on Complementarity and Division of Labor in 2007 at EU level. (Keijzer–Corre 2009: p.92). This document was important from the perspectives of the possible future division of labor between member states as it called them to identify their comparative advantages. Indirectly this meant the more efficient coordination and concentration of their activities regarding development cooperation.

[27] See official documents such as: Mexico High Level Meeting Communiqué Paragraph 10, or scholarly papers for example in Severino-Ray (2010): pp.17. 32. According to these, the problem is not related to the diversity of donors or recipients or the channels, but to incoherence and fragmentation. In practice, however, diversities and incoherence – because of the still existing differences in priorities – can easily generate even more incoherence and inefficiency.

[28] This need for change and the related complexity of problems are summarized for example by: Janus–Klingebiel–Paulo (2014): p. 2.

transforming an already existing organization, which would have to meet the following criteria:

- It is a development bank with concentrated activities;
- It is a transparent development institution that collects all kinds of funds with development purposes whether it is domestic, foreign, grant, subsidized loan or market based resource;
- Its scope of activity is strictly limited to development objectives;
- Operates in a bank-like manner (i.e. uses the evaluation and placement methods of commercial banks);
- Owned by the recipient country with minority donor ownership;
- The return criteria for subsidized loan products is "0" – it does not aim at profits – in order to ensure self-sustainability;
- Grants are channelled using the expertise of the bank and experts involved in fieldwork;
- Mitigates the risks of "shadow" borrowers or extortionate lending practices in the case of the most vulnerable;
- Operates countrywide or on a regional level depending on the country;
- Efficient use of funds is guaranteed by the local management of the banks;[29]
- Uses very strict cost controls through the personal liability of the senior management.

The rationale behind this approach is manifold.

1. *Economic history*. Modern and successful development banking goes back to the Marshall Plan after World War II when development banks in Western Europe were established in order to create market-based, banking-style and self-financing mechanisms to provide subsidized loans for rebuilding and modernizing the economies of Europe. In the first stage of their development, these financial institutions allocated subsidized loans and aid from the USA.

[29] If necessary, local experts should be trained in donor countries with assistance of private sector grants and fellowships. It could ensure that the available convergence assistance would be spent in the recipient country. The training of highly skilled experts (in traditional donor countries or in other MICs) – if necessary – may also strengthen donor and recipient relations.

They participated in the successful implementation of a large scale development assistance program.

2. *The current globalized international environment*. It is increasingly difficult to manage the economy without at least partly liberalized international economic relations that require competitiveness. This institution can be an instrument that is able to support modern, high value added industries based on comparative advantages and traditions of a given country.
3. *The need for economic inclusion.* The main goal is to ensure the creditworthiness of clients, particularly because many of them will be start-up companies, companies with a lack of capital, or come from the informal economy.
4. *The emergence of microfinance institutions in less developed countries*. In recent decades and despite all the criticism, microfinancing has been able to tackle the specific problems of the poor, mitigate the dependence of large segments of the society and contribute to social inclusion by providing the poor with means of economic activity.
5. *Current intentions of several MICs*. Development banking is thought to be an efficient instrument in financing economic development needs with emphasis on social inclusion. A recent example is the New Development Bank established by the BRIC countries. The operation of this institution may serve as a benchmark for the concentration of development assistance in select LMICs.

The benefits relate to the fulfilment of the *basic operational principles of efficient future convergence assistance:*

1. Efficient in terms of low costs – the principle of *cheap administration;*[30]
2. Benefits clearly appear in recipient countries – the principle of *impact;*
3. Resources are not transferred back to the donor countries through technical assistance or restrictive conditions used for that purpose – the principle of *local expertise;*
4. The control of donors is weakened but still evident and local authorities have a much greater role than beforehand. It confirms the engagement of advanced countries towards untied assistance – the principle of *local ownership;*

[30] There should be very strict controls over costs that are unrelated to the needs of recipient development. A possible tool to enforce control could be having managers personally answerable for ensuring prudency.

5. As this institute concentrates as much bilateral assistance as possible, the effectiveness and cooperation of donors and the concentration of funds would also be strengthened – the principle of *cooperation and concentration;*
6. This institution may also be instrumental in establishing indirect relations among donor countries from advanced and emerging countries – the principle of *cooperation between traditional and new donors;*[31]
7. Channelling all kinds of assistance into this institution in a concentrated way would answer to the need of accounting for every fund with development objective[32] – the principle of *more efficient measurement;*

Against this backdrop successful adaptation of development banking models of developing and advanced economies can support the establishment of an economic incentive system based on efficiency requirements (in terms of repayment of loan type assistance with zero profit) coupled with concentration, expertise, the knowledge of the local market and people. Generally speaking, by incorporating the best practices of microfinance institutions from the developing world and those of the institutions with the objective of economic inclusion in advanced countries, a development bank may be a good choice in today's global economy.

The ownership of this concentrated institution is in the hands of local authorities. It does not mean the complete lack of donor control, but that local expertise needs to be used much more extensively to ensure efficient utilization with lower costs. The financial resources of the institution comprise the original registered capital provided by the state, loans from international organizations (multilateral development banks,

[31] It is and idealistic picture because of the aforementioned ideological considerations make this more a reflection of wishful thinking. But in principle this would be an effective platform for this type of relationship. It is a really challenging issue since "... India, China and Brazil in particular have recently made it clear that they have no desire to align themselves with rules and standards that they see as still being defined by the OECD countries." (See: Klingebiel (2014): p. 2.)

[32] "A central concern of the wider measure is then to capture flows that are relevant for development irrespective of direct budgetary effort involved; in particular those mobilized with the help of official interventions, such as less concessional development loans. Moreover, the question needs to be addressed of whether and how to include, count and differentiate, flows that may not have a primary development objective, but are important resources for development, such as private foreign investments." See: ES (2013)67, To DAC Ministers and Heads of Agency Modernizing Development Finance. Paris, 10 January 2014

IFC, World Bank) and international development aid (bilateral and multilateral).[33] Thus the concentration of various international development funds could be achieved.

The increasing role of recipient countries in managing all kinds of funds raises the issue of concentration of bilateral donor activities too. As experiences prove, the coordination of bilateral donor activities is difficult but by doing so their parallel activities and the duplication of administrative costs may be avoided. Donors will put their resources with development purposes into an institution, which operates along programs tailored to the needs of the given country. The programs managed by a sound and efficient institution may be also able to attract co-financing from the private sector (domestic and foreign).

The institution may perform its activities along with five activity blocks that are important for LMICs (different countries or regions may have different needs – that is why this classification of functions may differ from country to country). The allocation of financial resources would be based on locally available efficient systems[34] being either branches of local financial institutions (which also would be involved on a non-profit basis), or other channels (for example post offices, field workers etc.) with the aim of reducing costs. The scopes of activities are as follows:

1. *Aid disbursement.* Aid can still make a significant contribution to the development of LMICs. The management and administration of these funds by a development bank using local field work expertise may be a more efficient instrument compared to other solutions. The possible co-financing with other forms of funding is made easier by using this institution with concentrated functions.
2. *Microfinance* (Using some elements of a grameen-type microcredit[35] and other similar forms). Group lending schemes for population segments with traditional activities in order to attract them into formal market operations, most importantly

[33] It may even be further improved if these firms were listed on the stock exchanges allowing small investors to have ownership, which could also increase the available funds for development purposes. It is a question that can be discussed on a case by case basis, but it probably could offer a solution to the transparency dilemma.

[34] Efficiency here means the capability to reach local clients even in most remote or underdeveloped regions.

[35] Grameen Bank (GB) has reversed conventional banking practice by removing the need for collateral and created a banking system based on mutual trust, accountability, participation and creativity. GB provides credit to the poorest of the poor in rural Bangladesh, without any collateral.

for arts and crafts to satisfy domestic demand, with the integration of women, the poor and those living in backward rural areas especially.

3. *SME development.* The primary objective is to help the development of small and medium sized enterprises and the expansion of the formal private sector by supporting employment. These objectives would be achieved by supporting cooperative enterprises in order to broaden their marketable product structure that is adequate to local conditions and conducive to internal economic integration.
4. *Aid for trade – export financing.* The upgrading of export structure towards higher value added products in manufacturing and in the case of agricultural products as well as the support of products in Fair Trade is also justifiable objectives. A basic objective of this activity is to finance product and geographic diversification of exports. In today's global business environment the integration through the value chains is an important phenomenon,[36] the utilization of which may be an important factor in development.
5. *Infrastructure development.* The promotion of infrastructural development in a broad sense (e.g. transportation, energy sector, water system, health care, disease prevention, education, etc.) of the term would also include the financing of global and regional "public goods". In practice this would mean co-financing of domestic or regional infrastructure projects with the objective of favourable spillover effects.

This structure may also be useful to channel certain funds aiming at emerging countries devoted to various development objectives. This institution ideally may function as a window for all development or convergence financing independently from their origin and nature. By doing so it ensures the full internal economic integration that helps promote faster economic growth and enhances social inclusion and integration by transforming the duality of economic and social structures, which is a precondition for long term economic development and cohesion.

[36] Its objective is a good fit for the Aid for Trade objectives. See more on that in e.g.: WTO (2014): Section IV. On the other hand the integration through trade and the opening up of markets should be very carefully analyzed after the economic crisis of 2008, which exposed the vulnerability of exports. Only those export-oriented countries were able to rebound relatively quickly that were more deeply integrated into the global value chains.

Conclusion

Existing proposals for transforming the system of development assistance and especially in relation to middle income countries are manifold. The idea of cutting assistance to middle income countries gained ground parallel with the questioning of the rationale to use only per capita income as an eligibility criterion for assistance. LMICs have much in common with LDCs but the operation and structure of their domestic economy and politics may be significantly different.

The essay tried to frame a possible instrument and solution that can manage the changing policies toward LMICs. It took into account the strengthening control over NGOs and subnational entities in a number of middle-income countries and also the challenges that the donor activity of some large countries or other states outside the DAC face in shaping the future of development assistance in LMICs. (In view of the non-reliable information about the size of assistance from emerging countries we may presume that their importance may be comparable with the volume of ODA from DAC members).[37] There are a number of reasons that may support intentions to cut assistance from this country group. The arguments for continued but restructured convergence assistance in terms of concentration and efficiency to these countries are at least equally as strong. It is only justifiable though if it meets the basic objectives and principles of an efficient policy in this respect (see: pp.10-12 of the essay).

It is not at all certain that the proposed solution is applicable in each of the lower middle income countries (and particularly LDCs). But it could be a potentially successful instrument if the objective was to achieve sizeable impacts. The execution of pilot projects in select LMCs may be feasible. But first of all the objectives of future development assistance should be answered. If the answer to development assistance to LMICs is affirmative, the proposals in this essay may potentially provide a positive and effective response to the need of clarifying the system of assistance in the countries in question.

[37] Severino-Rey (2010): p. 38.

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