EUROPEAN COMMISSION
Directorate-General for Development and Cooperation — EuropeAid

EUROPEAN EXTERNAL ACTION SERVICE

Subject: Methodology for country allocations: European Development Fund and Development Cooperation Instrument 2014-2020

This note presents the methodology used by the EEAS and the Commission services to allocate to the European Development Fund (EDF) and the Development Cooperation Instrument (DCI) countries the initial resources for bilateral cooperation during the period 2014-2020. The EEAS and the Commission services developed a transparent, clear and equitable methodology that, for the first time, was applied to both EDF and DCI countries.

1. Principles guiding the methodology for country level allocations.

The DCI-EDF methodology has to serve the policy objectives and comply with the criteria of the DCI Regulation, the Cotonou Agreement and Agenda for Change. These specify that the EU should allocate resources according to country needs, capacities, commitments, performance and potential EU impact. The EU must also seek to target its resources where they are needed the most to address poverty reduction and where they can have the greatest impact, including in fragile countries.

Currently, some institutions worldwide are reflecting on new allocation methods that are objective, inclusive and adapted to country specific situations at the same time. It stems from this experience and academic research that an objective and transparent methodology needs to be based to a high degree on a quantitative model that uses a limited number of internationally agreed indicators to achieve the stated policy objectives. However, quantitative indicators cannot capture all the dimensions relevant for decision making on the level of country allocations. The methodology therefore foresees an adjustment based on a qualitative assessment of the country situation and more particularly evolutions in the political/security situation and the absorption capacity as demonstrated by past cooperation with the EU.

Drawing from recent academic research and approaches adopted by other institutions and the comparative analysis of simulations carried out by EEAS and the Commission services, the adopted model builds on work carried out by FERDI[1].

2. Presentation of the methodology

The Commission services and the EEAS have translated the above mentioned principles into a simple model based on the following indicators:

[1] Fondation pour les études et recherches sur le développement international.

- **Population (P)**
  Positively correlated: the higher the population, the larger the allocation
- **Gross National Income per capita (GNI p/c)**, an indicator of need and capacity and a proxy of poverty
  Negatively correlated: the higher the GNI per capita, the lower the allocation
- **Human Asset Index (HAI)**, an indicator of need reflecting the state of human development in a country in close relation with MDGs
  Negatively correlated: the higher the HAI per capita, the lower the allocation
- **Economic Vulnerability Index (EVI)**, an indicator of vulnerability and fragility that measures structural constraints to growth represented by the exposure to and the incidence of exogenous shocks.
  Positively correlated: the higher the vulnerability, the larger the allocation
- **World Governance Indicators (WGI)**, an indicator of commitments, performance and impact that aggregates six dimensions of governance, from accountability to regulatory quality to rule of law
  Positively correlated: the higher the indicator, the larger the allocation
- **Qualitative Adjustment** (QUAL)
  a multiplication factor reflecting elements of criteria that cannot fully be captured through quantitative methods such as commitments, performance, impact, inequality, recent evolutions in country political/security situation and its demonstrated absorption capability.

Country *needs* are reflected in the level of income per capita, the level of human capital and high structural vulnerability. The *capacities* to mobilize other sources of finance (domestic and external) largely depend on the income per capita and the level of human development.

Performance is a complex concept that cannot be fully addressed through purely quantitative indicators. For the initial allocation it is mainly captured through the World Governance Indicator that includes six dimensions of governance (Voice and Accountability; Political Stability and Absence of Violence; Government Effectiveness; Regulatory Quality; Rule of Law; Control of Corruption). In certain cases a qualitative adjustment was applied.

The potential for *EU impact* depends on the quality of policy and governance of the recipient countries, but also on structural vulnerability. As it is the case for performance in certain cases qualitative adjustments were introduced.

A more detailed presentation of the model and indicators is attached in Annex 1.

3. <u>Qualitative adjustments and special cases</u>

Quantitative computation alone cannot capture all the dimensions relevant to decisions on country level allocations. Where necessary and appropriate the methodology therefore allows for adjustments on the basis of a qualitative assessment, reflecting elements such as commitments, performance, impact, inequality, recent evolution in country political/security situation and its demonstrated absorption capacity.

The justifications for an increase/decrease of the allocation to any given country had to be thoroughly assessed. On top of a very limited number of special cases whose allocation could not be calculated through the model, the approach allowed for adjustments, where duly justified, in light of highly sensitive cases (+/- 25%).

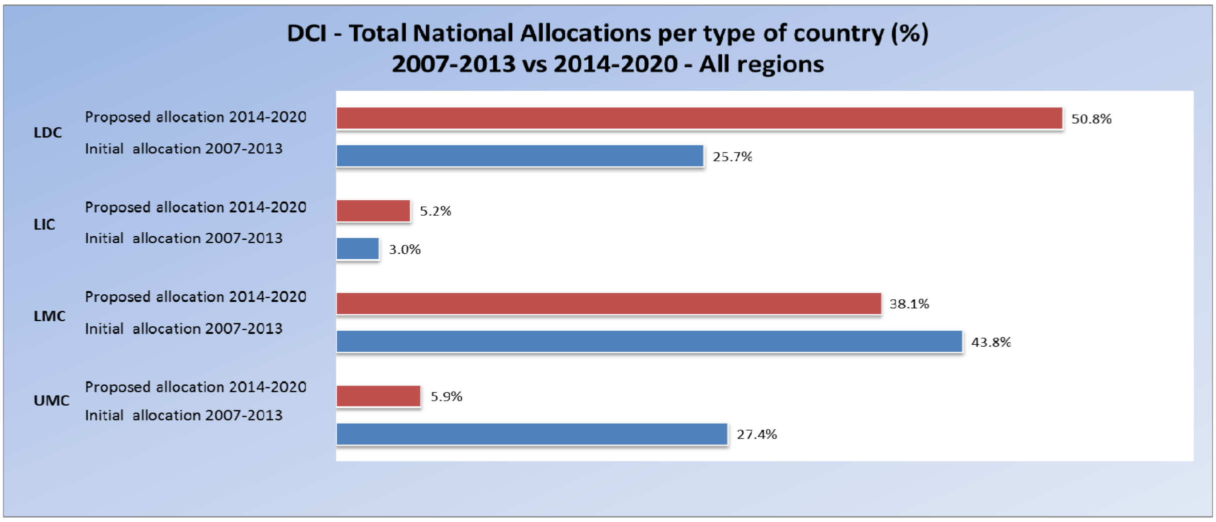
Apart from the special cases the great majority of allocations (74% of DCI and 85% of EDF countries) **followed the results of the quantitative formula or experienced just a minor adjustment (+/-10%)**.

4. Results of the methodology

The application of the methodology is consistent with the objective of **focusing more resources where they are needed most in terms of poverty reduction.**

In the DCI[2] Least Developed (LDC) and other Low Income (LIC) countries almost double their share in the total allocation moving from 28.7% to 56% (Table 1). The share of Upper Middle Income countries (UMC) reduces substantially from 27.4% to 5.9%, representing roughly a 78% decrease. Lower Middle Income Countries (LMC)' share is reduced by almost 13%.

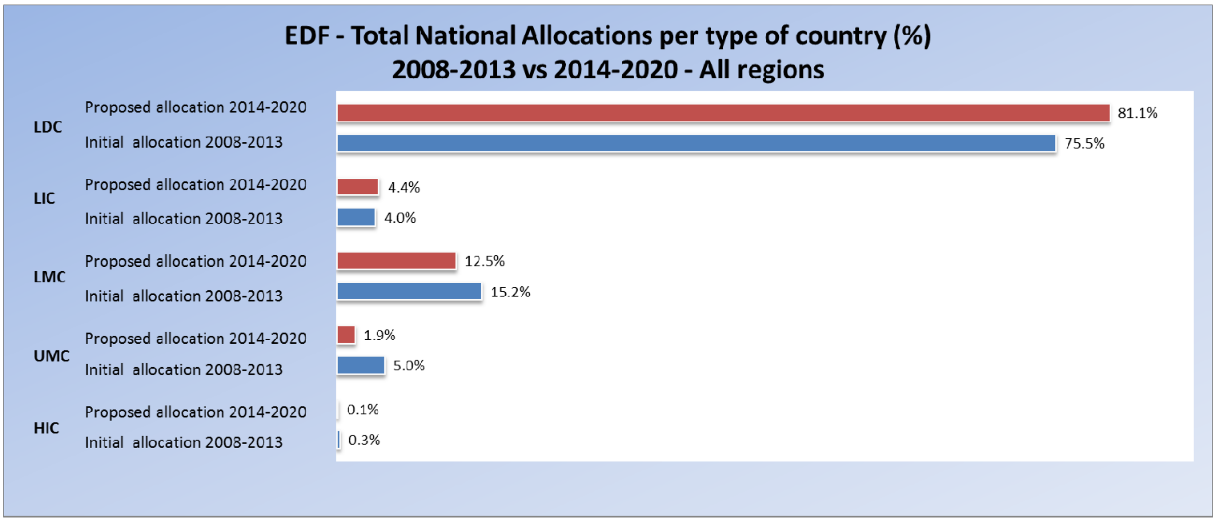
Table 1:



The same tendencies in favour of LDCs and other low income countries can be found under the 11th EDF instrument (Table 2). Their share increases further, notwithstanding it being already high under the previous EDF, reaching now 85.5% (from the previous 79.5%). The share of high income and upper middle income countries shrinks to an overall 2% (from over 5% earlier), while the lower middle income countries' share is reduced to 12.5% (from the previous 15.2%).

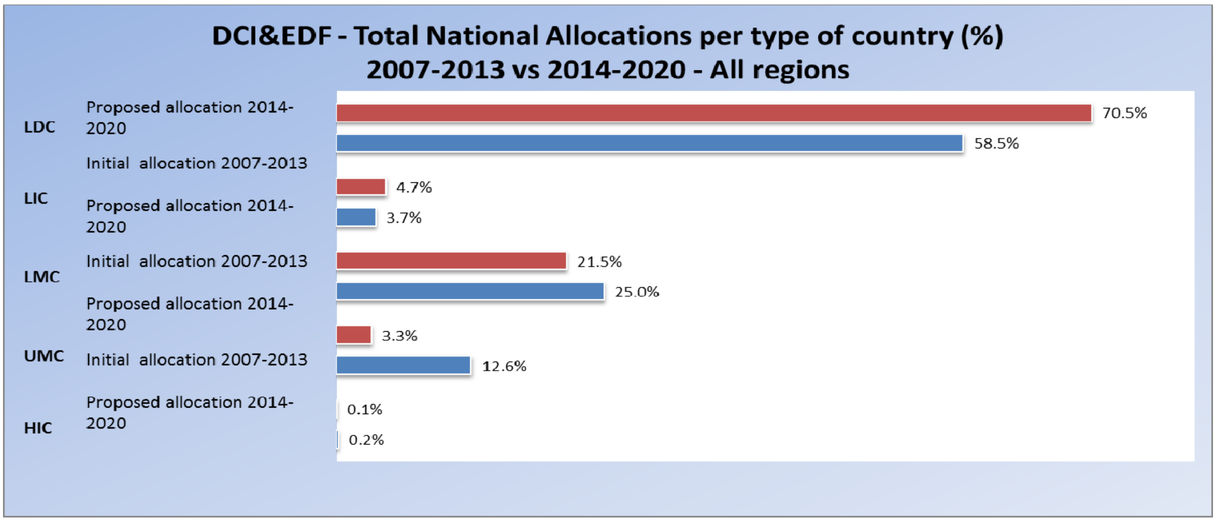
[2] In line with the DCI Regulation, 16 UMC were graduated from bilateral aid. However, in order to reflect the overall change in DCI allocations between the period 2007-2013 and 2014-2020, the data for the former include the allocations provided to the 16 UMC that were graduated. On an exceptional basis, 5 UMC still receive bilateral allocations.

Table 2:



Combining the DCI and EDF instruments (Table 3), it is possible to confirm the substantial increase of LDC and LIC allocations, which move from 62.2% to 75.2%, and the significant reduction of UMC (from 12.6% to 3.3%) and LMC (from 25% to 21.5%).

Table 3:



Annex I: Description of the formula and indicators used in the model

The country allocations are based on a formula using the following elements:

- Population: with a cap at 40MLN and an exponent of 0.5
- GNI p/c with an inverse weight: the higher the value, the richer the country, hence, the lower the allocation.
- HAI with an inverse weight: A high HAI value indicates fewer needs and results in a lower allocation.
- EVI with a positive weight: A high EVI means the country is highly vulnerable and, therefore, its allocation is raised accordingly.
- WGI with a positive weight: A low WGI value implies that the country is underperforming in terms of governance and thus its respective allocation is reduced; conversely, a high WGI will lead to a higher allocation.

The formula therefore reads as follows:

A (Country allocation) = $P^{0.5}$ * Adj-GNI p/c * Adj-HAI * Adj-EVI * Adj-WGI

Here below a brief description of the indicators used in the formula:

Population: a measure based on population; indicates for the "size of a country's needs". Data source: World Bank, 2012 review (http://data.worldbank.org/data-catalog/world-development-indicators).

GNI per capita: a measure of poverty; indicates the "depth of a country's needs". GNI is the sum of value added by all resident producers (i.e. GDP) plus any product taxes (less subsidies) not included in the valuation of output plus net receipts of primary income (compensation of employees and property income) from abroad. Data are in current international dollars.
Data source: WB, 2012 review (http://data.worldbank.org/data-catalog/world-development-indicators).

Human Asset Index (HAI): a measure of the level of human capital development of a country with a close relation to the MDGs. HAI is a composite index created by the UN DESA (used for the identification of LDCs) that includes four equally weighted indicators.

- Percentage of population undernourished (MDG 1.C).
- Mortality rate for children aged five years or under (MDG 4): this is highly correlated with mothers' health (MDG 5.A and 5.B) and access to drinking water (MDG 7c).
- Gross secondary school enrolment ratio: correlated with MDG 2 and a good proxy for youth employment.
- Adult literacy ratio (MDG 2)

Data source: UNDESA HAI 2012 review
(http://www.un.org/en/development/desa/policy/cdp/ldc/ldc_criteria.shtml#hai)

Economic Vulnerability Index (EVI): Economic vulnerability to exogenous shocks is a major structural obstacle to development. The EVI is designed to reflect the risk posed to a country's development by exogenous shocks, the impact of which depends on the magnitude of the shocks and on structural characteristics that determine the extent to which the country would be affected by such shocks (resilience). In this regard, EVI does not take into account vulnerabilities that result from economic policy choices made in the recent past and which are of a conjectural nature. The EVI incorporates eight indicators, which are grouped into two broad areas comprising an exposure index and a shock index:

Exposure Index:

- Population
- Remoteness.
- Merchandise export concentration
- Shares of agriculture, forestry and fisheries in the economy
- Share of population in low elevated coastal areas

Shock Index:

- Victims of natural disasters
- Agricultural instability
- Instability of exports of goods and services

Data source: UNDESA EVI 2012 review (http://www.un.org/en/development/desa/policy/cdp/ldc/ldc_criteria.shtml#evi).

Worldwide Governance Indicators (WGI): The WGI reports aggregate and individual governance indicators for six dimensions of governance (Voice and Accountability; Political Stability and Absence of Violence; Government Effectiveness; Regulatory Quality; Rule of Law; Control of Corruption). The aggregate indicators combine the views of a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. The individual data sources underlying the aggregate indicators are drawn from a diverse variety of survey institutes, think tanks, non-governmental organizations, and international organizations.

Data Source WGI 2011: average of the 6 criteria for the country estimates for 2010 (http://info.worldbank.org/governance/wgi/index.asp)