

DEVELOPMENT COOPERATION WITH MIDDLE-INCOME COUNTRIES

Executive Summary

1. In the last several years the international community has taken important steps to formulate in a more precise and concerted way its commitment to the fight against poverty. Through the Millennium Declaration and the adoption of the Millennium Development Goals, it has been possible to put together a program of basic development targets to which the whole international community is now committed. This achievement has been accompanied by a series of reforms in the development cooperation system aimed at facilitating a better absorption of development assistance on the part of the recipients, better coordination and harmonization of policies on the part of donors, and an effective alignment of those policies with the national development strategies of the recipient countries. The Monterrey Consensus and the Paris Declaration on Aid Effectiveness are both important landmarks in this process.
2. These developments have also been accompanied by a strong emphasis on directing foreign assistance toward the lower-income developing countries, where the levels of poverty are generally las

3. Just as an abrupt divide between recipient countries should not exist, it should also not be there among those who contribute to the development cooperation system. This means that, just as developed countries may be asked to cooperate with the developing efforts of MICs, this last group should also play an increasingly larger role in South-South cooperation, both among themselves and with lower-income developing countries. And this type of cooperation can be promoted and supported by developed countries through “triangular cooperation” modalities.
4. MICs are very heterogeneous in terms of size-South

of external disturbances; financing of local public institutions; financing of new private activities, such as infrastructure; and development financing in domestic currencies. In the same vein, it is necessary that MDBs strive to correct the excessively demanding and complex nature of conditionality, transaction costs which are too high, and their insufficient attention to the characteristics, procedures and specific needs of MICs.

9. Due to its horizontal structure, South-South cooperation has a great potential to generate a sense of ownership on the part of recipients, promote initiatives more relevant to the needs and conditions of the respective countries and further activities which generate a “double dividend”, such as the utilization of technical and institutional capacities of both donors and recipients. South-South cooperation has been manifested in the following three important areas: (i) macroeconomic cooperation, especially through dialogue on economic policies and provision of liquidity in times of crises; (ii) financing for development – through MDBs owned by developing countries and initiatives for the creation of regional bond markets; and (iii) technical cooperation.

Social Cohesion, Democratic Governance and Institutional Development

10. Development processes often generate distributive tensions which need to be channeled through effective and legitimate institutions. It is a two-way relationship: effective institutions are required to promote social harmony, striving to bring income and wealth distribution within the levels considered socially desirable; but, at the same time, the correction of social inequalities fosters the consolidation of the institutional system, increasing its degree of legitimacy.
11. Notwithstanding the diversity of situations and limited knowledge about processes of institutional change, there are several generally agreed principles. Thus, it is recognized that institutional frameworks are highly specific to each context and that there is no universally-optimal institutional design. It is also recognized that it would not be necessary to carry out far-reaching reforms in order to begin an effective process of institutional improvement: it suffices to produce credible –and thus sustainable–enhancements which can change in a positive way the behavior of the various players. Changes will be sustainable to the degree that they generate a reduced number of “losers” and widen with time the number of “beneficiaries”. These principles imply that gradual reforms can help make feasible effective progress in institutional change. In this regard, the building of high-quality public administrations and the fight against corruption play a crucial role in the process of institutional development.
12. Even though the task of institutional change is the responsibility of MICs themselves, international cooperation can provide support to this process through two fundamental channels: the dissemination and exchange of experiences that can be replicated -thus reducing innovation costs- and encouraging arrangements conducive to the empowerment of social groups who cooperate with institutional change and exert pressure to make those institutions more inclusive and accountable.

13. A large number of MICs have had difficulties in making their growth processes compatible with substantial reductions in levels of poverty. However, it is possible to achieve compatibility between growth and equity objectives. Experience shows that redistributive policies do not necessarily reduce market efficiency. Redistributive spending, especially in the education and health sectors, can indeed reduce poverty without hindering the rate of economic growth. One valuable recent experience is the development of transfers to poor families which are made conditional on school attendance and the use of basic health services. Similarly, the history of MICs demonstrates that severe macroeconomic shocks can increase their poverty levels substantially, which highlights the importance of setting up social safety nets in anticipation of possible crises.
14. The need to implement redistributive policies leads MICs to increase social spending, which calls for a broadening of the respective governments' fiscal capacities. International cooperation in these areas can help both from the financial and the technical assistance aspects, to enlarge the provision of social services and contribute to the consolidation of social protection networks.
15. Tax management is also a central aspect in development processes: it affects the economic behavior of individuals and enterprises, defines the capacity of action of the public sector, and provides a framework for the social covenant on which the concept of good citizenship is built. Nonetheless, putting together a fiscal system that combines the characteristics of sufficiency, efficiency, equity, administrative simplicity and flexibility is a great challenge. Notwithstanding the heterogeneity of MICs, there is still room to reform tax systems to enhance, broaden and make them less regressive. International cooperation can be of help in this process, assisting in the design and technical development of tax reforms, in the improvement of statistics, in human resource training and in the strengthening of tax management institutions. Along the same lines, globalization, mobility of capital, and tax competition among countries call for greater international cooperation in areas such as double taxation, tax evasion and fraud.

Financial Stability and Innovation.

16. While the liberalization and deregulation of capital markets and financial innovation have increased the efficiency of international capital markets, they have also increased the risks of instability accompanying rapid capital movements and of widespread contagion of financial crises. The MICs have experienced both sides of this process. Reducing such risks requires a consolidation of macroeconomic fundamentals, creating more space for counter-cyclical policies and strengthening prudential regulation and financial supervision. At present, financial markets are less tight than a decade ago (and MICs and other developing countries are taking precautionary measures in this regard, like

17. A critical problem lies in the different capabilities and lack of continuity in the access to international markets by developing countries. This has a significant impact on the degree of autonomy of economic policies. In the case of MICs, the mix of volatile capital markets and high debt levels compounds the cyclical behavior of their economies. During boom periods, capital markets encourage expansionary policies; during recessions, governments have to emphasize restrictive measures, impacting negatively on investment and growth. Herein lies the importance of adopting counter-cyclical macroeconomic policies.
18. A crucial element for that objective is a degree of flexibility in managing the exchange rate, having in mind that there is no optimal

27. From a financial stand-point, reviving infrastructure investments will require efforts that go beyond fiscal budget possibilities and eventual domestic or international private financing. Official resources –bilateral and (particularly) multilateral- can, therefore, be decisive in this area. This constitutes one of the priority challenges of international cooperation with MICs.

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