



IDA13

IDA, Grants and the Structure of Official Development Assistance

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I. Background

1. Subsequent to the Asian financial crisis there has been considerable debate about the effectiveness of the international financial architecture, including with respect to its ability to provide appropriate financing to emerging market countries. Given the enormous development challenges facing low income countries -- which have been made even more difficult by the impact of the global slowdown and the aftermath of September 11 and the subsequent declines in commodity prices and tourism -- this debate is now being extended to include **official development finance**, which is the most important source of the external financing for these countries. The current IDA13 replenishment discussions, the forthcoming Financing for Development conference and the renewed international attention to levels and priorities of aid are welcome instances of this broadened debate. The IDA13 discussions have reached consensus on a strong basic replenishment of SDR 18.1 billion, or approximately \$23 billion. Differences persist, however, on the appropriate level of IDA grant funding within that envelope. In resolving the range of views which exist on this issue, it may be helpful to view IDA within this broader context of the structure of development finance for low-income countries.

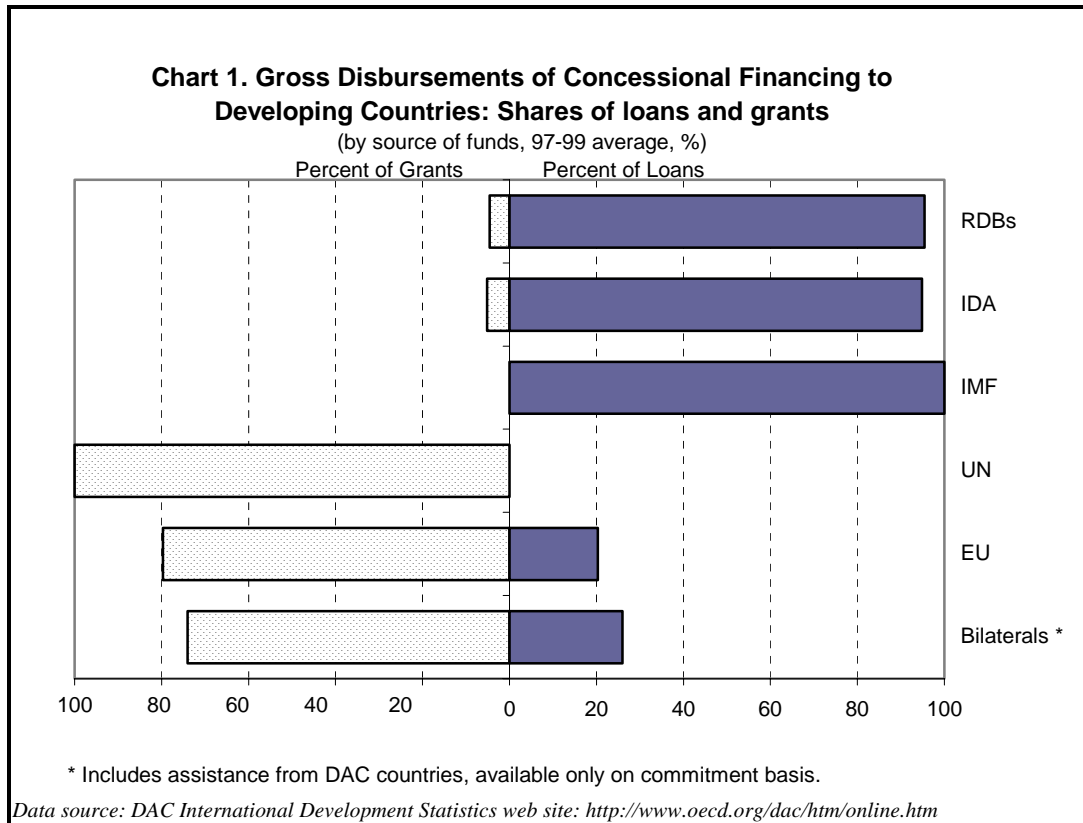
2. The purpose of this note is therefore to outline the components of the development finance system and the roles and financial terms of assistance of the major providers of aid (bilateral donors, the UN, EC, regional banks and the Bretton Woods institutions) within this system.

3. The thrust with respect to IDA can be succinctly stated. The concessional arms of the Bretton Woods institutions play a distinctive role in the development finance system, providing a framework for performance and financial and credit discipline which is important for improving the effectiveness of all aid. The character of IDA, alongside that of the PRGF, as a lender on highly concessional terms, is significant for this purpose, and in encouraging a transition of poor countries towards normal credit status. Within this framework, however, IDA needs to deal with intensified development challenges such as conflict, disease and very basic social investment which require not only innovative operational approaches, but greater flexibility, including a carefully defined ability to provide grant financing.

II. Overall Structure of Development Assistance

4. Most concessional assistance to developing countries is now provided in the form of grants. During the 1997-99 period two-thirds of total concessional assistance was provided as grants. Within the group of multilateral creditors almost half of concessional assistance to all developing countries was provided as grants (see Table 1 and 2). Institutions that provide assistance primarily in the form of grants are the bilateral donors, the UN and the EU, while

institutions that provide assistance primarily in the form of highly concessional loans are the World Bank, IMF and the Regional Development Banks¹.



a) Bilateral Creditors and Donors

5. About three-quarters of bilateral assistance from DAC countries is now being provided in the form of grants (see Table 3) with most bilateral ODA programs at well over 90% grants. Over time the bilateral system (particularly in DAC countries) has moved towards a stronger emphasis on grants, particularly for development projects. Grants have also been the preferred vehicle for specialized and program aid supported by bilaterals (e.g., technical assistance and commodity aid programs).

6. Most bilateral aid is driven by a complex set of historical, political and sometimes commercial motivations alongside broader development and poverty considerations. As a result bilateral assistance to a large extent represents an element of donors' foreign policy, and the allocation of this bilateral assistance is generally seen as less performance-driven than that of the Bretton Woods Institutions and the Regional Development Banks -- a view supported by research into aid and performance (Collier, Dollar).

¹ strictly speaking some would hold that the IMF does not provide "development assistance", but PRGF resources are included in this category.

7. It should be noted, however, that while bilateral donors have shifted over the last two decades to primarily grant funding, they still account for over half of the \$22.6 billion in concessional lending to the developing countries. A few bilateral donors have not moved to a primarily grant-funded program, leaving some potential scope for a further increase in grant funding within the overall bilateral aid envelope.

b) Multilateral Institutions

8. The assistance provided by multilateral development institutions is relatively evenly split between loans and grants. Underlying these aggregate figures is a more complex differentiation of roles and terms of assistance among these institutions. Multilateral creditors can be seen as four separate categories -- the UN, the European Union, the Bretton Woods Institutions, and the other Multilateral Development Banks -- with different roles, development objectives and levels of concessionality (see Table 4).

9. Two of these institutions -- the UN and the EU -- provide almost all of their assistance in the form of grants and account for almost all of the grant funding provided by multilaterals. IDA, the IMF and the Regional Development Banks (RDBs) provide almost all of their assistance in the form of concessional loans, and account for almost all of the concessional lending provided by the multilaterals.

10. Assistance by IDA and the regional development banks combined represented a little more than 13% of total ODA commitments (grants plus loans) to developing countries during 1997-99 but accounted for close to 40% of total concessional lending. IDA plays a particularly crucial financial role for many low-income countries, providing a steady level of assistance to developing countries over time for good performers through both project and program support. In many countries IDA has provided the core of external financing for certain sectors, and hence has played a strong long-term financing role.

The European Union (EU)

11. The EU provides grant assistance to non-EU developing countries primarily through specific regional or country-based protocols reflecting European commitment to a broad range of external affairs priorities, including trade, investment, development, humanitarian, and strategic programs. With regard to low-income countries, the most significant source of grant funding is the European Development Fund, the aid instrument of the Cotonou Convention between EU member states and the ACP countries,^{2/} although recipients in the Balkans, Asia, Latin America, and the FSU also benefit from EU grants. The EU, like the bilaterals, has shifted to grant funding in recent years for its development assistance for the low-income countries.

The United Nations (UN) System

12. The UN system provides grants and technical assistance in specialized areas such as humanitarian assistance, sustainable development, protection of women and children, and immunization programs. UN assistance is delivered through an array of specialized agencies and

^{2/} Africa, Caribbean and Pacific countries.

-- apart from peace-keeping -- tends to be in relatively small amounts and often focussed on technical cooperation and institution building. The UN is often the predominant international organization in providing assistance during a conflict and in the early post-conflict stage.

Regional Multilateral Development Banks (RDBs)

13. There are three main regional development banks that play key roles in promoting the development of countries in their regions. These banks -- the African Development Bank, the Inter American Development Bank, and the Asian Development Bank -- function similarly to the World Bank in that they provide highly concessional assistance to the poorest countries for both project financing and budget support, and include performance-based indicators in their allocation formulas. These creditors often depend on the policy work and programs of the IMF and IDA to create the development framework and performance track records on which to base their country programs. The RDBs work closely with the Bretton Woods Institutions to provide the co-financing needed to support the development goals and policy reform efforts of specific countries.

Distinct Role of the Bretton Woods Institutions

14. The Bretton Woods institutions play a distinct role in the development finance architecture. Shareholder governments tend to look to these two institutions to take the lead in working with developing countries to design and support a policy, institutional and fiduciary framework that promotes broad-based growth and long-term development. Other donors often view this framework as an important foundation for their own development assistance programs and it is also within this framework that regional development banks play an important financing and development-support role. Furthermore, IDA resources are allocated to countries by a robust performance-based system. This framework of performance-based lending, linked to the discipline of IMF programs, is strongly supported by the shareholders of these institutions and is widely recognized by the international and financial community at large. Financial support from the BW institutions -- particularly policy-based/budget support -- has therefore often been seen by other bilateral and multilateral agencies as providing a signal to initiate or expand assistance programs, and, as countries develop, this becomes a signal to private capital markets as well. Hence IDA plays a special role as an instrument for structural and investment climate reform, alongside PRGF programs focusing on changes on the macroeconomic front. Together the Bretton Woods institutions work to establish a framework that stimulates and promotes the effective use of other financial flows.

15. As creditors, an important function of both the Bank/IDA and the Fund/PRGF is to encourage the creation and maintenance of credit discipline. Although IDA and PRGF lending is concessional, it still requires the acceptance of international obligation, the development of fiscal responsibility and a sound credit culture. Clearly, although market access is some way off for most IDA countries, building a track record becomes an important precursor for eventual participation in capital markets and for integration into the global economy on normal terms. In this respect, the Bank's and Fund's role as concessional lenders is a significant factor.

16. In discharging this concessional lending role, IDA has a very good repayment record. For example, over the last ten years (1992-2001), the total amount of expected repayments from IDA borrowers was \$13 billion. Of this total, \$0.6 billion or 4% in payments were overdue from IDA countries in non-accrual status -- a ratio which has been relatively steady over the years. As a result, repayment of IDA credits, as the portfolio has grown and matured, has become an increasingly important source of IDA's lending resources, with repayments now financing over 40% of total IDA lending (the bulk of IDA repayments have come not from current IDA-only countries, but from those which have "graduated" to blend or IBRD status). This self financing aspect of IDA is important to most donors as it reduces the overall demands on donor budgets, and reflects the seriousness with which resources are allocated and recipients view their payment responsibilities. The most important factor to date to affect IDA repayments has been the HIPC Initiative. This Initiative will cut eligible countries' IDA debt service payments by 50% or more for up to 20 years. However, since most IDA borrowers are able to meet their IDA debt service obligations and are not candidates for debt relief under this Initiative, HIPC -- when fully implemented by IDA -- will only involve a reduction of about \$11 billion or about 13% of IDA's total assets.

III. New Development Challenges and the Need for Flexibility

17. Within the broad framework outlined above, there is increasing recognition that many IDA countries (and the development community at large) are confronting new challenges, including promoting development in an environment of conflict, post-conflict and severe social dislocation; addressing the AIDS/HIV epidemic and the rise of other communicable diseases; confronting issues of corruption and supporting improved governance; and redressing long-term social and economic inequities. While most IDA donors have emphasized that it is important that IDA remain primarily a lending institution, it has also been acknowledged that IDA will need greater flexibility, creativity and choice of instruments to address these increasingly complex issues. This flexibility includes an increased capacity to provide selective and focussed grant assistance.

18. Some increase in IDA grant funding would not and should not alter the overall character of IDA, including its role in promoting sound policy performance and providing a signal to other development partners and creditors. Even where provided as grants, IDA assistance should still require strong government commitment, financial management and fiscal responsibility, and grants would be provided as part of an overall envelope of assistance whose size would continue to be based on government performance. Similarly, any IDA grant funding should remain within IDA's overall development framework, and IDA would retain the same focus on performance, growth and equity.

19. IDA management has indicated to IDA Deputies areas where providing assistance on a grant basis would provide valuable flexibility to meet special challenges, while not changing the fundamental nature of IDA. These areas include:

- Interventions for *arresting major social crises* such as disease pandemics, or *dealing with disasters*;

- Areas where there are *large social benefits from long-maturing investments (such as capacity building, basic education, health)*, and where a strong signal effect is needed, especially for disadvantaged or discriminated-against groups;
- Assistance in *post-conflict situations*; and
- Interventions where there are *large regional and global externalities*.

In previous papers for IDA Deputies discussing IDA grants, IDA staff have estimated that the level of grants which might be undertaken to support programs in these areas could total between 10% and 25% of the IDA13 portfolio, depending on absorptive capacity and country performance overall, and specifically in the areas on which grants are focussed.

20. In the discussion of IDA grant funding, two related issues have been raised: does IDA have a role in these areas, and would this substitute for the specialized work of others in these areas. Regarding the issue of IDA's role, it is important to recognize that in many of these areas such as education and health, IDA has been the major source of long term funding -- supporting both specific projects and the development of the policy and institutional framework within which other agencies programs operate. IDA grant funding in these areas would not substitute for the important work of the specialized agencies or bilateral donor programs. Indeed it would be important for IDA to ensure that its involvement in these areas remains complementary to the activities of other agencies.

21. In this context it has also been suggested that IDA grant funding be allocated on a country basis rather than for specific programs, and primarily on the basis of countries' debt sustainability. However, while IDA grants would reduce IDA's exposure to future risks of unsustainable debt, the freed-up fiscal space could enable borrowers to substitute lending from other sources. Furthermore, debt sustainability indicators are strongly affected by commodity prices, and hence IDA grants for a portion of the IDA lending portfolio would not in themselves secure sustainability in the face of adverse commodity price movements. As a result, a general consensus has evolved that IDA grant funding should address specific challenges where lending may not be the most appropriate course, rather than be determined on a country basis. There is clearly room, however, to consider focusing grant assistance primarily on the very poorest IDA countries.

Conclusion

22. The Bretton Woods institutions play a distinctive role in the "architecture" of development financing for low-income countries, in particular in providing a framework of performance and financial discipline within which other aid resources can be deployed more productively. The character of Fund/PRGF and World Bank/IDA as concessional lenders is important in that respect. Added grant flexibility for IDA could, appropriately designed, be a valuable development of this role in order to deal with emerging special development challenges, rather than a change in IDA's basic character and mission. In the view of IDA management,

agreement on a grant capability as indicated above, sharply focussed initially in terms of level and specific problem areas, and subject to careful review going forward, would be a valuable outcome of the IDA13 replenishment.

Table 1. Structure of Concessional Assistance Commitments (1997-99 average)

	Grant Assistance	Non-grant Assistance (\$ millions)	Total
Bilateral	33,026	12,734	45,761
o/w			
DAC Countries	32,981	12,036	45,017
Non-DAC Countries	45	698	743
Multilateral	9,169	9,855	19,024
o/w			
EC	6,508	557	7,066
Other Multilaterals	2,661	9,298	11,958
Total	42,195	22,589	64,785
% of Total	65%	35%	100%

Data source: DAC International Development Statistics web site: <http://www.oecd.org/dac/htm/online.htm>

Table 2. Gross Disbursements of Concessional Financing from Multilaterals to all Developing Countries (1997-1999 average)

	Grants (US\$ millions)	Loans	Share of Grants (in percent)
IDA	305	5,622	5% *
Regional Development Banks	104	2,195	5%
African Development Fund	22	572	4%
Asian Development Fund	3	1,137	0%
Inter American Development Bank	80	486	14%
EC	6,041	1,540	80%
UN Agencies	2,870	-	100%
IMF	-	567	
Other Multilaterals	82	432	16%
Total	9,403	10,355	48%

Data source: World Bank DECPG.

* Entirely consists of HIPC debt relief grants under the original HIPC framework for Uganda and Mozambique.

NB: The statistics in Tables 1 and 2 tend to overstate EU, UN and bilateral flows relative to IDA, since these agencies provide assistance to all developing countries and not just to IDA eligible countries.

Table 3. Grant Share of ODA Provided by DAC Countries
(Commitment basis)

Country	1999	1998
Australia	100%	100%
Canada	100%	100%
Denmark	100%	100%
Ireland	100%	100%
Luxembourg	100%	100%
Netherlands	100%	100%
New Zealand	100%	100%
Switzerland	100%	100%
Sweden	100%	100%
Norway	99%	99%
United States	98%	97%
Greece	98%	N/A
Belgium	97%	97%
Finland	97%	99%
Portugal	96%	88%
United Kingdom	92%	94%
Italy	91%	81%
France	80%	79%
Spain	77%	61%
Germany	75%	80%
Austria	67%	80%
Japan	39%	35%
DAC Countries Total	76%	73%

Data source: DAC International Development Statistics web site: <http://www.oecd.org/dac/htm/online.htm>

Table 4. Composition and Terms of Concessional Lending from Major Multilateral Institutions, 1990-99

	Debt Outstanding				Average Terms of New Commitments in 1999 1/				
	Amount		Share of total		Interest Rate or Service Charge	Maturity	Grace	Grant element using discount rate of 2/	
	1990	1999	1990	1999				10%	CIRRs 3/
	<i>(In billion of US dollars)</i>		<i>(In percent)</i>		<i>(In percent)</i>	<i>(In years)</i>		<i>(In percent)</i>	
Concessional debt	72.5	138.7	100.0	100.0	1.5 4/	25 4/	7 4/	58 4/	54 4/
IDA 5/	44.6	86.7	61.5	62.5	0.75	38	10	80	72
AsDB Soft Window	6.2	16.7	8.6	12.0	2.0	33	9	66	50
AfDF	3.0	7.7	4.1	5.6	0.7	49	10	82	77
IDB Soft Window	3.9	5.8	5.3	4.2	1.9	40	10	71	66
Arab Fund for Economic and Social Development	0.9	4.0	1.3	2.9	4.5	23	8	40	33
International Fund for Agricultural Development	1.6	2.7	2.1	1.9	1.4	36	9	72	68
European Development Fund	1.5	1.6	2.1	1.1	3.6	15	11	45	39
Islamic Development Bank	0.4	0.9	0.5	0.6	2.4	22	6	53	48
OPEC Fund	0.7	0.8	0.9	0.6	1.7	16	6	52	48
Other	6.1	3.1	8.4	2.2	1.7	20	6	50	48
IMF (SAF/ESAF/PRGF/Trust Fund)	3.7	8.9	5.0	6.4	0.5	10	6	52	32
Mean					1.9	27	8	60	53
Median					1.7	23	9	53	48

1/ Weighted by new commitments in reference year.

2/ For the purpose of calculating the grant element, loans are assumed to be repaid in equal semiannual installments of principal, and the grace period is defined as the interval to first repayment minus one payment period, or one semester, in this case.

3/ Commercial interest reference rates. For the World Bank and the main regional development banks (AfDB/AfDF, AsDB and IDB), the CIRR-based discount rate is derived from the average CIRRs in February-August 1999, weighted for the top five currencies in which the outstanding loans are repayable. For the other institutions, average CIRRs in 1999 for either the U.S. dollar, ECU/Euro, or SDR are used. For loans with an original maturity of 15 years or more, CIRRs averaged over the period 1990-99 are used. A margin reflecting longer repayment periods was added (0.75 percentage points for repayment period of less than 15 years, 1.0 percentage points for 15-20 years, 1.15 percentage points for 20-30 years, and 1.25 percentage points for over 30 years).

4/ Excluding IMF.

5/ IDA credits have maturities of 35 and 40 years with a 10-year grace period on repayment of principal. There is no interest charge, but credits do carry a small service charge, currently 0.75 percent on disbursed balances.

Source: "Official Financing for Developing Countries", IMF, 2001, with IMF staff updates.