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FROM: Vice President and Secretary

Focussing IDA Grants on Poor Country Vulnerability

Attached for information is a paper entitled "Focussing IDA Grants on Poor Country Vulnerability" reflecting the Deputies' discussion on grants during IDA13 Replenishment meeting in London on May 1-2, 2002. In accordance with the guidelines for the replenishment documents, this paper will be publicly disclosed.

Questions on this document may be referred to Mr. Lamb (x85522).

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IDA13

**Focussing IDA Grants
on Poor Country Vulnerability**

**International Development Association
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FOCUSSING IDA GRANTS ON POOR COUNTRY VULNERABILITY

1. This note is a revised version of a management presentation on grants discussed by Deputies in London on May 2, 2002. Management undertook in London to do a quick revision and expansion of that presentation to aid Deputies' further reflection and consultation in capitals. This note takes account of Deputies' comments and also refines some of the calculations and ranges presented earlier.

Approach

2. The basic approach set out below focuses the use of grants in IDA on sources of special vulnerability -- conflict, HIV/AIDS, and debt -- each of which particularly constrains the development possibilities and poverty reduction efforts of the poorest countries. The approach combines Deputies' earlier discussion of the use of grants for post-conflict and natural disasters and for HIV/AIDS, and more recent proposals to use grants for very poor countries, especially those which remain vulnerable to unsustainable debt even after completing debt-reduction processes.

3. Within this three-part framework, IDA grant proportions and ranges are estimated to arrive at a potential "global" range for grants in IDA13 of 16-22%. Each of these components could, of course, be differently calibrated in terms of precise coverage and the grant percentages attributed to them. Those presented here are broadly consistent both with projections of likely IDA13 resource use and with recent discussions among donors.

4. For post-conflict countries, the use of grants would be governed by IDA's general framework for post-conflict support, based on a Transitional Support Strategy approved by the Board and performance-based allocations focussed on governance and the rebuilding of basic economic and governmental capacity (see **Adapting IDA's Performance-Based Allocations to Post-Conflict Countries**, IDA13 paper, May 2001). Grants would be front-loaded in the initial period of engagement, and would then be phased down over the three-year span of post-conflict allocations, to average 50% of IDA's support over the period. Further reflection may be needed as to whether exceptional levels of allocation are necessary if a high proportion of assistance to post-conflict countries is being provided as grants.

5. For HIV/AIDS, IDA would provide full grant financing for HIV/AIDS programs in IDA-only countries. To help deal with the threat of rapidly rising levels of the disease in a number of large blend countries, which face a major challenge but have greater capability, it is recommended that 25% of financing for HIV/AIDS programs in these countries should also be on a grant basis. This framework of grant financing for IDA countries would also permit strong support for transnational or regional activities to fight the disease.

6. For the poorest (below \$360 per capita/per annum) and most vulnerable countries, the recommended approach has three basic components, designed to focus on debt-related vulnerability but within a framework of equitable treatment across countries. First, all countries in this poorest group would receive a proportion -- set here at 20% -- of their IDA support in the form of grants. It is expected that such grants would reflect PRSP priorities and be focussed especially on support for health, education and social programs. Second, for countries reaching the HIPC completion points but still facing unsustainable levels of debt, 50% of IDA support would be provided in the form of grants, but only after full use of HIPC remedies, including topping-up.* A similar approach, based on the same indicators, would be used in possible cases of poor countries with unsustainable debt outside the HIPC framework -- but again, only after the completion of available debt-reduction processes, for example through the Paris Club. Third, the same level of grant financing would be available to countries below \$360 p.a. with debt approaching unsustainable levels and with particular vulnerability to adverse trade shifts.

7. Further detail for each of these categories is set out in the Annex below.

Managing an IDA13 Grant Program

8. Introduction of grants in IDA13 will clearly require careful management and implementation. It is useful to set out some basic considerations which should guide the process.

9. First, grants in IDA13 should be allocated on the same principles as IDA overall -- that is, firmly on the basis of country performance as determined by IDA's performance-based allocation framework. Within that performance-based framework, PRSPs should guide priorities for the specific use of grants at country level, and going forward CASs will need to include specific discussion of the role of grants in IDA's business plan for the country.

10. Second, the deployment of IDA grants to help poor countries which are vulnerable to renewed debt problems should complement and support -- but not substitute for -- the HIPC initiative, which is based on international agreement and a framework of equitable creditor burden sharing. In the same vein, IDA grants to support post-conflict countries or to combat HIV/AIDS will need to be carefully aligned with, but not replace, the mandates and resources of other international entities, in these cases respectively United Nations agencies and the Global Fund for AIDS, TB and Malaria.

* A case could be made that the limited number of unsustainable HIPC countries above \$360 p.a. should be included: in this case, the amount devoted to grants would need to rise somewhat.

11. Third, it will be essential to implement any agreed grant program flexibly: Management and the Board will need to make specific grant decisions within the agreed framework, learning by doing during IDA13. Thus, for example, within any overall grant ceiling, grants at the country level would need to be rationed, and some flexibility devised to deal with “boundary” issues at the income cutoff. Deputies should keep this emerging experience under review, including at the mid-term review, to inform judgements about the future shape of grants in IDA14 and beyond.

12. Fourth, it will be important to treat the financial impact of grants transparently, and to ensure that IDA’s long-term financial capacity is protected. The structure of IDA’s concessional assistance means that most of the cost of current grants would be incurred two and three decades from now. Commitments to strengthen IDA’s resources will need to be secured from donors much earlier, however, if IDA is to be protected against out-year losses which would at that point be difficult or impossible to cover.

Attachment

The following describes the three components of the proposed package for IDA13 grants:

1. Grants for 50% of IDA13 Program in Post-Conflict Situations

- ❑ Recent experience has shown that a stronger IDA role in post-conflict situations has positive regional and global, as well as national, benefits, even though such cases are frequently fragile and susceptible to reversals.
- ❑ We propose to expand the scope of post-conflict grant coverage to up to three years for post-conflict countries. On average, about half of IDA’s financial assistance to qualifying countries during IDA13 would be in the form of grants.
- ❑ Grants would also be used on an exceptional basis to assist countries which are affected by natural disasters.
- ❑ The estimated size of post-conflict and natural disaster grants is approximately 4-6 % of the IDA13 program.

Table 1. IDA13 Grants for Post-Conflict and Natural Disaster
(USD Million)

| Current Post-conflict Country | Estimated Exceptional IDA Assistance During the IDA13 Period |
|--|---|
| Congo, DR | 1,300 |
| Afghanistan | 600 |
| Burundi | 247 |
| Sierra Leone | 169 |
| Others (Including Congo Rep, East Timor, Eritrea and Guinea-Bissau) | 300 |
| Total IDA13 Exceptional Allocation for Post-Conflict Countries ^{a/} | 2,616 |
| Average Grant Component (1/2) | 1,308 |
| <i>Estimated Post-Conflict Grants as % in IDA13 Program</i> | <i>5.7%</i> |
| <i>Estimated Natural Disaster Grants as % in IDA13 Program</i> | <i>1.0%</i> |
| <i>Total as % in IDA13 Program</i> | <i>6.7%</i> |
| Range Estimate (Post-conflict and Natural Disaster Grants as % in IDA13 Program) | 4 - 6% |
| <small>a/ <i>Note:</i> While some additional countries (e.g., Angola) may enter this category during IDA13, performance and resource use by post-conflict countries tends to be fragile. These numbers also assume both exceptional allocations <u>and</u> high grant proportions.</small> | |

2. Grants for HIV/AIDS Programs

- Fighting HIV/AIDS is a development challenge that is huge and, despite recent positive funding developments, still so underfunded as to pose a threat of reversal of the most fundamental social and economic advances which poor countries have made.
- To sharpen the focus of grant use, we propose to use 100% grants for HIV/AIDS programs for IDA-only countries, and 25% for blend countries.
- The estimated share of HIV/AIDS grants is 4-5% of the IDA13 program.

Table 2. IDA13 Grants for HIV/AIDS
(USD Million)

| | |
|--|---------------|
| HIV/AIDS Programs in IDA-only Countries with GNI/capita <= \$360 | 700 |
| HIV/AIDS Programs in IDA-only Countries with GNI/capita > \$360 | 300 |
| 25% of HIV/AIDS Programs in Blend Countries | 150 |
| Total HIV/AIDS Grants | 1,150 |
| <i>% in IDA13 Program</i> | <i>5.0%</i> |
| Range Estimate | 4 - 5% |

3. Grants Based on Poverty Level and Debt/Export-Related Vulnerability Criteria

- There is a strong case to be made for some expansion of grants to be focussed on to the countries most vulnerable to renewed debt problems -- countries with low income and dependent on few major export crops, thus highly vulnerable to terms of trade shocks -- especially since IDA is likely to continue as the key element of their external development financing over the long term.
- Within this framework, non-oil exporting IDA countries with GNI/capita at or below \$360 (less than a dollar a day) would constitute the basic group of IDA grant eligible countries, all of which would receive 20% of their IDA13 assistance in grant form. Based on 2000 GNI/capita, 29 IDA countries fall in this group. (Five of them would be eligible for higher levels of grant assistance under the post-conflict component and therefore may not receive grants under this category.)

- Further expansion of IDA grants would be provided to countries in this income category, if HIPC and/or other officially-supported debt-reduction processes (including HIPC topping up where and if needed) still leave them with a particularly precarious situation. In such cases, these countries would receive an additional 30% (i.e., up to 50%) of the assistance in the form of grants after they reach their Completions Points. Specific criteria under which countries would qualify for the additional grants are as follows:
 - HIPC countries with a severe debt sustainability problem, defined as post-Completion Point NPV of debt/export ratios greater than 150, would be eligible for these additional grants.*
 - Non-HIPCs could also qualify for additional grant funding under the debt vulnerability criterion if they had an estimated NPV to export ratio above 150% as estimated by a DSA **and** (i) had 3 years performance under a PRGF and comparable IDA program, (ii) developed a PRSP and had 1 year performance under the PRSP, and (iii) received a Paris Club concessional rescheduling.
 - For countries with a smaller but still fragile debt sustainability problem (for example, NPV of debt/export ratio between 120 and 150), an index of export vulnerability (defined here as “3 main products as % share in exports” > 60%) would provide a further qualifying trigger for additional grants.
 - Based on 2000 data, 13 countries would be expected to meet these tests during the IDA13 period.
- Grants priorities in these countries would be determined on the basis of PRSP and CAS priorities, and are expected to focus primarily on health, basic education, clean water and other social sector programs, whose benefits are of a long-term nature. IDA grants under this category would account for an estimated share of 8-11% in the total IDA13 assistance. The following table shows more detailed data.

* The additional HIPC ratio of debt/fiscal revenue is considered to be an inappropriate measure in this context: since revenue is a variable which is to a significant degree under government control -- unless the fiscal revenue and expenditure structure is such that the terms of trade shocks have a major impact on budgetary performance -- its use as a forward-looking indicator for IDA grants has strong moral hazard problems.

Table 3. Debt Sustainability and Export Vulnerability Parameters of Non-oil Exporting IDA-only Countries with GNI/Capita <= 360

| Country ^{a/} | Poverty | | Debt Sustainability (Stock Indicator) ^{b/} | Export Vulnerability ^{c/} |
|-----------------------|---------|--------------------------|--|--|
| | HIPC | 2000 GNI/Capita (USD) | Post HIPC Completion Point NPV of Debt/Exports without Grants | 3 Main Products as % Share in Exports |
| Zambia | ✓ | 300 | 212% | 56% |
| Uganda | ✓ | 310 | 211% | 51% |
| Malawi | ✓ | 170 | 194% | 83% |
| Ethiopia | ✓ | 100 | 187% | 74% |
| Rwanda | ✓ | 230 | 180% | 85% |
| Gambia, The | ✓ | 330 | 178% | 61% |
| Kyrgyz Republic | | 270 | 169% | 51% |
| Guinea-Bissau | * ✓ | 180 | 166% | 94% |
| Madagascar | ✓ | 260 | 162% | 41% |
| Niger | ✓ | 180 | 160% | 67% |
| Burkina Faso | ✓ | 230 | 150% | 86% |
| Mali | ✓ | 240 | 148% | 74% |
| Tanzania | ✓ | 280 | 143% | 48% |
| Sierra Leone | * ✓ | 130 | 142% | 58% |
| Sao Tome & Principe | ✓ | 290 | 132% | 71% |
| Kenya | ✓ | 360 | 110% ^{d/} | 47% |
| Mozambique | ✓ | 210 | 108% | 48% |
| Ghana | ✓ | 350 | 83% | 61% |
| Burundi | * ✓ | 110 | N/A ^{e/} | 94% |
| Central African Rep. | ✓ | 290 | N/A ^{e/} | 88% |
| Somalia | ✓ | 148 | N/A ^{e/} | 79% |
| Togo | ✓ | 300 | N/A ^{e/} | 70% |
| Myanmar | ✓ | 316 | N/A ^{e/} | 38% |
| Lao PDR | ✓ | 290 | N/A ^{e/} | 25% |
| Tajikistan | | 170 | N/A ^{f/} | 78% |
| Afghanistan | * ✓ | 274 | N/A ^{f/} | 71% |
| Nepal | | 220 | N/A ^{f/} | 55% |
| Cambodia | | 260 | N/A ^{f/} | 54% |
| Eritrea | * ✓ | 170 | N/A ^{f/} | 36% |

a/ Excluding oil-exporting countries (Angola, Chad, Congo DR, Sudan).

b/ Source: World Bank HIPC Unit May 2002 estimates.

c/ Source: UNCTAD-WTO *HS Merchandise Trade Statistics* (2000 data).

d/ Preliminary mission findings.

e/ Unlikely to reach Completion Points before late in the IDA13 period.

f/ Countries with a low probability of an unsustainable NPV debt-to-export ratio

* May receive post-conflict grants. Excluded from the range estimates for net total percentage.

Overall, grants for these three areas are expected to represent between **16% and 22%** of IDA assistance during the IDA13 period. The following table summarizes the estimated shares.

Table 4. Summary: Possible Uses of Grants in IDA13

| | Share in IDA13 Assistance |
|---|---------------------------|
| 1. Grants for Post-Conflict and Natural Disaster | 4 - 6% |
| 2. Grants for HIV/AIDS | 4 - 5% |
| 3. Grants for IDA Only Countries Which Meet the Poverty/Vulnerability Tests ^{a/} | 8 - 11% |
| 4. Total (1+2+3) | 16 - 22% |

^{a/} Focused on health, basic education, water and social protection.