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IDA13

Grants in IDA13

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Acronyms and Abbreviations

CAS	Country Assistance Strategy
CDF	Comprehensive Development Framework
DAC	Development Assistance Committee
DGF	Development Grant Facility
DRC	Democratic Republic of Congo
DSA	Debt Sustainability Analyses
GAHF	Global AIDS and Health Fund
GEF	Global Environmental Facility
HIPC	Heavily Indebted Poor Countries
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immune Deficiency Syndrome
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IDG	International Development Goals
PRSC	Poverty Reduction Strategy Credits
PRSP	Poverty Reduction Strategy Paper
TSS	Transitional Support Strategy
UN	United Nations Organization
UNAIDS	Joint United Nations Program on HIV/AIDS
UNDP	United Nations Development Program
WHO	World Health Organization

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GRANTS IN IDA13

1. Introduction

1. The basic objective of IDA is to help poor countries to reduce poverty by growing faster, more equitably and on a sustainable basis. Most of IDA's client countries will continue for some time to need large amounts of external financing, particularly in the form of concessional loans and grants and, in some circumstances, debt reduction. Increased concessionality is particularly relevant for resource-poor countries requiring large expenditures and investments to achieve their poverty-reduction goals and to reduce the incidence of diseases that erodes their prospects for growth. At the same time, many of these countries remain vulnerable to external shocks, including natural disasters, conflicts, and fluctuating commodity prices. Beyond the purely national frame of reference, IDA may also need to develop instruments to help the international community deal with emerging regional and global issues, in ways which could increase the effectiveness of IDA operations at the country level.

2. IDA provides highly concessional support for poor countries to facilitate their integration to the world economy and international markets. IDA was therefore designed as a transitional instrument of concessional assistance, from which most countries should graduate over time as their incomes rose, and their economic performance enabled them to acquire some access to capital markets.[1] IDA is also predominantly a lending institution, based on a framework embodying performance-based allocation of funds, and the maintenance of high standards of credit discipline and fiduciary responsibility. While performance on these standards varies across countries and over time, credit discipline in IDA is in fact high.[2] Any proposed changes to IDA's terms will need to be guided by these basic principles that have served the institution well: IDA should remain primarily a credit institution; its resources should be focused mainly on countries that are both poor and non-creditworthy or marginally creditworthy; IDA should allocate its resources on the basis of performance; and IDA should maintain high fiduciary and operational standards, irrespective of what its terms are.

3. Against this background, this paper focuses on the possible expansion of IDA grants, as requested by IDA Deputies, following their discussion of *IDA Eligibility, Terms, and Graduation Policies-Discussion Paper* in Paris in March 2001, and the second IDA13 Replenishment meeting in Addis Ababa in June 2001. The Paper deals with IDA grants at two levels: grants in country allocations, including post-conflict grants, and grants for regional and global purposes. It presents some principles which could underpin an expansion of IDA's existing grant authority; provides an overview of possible operational modalities and risks associated with increased use of grants; assesses the impact of different grant ratios on IDA's finances; and finally, poses some issues for discussion. This is intended to provide a reasonable basis for discussion and decisions about grants, while recognizing both that there is a wide diversity of views on the subject, and that there can be no analytically rigorous answer about the appropriate pricing of assistance

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[1] Over the last four decades, 29 countries have graduated from IDA.

[2] Over the past 10 years, overdue debt service payments in IDA have amounted to less than 5 percent of the total debt service payments received. During the IDA12 period, approximately 40 percent of IDA's lending commitments are financed by IDA's internal resources, mostly reflows.

across all aspects of IDA's activities. Decisions will need to be informed by a large degree of pragmatism, in terms of impact on the ground, interaction with and roles of other development assistance partners, and -- not least -- implications for IDA's capacity and finances. With these considerations in mind, the paper seeks guidance from Deputies as the basis for operational guidelines for the use of grants in IDA13.

2. Grants at the Country Level

4. ***Grants, Lending and Debt Sustainability.*** IDA's highly concessional financial assistance to poor countries helps bridge the gap between grant aid and non-concessional forms of aid. Together with the instruments of the International Monetary Fund (IMF), IDA resources and programs provide a framework of financial discipline and economic performance within which other flows, especially from donors on a grant basis, can be most productive. Within that framework, IDA credits support basic investments in structural reform, physical and human capital which are intended to generate economic growth well in excess of their cost of funds.

5. While this framework has worked reasonably well for a long time, the necessity for the HIPC initiative demonstrates that its operating assumptions are vulnerable to the circumstances of conflict, poor policies and governance, economic inflexibility and unfavorable external conditions which have beset many poor countries. Debt reduction has therefore needed to be added to the range of assistance instruments for IDA countries. The enhanced HIPC initiative is intended to reduce eligible countries' debt stocks to manageable levels. It is expected to bring the average debt-to-exports ratio for the 22 HIPCs that have reached their decision points from 260 percent in 1999 to 126 percent in 2003, well below the empirical threshold of 200 percent that triggered the debt problem in the past. It is rather unlikely that additional lending on standard IDA terms -- with over 60 percent grant element[3] -- could of itself cause a recurrence of unmanageable debt levels, unless the rates of return on future IDA projects are dismally low, and countries do little to address the fundamental causes within their control which triggered the debt buildup in the first place. IDA's long grace period and extended maturities mean that debt service on new post-HIPC IDA credits cannot be a problematic component of future debt obligations for a long time -- and is, in fact, virtually zero for a decade.

6. At the same time, *The Challenge of Maintaining Long-Term External Debt Sustainability*[4] underscores the high sensitivity of some HIPCs' forward-looking scenarios to changes in economic and export growth projections. This situation is not very different in some low-income countries not currently classified as HIPCs. Debt sustainability is likely to become an issue, even if countries follow the right policies, in cases where: (a) there is a disconnect between the structure (repayment schedule) of debt and the country's profile of economic and export growth; (b) external assistance, other than IDA, is not forthcoming in sufficient quantities

[3] IDA's concessionality depends, of course, on the discount rate used. If instead of the Commercial Interest Reference Rate of 6.3 percent (the average 2000 rate for SDR), DAC's discount rate of 10 percent is used, IDA's grant element would be 80 percent.

[4] *The Challenge of Maintaining Long-Term External Debt Sustainability*, IDA/SecM2001-0204, March 20, 2001.

and with sufficiently high concessionality;[5] and (c) countries are borrowing for activities that do little to increase growth and debt servicing capacity (see para. 8). While a country's susceptibility to external shocks also has important implications for its repayment capacity, this is not *a priori* a reason to link IDA grant eligibility to future debt sustainability, which should be handled by the mechanisms already provided in the HIPC process itself. The current HIPC framework allows, in exceptional cases, for the consideration of additional assistance at the completion point, if a broad assessment of a country's debt sustainability shows that exogenous factors have caused a fundamental change in a country's economic circumstances.

7. ***Criteria for IDA Grants***. Putting aside debt sustainability *per se*, a case for IDA grants should be based on some clear but practical guiding principles. These principles, set out below -- and further discussed in the paper -- cover a number of areas where IDA could provide grants in a way that supports its activities as a development lending institution, in the context of the interventions of all partners (particularly large grant providers such as bilateral donors, the EU, and the UN system), and its own comparative advantage:

- When interventions are for *arresting major social crises* or *dealing with disasters*;
- When there are *large social benefits from long-maturing investments*, and where a strong signal effect is needed;
- In *post-conflict situations*;
- As a means of *increasing IDA's concessionality* to the poorest countries; and
- When there are *large regional and global externalities*.

8. ***Arresting a Social Crisis or Repairing a Major Damage.*** There are many low-income countries facing potentially catastrophic events or trends which pose a critical threat to their growth, and in some cases to the entire social fabric. The most obvious examples are the rapid spread of communicable diseases, severe environmental degradation, and devastating damage from natural disasters. In these situations, a major part of IDA's assistance needs to be directed to arrest calamitous deterioration rather than to foster growth and rising incomes. The result of concessional borrowing by a poor country to mitigate the damage resulting from a major natural disaster, or to stop further economic and social deterioration because of communicable disease epidemics, would be the avoidance of further costs, rather than a contribution to economic growth and increased debt servicing capacity. In such cases, even regular IDA terms may not be concessional enough, and may unduly contribute to a country's debt burden, even though the economic returns to such activities are, in a technical sense, high.

9. An Africa Region study[6] shows how the AIDS epidemic could have a substantial impact on macroeconomic performance: economy-wide simulations for South Africa, for example, show that the country's GDP will be noticeably lower, even within the space of a decade, at high

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[5] The debt sustainability analyses (DSAs) of 22 HIPC countries show that the grant element of new financing should on average be 58 percent for these countries to achieve sustainability, i.e., an average level of concessionality that is less than IDA's.

[6] C. Arndt and J. Lewis, the *Macro Implications of HIV/AIDS in South Africa: A preliminary Assessment*, Africa Region Working Paper Series, Number 9, November 2000.

rates of AIDS infection, compared to the counter-factual. This deterioration in economic growth -- which could be even more pronounced in poorer and resource deprived countries affected by AIDS -- is primarily attributable to slower growth in total factor productivity, and the shift in government current spending towards health expenses (which increases the budget deficit and reduces total investment). If the epidemic has a long duration, these negative effects, in any given country, would be amplified over time. Recourse to IDA grants would have the advantage of providing a powerful incentive for countries to prepare strong programs but not contribute to their debt problems. Moreover, interventions in this area can have large regional and global externalities as further discussed in paras. 28-32.

10. In fact, IDA has stepped up its efforts to help countries fight *communicable diseases*, with HIV/AIDS in the forefront. During IDA12, to date, over half of commitments in the Health, Nutrition and Population sectors have been for communicable diseases, in particular for HIV/AIDS. On the basis of current expansion and future estimates of IDA financing of disease-related programs, IDA could allocate up to $3 billion in grants to help eradicate communicable diseases over the IDA13 period. (The actual implementation could, however, be constrained by countries' limited absorptive capacity.) IDA's comparative advantage in this area lies in the operational linkage of its disease effort to support for the broader strengthening of national health systems, without which no sustained war can be waged against epidemics. In full collaboration with the UNAIDS Secretariat, IDA is treating HIV/AIDS as a multisectoral development issue, and giving it top priority in development policy, dialogue with all sectors of government, planning, analysis and its operations. IDA is in a better position than most other agencies in its ability to adopt such a multisectoral approach. Past HIV/AIDS programs have typically been coordinated and supported by health ministries which seldom had the authority or experience to coordinate various stakeholders in different sectors needed for effective prevention, care and treatment. IDA brings to communicable disease issue the much needed visibility, priority and coordination capacity at the country level, as well as its ability to support large scaling up of effective programs (also see para. 32).

11. Another role for IDA grants in this category could be in mitigating the effects of a spectrum of *severe natural disasters*, ranging from catastrophic events such as floods or earthquakes to severe and prolonged droughts. Providing grant resources in these areas would slow the buildup of unplanned debt for emergency economic stabilization and reconstruction in the wake of disasters, and help offset the large losses in productive capacity which these events entail. The extent to which grants would be provided should be decided on a country by country basis, depending on the poverty level of the country and the severity of the disaster. In the past, emergency assistance has been provided through IDA credits, and this approach would be expected to continue in IDA13. However, in cases where the disaster is extraordinarily grave, a careful use of grants could be considered in the context of a concerted donor relief effort. Recent examples of disasters on this scale include severe floods in Mozambique, and the impact on Central American countries of Hurricane Mitch. In both those cases, the international community, as a practical matter, dealt with the emergencies through special ad hoc debt relief. While it is obviously impossible to estimate IDA's financing for recovery from extreme disasters that will be faced by borrowers during IDA13, it would be reasonable to assume that the majority of these needs would be met through regular IDA credits, and only in the case of severe shocks to the most vulnerable and poorest countries that IDA would need to resort to grants.

12. ***Large Social Benefits from Long-Maturing Investments***. An important focus for IDA is investment in human development. About 10 percent of IDA resources are allocated to education, almost all of which is directed to basic primary education. In general, the individual benefits associated with investing in education are high, and in normal circumstances the social benefits to education are even higher, taking into account not only rises in productivity and income, but also other benefits such as health improvements (maternal and child health, protection against HIV/AIDS, etc.), civic participation, good governance, crime reduction and other factors. It is now widely accepted that building human capacity increases productivity, generates high economic returns as well as private benefits, and is fundamental to the progress of poor countries. At the same time, while many benefits from rising educational levels occur quite quickly, these investments generate a significant part of their benefits only over the long term, and also yield increases in revenue only indirectly and often slowly. Governments in poor countries can therefore face fiscal disincentives to borrow to take on such vital but long-maturing human investment, especially in the case of potential beneficiaries who lack significant voice and political leverage. Education of the poor is the most important case in this category. In addition, in slow growth environments -- characteristic of many African countries in past decades -- the rates of return on education projects are more difficult to realize: a growing number of school graduates with no employment opportunities is indicative in that regard. Also, as "brain and labor drain" increases worldwide, education's benefits spill over national borders with uncertain returns to the country.

13. These factors do not argue for general grant financing even for all primary education in IDA countries, but for consideration of a more targeted approach. IDA grants should be focused on interventions to increase access to school and improve the learning outcomes of groups who are disadvantaged because of extreme poverty, gender considerations, and/or fragile post-conflict situations. Such interventions could focus, in particular, on girls, poor children in rural areas, indigenous children, AIDS orphans, child soldiers and displaced children. In these cases, grants would help increase the social and economic opportunities for these underprivileged groups who otherwise would have no access to basic education.

14. The deployment of IDA grants needs to be weighed in the context of grant resources available from other donors and partners. Many bilateral donors support education in their aid programs, primarily through grants, and it would be important to ensure coordination among the various donors in the provision of educational resources to each country. IDA interventions focused on the priorities noted above -- girls, poor children in rural areas, indigenous people, AIDS orphans and displaced children -- would build on IDA's strengths, and could form the framework for IDA grants for education where a strong signal effect is needed. Through the analysis underlying the PRSP process, including poverty maps and public expenditure reviews, IDA will be better equipped to focus grant assistance on areas of highest priority from a poverty standpoint. Given strong programs along these lines, it would be possible for IDA to allocate up to half of its support for education, or about $1 billion, for this purpose during IDA13.

15. ***Post-Conflict Situations***. In 1999, IDA donors authorized the limited use of grant financing to support recovery efforts during the pre-arrears clearance phase in IDA-eligible *post-conflict countries* with large and protracted arrears, recognizing that in such cases lending would not be appropriate. These post-conflict grants are intended to enhance IDA's ability to contribute to the international support effort for heavily indebted low income post-conflict

countries, throughout all phases of their recovery. The conditions for access to IDA's existing post-conflict grant facility include the following: (a) the recipient is taking convincing steps towards social and economic recovery; (b) arrears to IBRD and/or IDA are large and protracted, (c) a concerted international assistance effort is underway; (d) all creditors have agreed not to make net withdrawals of financial resources from the country; and (e) alternative sources of financing for post-conflict recovery are inadequate or only available on inappropriate terms. The Democratic Republic of Congo (DRC) is the first such country to make sufficient progress towards peace to warrant the use of this grant instrument. A proposed operation to be supported by a $50 million IDA post-conflict grant was approved by the Board on July 26, 2001, along with a framework for post-conflict grants.[7]

16. The recent Development Committee paper[8] on post-conflict countries also broached the idea of a modest expansion of this approach to provide initial capacity building to re-establish core functions of governance and economic management. Under this approach, IDA post-conflict grants -- in small amounts, of less than $10 million -- could also be used to help restore severely damaged key public functions more quickly. Owing to limited fungibility of these funds, a smaller set of preconditions could be required in these instances. The justification for these grants would be set out in Transitional Support Strategy (TSS) papers, and operations would be processed according to standard Bank procedures. This would make it possible to respond more rapidly to post-conflict situations at a time when such assistance is needed the most.

17. IDA's comparative advantage vis-à-vis other donors in the area of early post conflict support is being clarified through current practice in IDA12. In general, other donors typically look to Bank and Fund for assurance on the economic framework for recovery, and to the Bank for leadership in resource mobilization. The availability of early financial support, even before arrears issues are resolved, can be an important component of the normalization process. At the same time, in several cases thus far, arrears concerns have been resolved quickly, and IDA has been able to move forward with regular credits. Thus post-conflict grants are, in practice, being used as an instrument of last resort in limited amounts. We expect this *modus operandi* to continue.

18. A special case for post-conflict grants would be for assistance in territories that, because of prior conflict, are currently being administered by the UN on an interim basis and which cannot be IDA borrowers because they are not, or not yet, sovereign states. In these instances, a strong case can be made for IDA to provide small amount of grants for a limited period of time, until the legal status and long-term prospects for the territory are resolved. In the past, financing for such instances (e.g., East Timor, Kosovo) has been handled through special allocation of IBRD net income. However, in the context of the difficult prospects for IBRD net income, the Bank's flexibility to finance recovery programs may be severely limited, and case-by-case access to IDA grants is worthy of consideration. By their nature, it is very hard to quantify the potential uses of grants for post-conflict purposes in IDA13. Grants in current arrears cases are unlikely to exceed $50-100 million, while quick-response capacity-building in the wake of conflict could account for a comparable sum. Together with limited funding for special cases of

[7] "Emergency Early Recovery Project for the Democratic Republic of Congo", July 26, 2001.

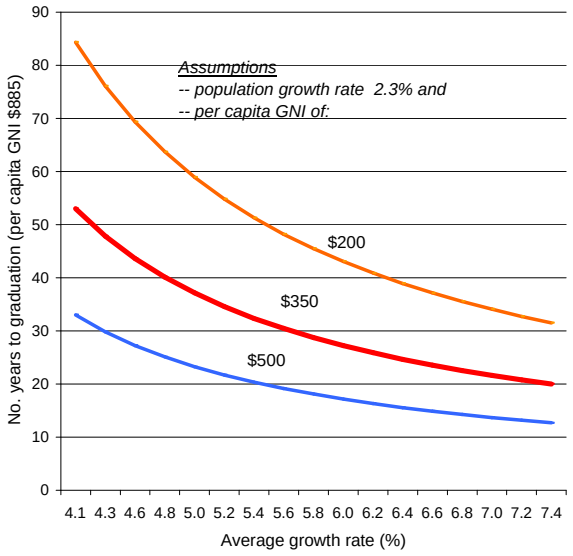
[8] *Assistance to Post-Conflict Countries and the HIPC Framework*, DC2001-0014, April 20, 2001.

UN-administered territories, an indicative total of $200 million seems plausible, although such judgements must always be susceptible to changes in circumstances of domestic and international conflict.

19. The analysis above argues for a cautious extension of IDA's grant capability for certain specific purposes, in practice, focused on projects for well-defined investments and beneficiaries. Important issues remain about relating grants to overall poverty levels, and to broader poverty reduction programs.

20. ***Increasing IDA's Concessionality to the Poorest Countries***. The need to increase IDA's concessionality can also be viewed in the context of countries' continued poverty and limited prospects for graduation from IDA. The recent growth performance of the poorest IDA countries -- the 32 countries at the lowest end of IDA eligibility -- has been disappointing, with periods of growth too often followed by setbacks. In the 1990s, growth was more than 4.4 percent in only six of these countries. At the other end of the spectrum, seven countries experienced negative or no growth at all. As Chart 1 below shows, it would take growth rates well above recent performance for low-income IDA countries to graduate from IDA within a generation. These countries are particularly vulnerable to the ravages of armed conflicts and the toll of natural disasters and epidemics, especially HIV/AIDS. These adverse shocks to their populations and economies require relatively large expenditure to prevent bad situations from getting worse, thereby crowding out the productivity-increasing investments that these countries need to make in order to grow.

Chart 1: Growth and Graduation from IDA



65 IDA-only countries growth performance in 1990-99:
mean: 2.3% p.a., median 3.1% p.a.

21. In this light, using grants to increase the level of concessionality of IDA's assistance to the poorest borrowers could also be explored. Consideration could be given, for example to concentrating a significant proportion of IDA's grant resources on the poorest countries, with a progressively smaller proportion in countries with higher per capita income. It would be

important to note, however, that if large amounts of grants are provided to a country, it may be also necessary to allow the use of grants to be used against a broader range of criteria than those set out above, to avoid undue sectoral or functional biases in country lending programs. This 'broadband' approach therefore could compromise the framework set out above, which justifies the use of IDA grants only on the basis of defined principles.

22. ***Supporting Broader Sectoral Approaches and PRSCs***. The principles outlined above (paras. 7-18) would thus limit IDA grants to communicable diseases, post-conflict situations, large natural disasters, and the basic educational needs of underprivileged populations. In many cases, however, a broader approach of institution building/strengthening in the health and education sectors, may be needed. This is particularly important for improving overall service delivery in these sectors, which would impact on the efficiency with which the fight against communicable diseases is pursued, and education services are delivered to the poor. Moreover, in small countries or in countries where IDA has adopted a sector-wide approach, unbundling an HIV/AIDS project from a health sector operation may not be a sensible option. Also, in the case of the poorest IDA countries -- for example, with per capita incomes equal to or less than $350 -- that implement strong poverty reduction strategies assisted by PRSCs (Poverty Reduction Strategy Credits), consideration might be given to using limited IDA grants in support of these PRSCs. In such cases, some flexibility may be warranted in the use of IDA grants.

23. The use of IDA grants for capacity building and institutional development in general is not recommended, however. There are substantial grant resources to respond to countries' capacity-building and technical assistance needs available from bilateral and multilateral donor sources, UN institutions such as UNDP, Trust Funds managed by the Bank, and other sources. UNDP, in particular, has traditionally assumed a leading role within the multilateral framework as a provider of grant-based capacity-building and institutional development services, and there is no reason for IDA to duplicate that role. Maintaining most of IDA's capacity-building operations in the form of highly concessional credits rather than grants would therefore be consistent with that division of labor, and would help keep the focus and selectivity of these interventions, and maintain borrower's close scrutiny and ownership.

3. Grants for Global and Regional Purposes

24. ***Global and Regional Externalities***. The World Bank's role in responding to the growing need to provide global public goods was discussed at the Development Committee in September 2000 and reviewed again in April 2001. Global public goods are commodities, resources, services, and systems of rules or policy regimes with substantial cross-border externalities that are important for development and poverty-reduction, and that can be produced in sufficient supply only through cooperation and collective action by developed and developing countries. Ministers discussed Bank involvement in the provision of global public goods and endorsed the following criteria for Bank action:

- There should be clear value added to the Bank's development objectives at the country level, as expressed by the International Development Goals (IDGs) for poverty reduction.

- Global action should be an international complement to the CDF approach at the country level. The needs and priorities of developing countries should be a primary consideration in the selection of global priorities for Bank action. Global action by the Bank should catalyze other resources and build collaborative partnerships at the country, regional and global level.

- Bank action should play to its dynamic comparative advantage -- primarily its operational experience and instruments at the country level, but also its global reach and its ability to mobilize and manage large financial and knowledge resources.

- There should be an emerging consensus in the international community that global action is required, or a base from which Bank leadership can muster sufficient support for collective action from key development partners.

25. Ministers also pointed to five broad areas as particularly important near-term priorities for Bank engagement in global collective action: communicable disease, environmental commons, economic governance and financial stability, trade integration, and the knowledge revolution. Clearly, collective action is important -- it is generally agreed that the provision of global public goods is beyond the capacity of any one institution, and requires the formation of partnerships or coalitions among institutions with complementary mandates and capabilities.

26. IDA grants for global/regional goods should not replace the role of existing mechanisms, such as the Bank's DGF, [9] which have provided a track record of effective collective action through grant funding (although relatively small), or the work of other donors. Specifically, IDA support for global public goods should complement, not compete with, the efforts of other partners, notably UN agencies, other international organizations, and bilateral donors. This complementarity should be based on the functions and comparative advantage of each institution, and not necessarily on the terms on which their resources are made available.

27. Within the broadly endorsed menu of Bank action on global public goods, the most urgent area requiring grant-based action by IDA is the control and eradication of communicable diseases, as discussed in paras. 8-10 above. In other areas, the case for IDA grant intervention is less clear. While a case can also be made for IDA grants for trade integration, especially when poor countries seek help in establishing regional approaches to uneconomic domestic market structures or need to build capacity to engage in global trade relations, the funding needs in this area are to be relatively small, and could be financed by innovative uses of IDA credits, or the DGF. An enhanced DGF grant program more carefully targeted at regional organizations may be needed.[10] As for environmental commons, the Global Environmental Facility (GEF) is already active in this domain. In the case of global economic governance and financial stability

[9] The DGF promotes partnerships and provides grants for global and regional programs external to the Bank and is funded as a special program through the Bank's administrative budget. In FY02 it will provide $176.9 million to 47 programs supporting a wide range of global and regional programs. For health, DGF will provide about $25 million, of which about $16 million is for communicable disease programs.

[10] A case on these lines is made in *Regional Integration Assistance for West Africa*, Memorandum of the President, Report No. 22520-AFR, July 11, 2001.

of global markets, to date the poorest countries have had limited practical involvement, and hence there does not appear as yet to be a major role for IDA.

28. ***Combating Communicable Diseases***. Communicable diseases are the main cause of death of children worldwide and a top killer of adults in the developing world. These diseases account for almost 80 percent of the mortality gap between rich and poor countries. As noted above, action against communicable diseases would be a priority to be addressed by IDA, preferably through grants because of large global and regional externalities, weak incentives for the countries to borrow, and market failure. The use of IDA grants in this area would be complementary to IDA's continuing focus on investment in basic health systems within country programs, financed by credits or grants going forward. The case for grants should be made on the basis of two factors: (i) need for collective action at the regional/global level; and (ii) weak incentives for individual countries to borrow. The factors are further discussed below.

29. *Need for Collective Action at the Regional/Global Level:* Various studies estimate that the annual cost of scaling up HIV/AIDS interventions (including a relatively small coverage of antiretroviral treatment) for low income countries would range between $5 billion to $7 billion, depending on the scale of new investments needed in health systems. The funding gap is especially large in the poorest and hardest hit countries. In Sub-Saharan Africa, current HIV/AIDS funding from all sources stands at $0.3-0.4 billion per year, which is less than one-tenth of the estimated resource needs.[11] Many non-financial factors are also critical to the success of national HIV/AIDS programs, such as strong political commitment, sound national HIV/AIDS strategies, active community and civil society involvement, a functioning health system, and adequate absorptive capacity. IDA has an important role to play in some of these areas. Overall, however, countries and development partners would need a concerted and collaborative effort to overcome this enormous challenge.

30. In the case of HIV/AIDS, as in other communicable diseases, relying exclusively on country-based operations would result in an inadequate response, particularly for sub-regional activities (for example, in parts of Africa, the Caribbean, and along the Myanmar/Thai border). The strongest cross-border externalities arise among countries that are intensively linked via trade, migrant labor movements, or warfare, because HIV travels beyond national borders through trade, tourism, migration, armed forces and with refugees. It is therefore essential to build effective sub-regional programs that can address externalities across borders and in entire sub-regions, by targeting high-risk populations and achieving economies of scale for highly specialized activities. At the same time, national epidemiological surveillance systems -- needed to monitor disease and prevent outbreaks -- must be part of coherent regional and global networks (with consistent disease tracking, and sharing of data using common definitions). When surveillance capacity is limited, the identification, notification, information, treatment and prevention responses are slow, and disease spreads unnecessarily.

31. *Externalities and Incentives to Borrow*: Countries may have weak incentives to borrow for areas such as the eradication of poliomyelitis, which would have tremendous benefits worldwide, as all countries would be able to stop immunizing against polio -- with annual

[11] Mobilizing Billions to Fight AIDS in Africa: the Way Forward, UNAIDS, Geneva, May 2001.

savings of $1.5 billion.[12] However, the benefit to any individual country is marginal, because polio is no longer a large health threat. Achieving eradication would require a coordinated, concerted effort by all affected countries. Only a few countries (Bangladesh, Democratic Republic of the Congo, Ethiopia, Nigeria, Pakistan, and Sudan) continue to have polio virus circulation. The primary activities necessary are national immunization campaigns and mop-up activities, with particular focus on reservoir countries.

32. To date, IDA has played a limited but critical role in polio eradication by facilitating strategy implementation in India, the largest polio reservoir in the world over the period 1999-2001. With the support of IDA and other partners, India has now virtually eradicated the virus, with the last case expected in early 2002. Recognizing the progress in countries such as India, the World Health Assembly called in 1999 on the polio partnership to "accelerate" the eradication effort so that the world might be certified polio-free by the end of 2005. Key challenges to achieving this goal are identified as: (i) maintaining political commitment in the face of a disappearing disease; (ii) closing what is currently estimated to be the $400 million funding gap; and (iii) ensuring access to all children, particularly in conflict-affected areas. Working with WHO and other partners IDA could provide timely funding for this initiative,[13] and positively influence other global investments in polio eradication, notwithstanding the competing claims on the resources being used for this effort. This would help avoid a rapid increase in the marginal cost of every polio case prevented. As these concerns are likely to increase, IDA's involvement in this initiative and working mechanisms would help provide much needed visibility and advocacy for polio eradication at the country level.

33. Overall, financing of global public goods still requires more reflection at the international level, as global issues grow in importance. The forthcoming UN conference on Financing for Development, in March 2002, could play an important role in this respect. A multiplicity of separate financing vehicles is not the ideal approach; nor is simply diverting existing development assistance funding from IDA and other channels. In this respect, an important issue is the future synergy between the Global AIDS and Health Fund (GAHF) and IDA. IDA's comparative advantage lies in supporting country level health institutions and programs, and there is significant scope for cooperation and complementarity between IDA and GAHF. Beyond immediate coordination and operational issues, there remain significant problems of market assurance and market failure, for example in developing vaccines and drugs which address poor country priorities. As the global fund defines its role in complementarity with IDA and other partners, it will be important to assess whether an adequate international framework of funding is in place to deal with these large and urgent asymmetries.

34. Within this broader context, IDA grants for regional or global public goods purposes should be focused primarily on country-level interventions where the regional/global benefit is also considerable. In actually devising such programs it is important that IDA's role be carefully coordinated with other participants -- public, philanthropic and private -- active in the areas concerned. In the instance of both regional support for HIV/AIDS and eradication of polio, IDA is already working closely with WHO, UN agencies, and other bilateral and multilateral

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[12] The estimation is based on the cost of stopping all immunization, as well as averted health care costs.

[13] WHO estimates that for each year that the goal is delayed due to lack of funding, or other reasons, the overall cost of the polio initiative increases by $100-200 million.

institutions using its own expertise of in-country health programs and harnessing the technical knowledge and regional outlook of these agencies. Over the IDA13 period, about $300-500 million of grant resources -- out of a total of roughly $3 billion for communicable diseases (see para. 10) -- might be channeled in support of eligible regional/global projects.

4. Operational Modalities and Risks

35. **Policies and Procedures**. The preceding discussion has provided some principles on the basis of which IDA could include a somewhat broader range of grants in its instruments. Based on the guidance provided by Deputies on the use of grants, Management and the Executive Directors would need to determine the operational policies and procedures within which the limited IDA grant resources would be allocated among countries, and among competing claims for country-based support for regional and global public goods. While details of this allocation process remain to be worked out, they are likely to be driven by the following principles:

- Countries benefiting from IDA grants would be in the IDA-only category, and the level of poverty could be factored in as an additional eligibility criterion. Blend countries could also receive grants to contain HIV/AIDS epidemic, possibly subject to a cap in the case of large blends.

- IDA aggregate resources (credits and grants) will continue to be allocated to individual countries on the basis of the performance based allocation system (and reflected as such in CASs). Grants for global/regional goods would not be allocated through this process, but would be kept to a small proportion of IDA's overall financial assistance.

- Grants would only be provided in the context of justification clearly spelled out in a Country Assistance Strategy (CAS) or in a Transitional Support Strategy (TSS), except in the case of emergency assistance. In countries where a new full CAS is not planned for some time,[14] a strategy update would be prepared, clearly making the case for financing on grant terms.

- IDA grants would be governed by the same policies and procedures that apply to IDA credits.

- To support regional entities in the context of global or regional projects, grants would normally be made to the individual member countries participating in the regional project. However, grants could also be given to a public regional organization established by two or more of such countries, depending on the suitability of the institution to be the grant recipient and the circumstances of the particular operation. There should be an adequate fiduciary framework in place for the implementing regional institution, and an agreement by participating governments to facilitate the carrying out of the projects being supported.

[14] For example, in countries where CAS preparation is scheduled after completion of a PRSP, or in smaller countries that are on a three-year CAS cycle and had just completed a CAS.

36. **Risks**. There are several risks associated with the expansion of IDA's grant authority, as follows:

- This would bring a new level of complexity to IDA, with implications for IDA eligibility categories and use of a new financing instrument. Bank staff and IDA recipient countries would need to be trained on the use of IDA grants (to the extent agreed by Deputies) and guidelines would need to be incorporated in operational processes and procedures.

- There could be risks of weakening the credit and financial discipline culture overall in recipient countries. IDA would need to ensure the existence of an adequate fiduciary framework as a precondition for grant financing, and to insist on continued high standards of credit discipline for its non-grant portfolio.

- The expansion of grants might jeopardize the integrity of existing commitments. There could be pressure from clients to convert all or part of existing IDA credits to grants in eligible sectors, with further impacts on reflows and total resources.

- There could be risks related to country ownership, and it would therefore be important to ensure that countries follow the same public transparency processes in agreeing to IDA grant funding that they normally use in accepting an IDA credit (for example, informing the public through public registers and parliamentary processes). To mitigate this risk, counterpart funding -- as an indication of ownership -- may need to be considered. In general, grant approval processes in countries should follow those applicable for IDA credits.

- Restricting grant financing to only certain activities could introduce a bias to the phasing and choice of projects within an IDA program in a given country. While some bias in favor of urgent priorities might be desirable, the risk of excessive bias could be mitigated by a clear strategy for the needs for and uses of grant financing spelled out in CAS and/or TSS, in line with other partners' programs.

5. Financial Impact Analysis

37. The expansion in the use of IDA grants, in addition to some operational changes in IDA, would have financial ramifications over the long term: either (a) IDA's resources (grants and credits) available for client countries would be reduced, or (b) donors' contributions would need to be increased to maintain the volume of IDA lending and grants at a certain level.[15] At the outset, it should be noted that IDA's continued financial health requires that its projections be based on assumptions that are long-term, realistic and prudent. IDA's finances have been dynamically managed on a cash flow basis. Under the Advance Commitment Scheme (in operation since 1988), IDA has been making lending commitments without having actual liquid resources, against future repayments that it expects to receive in the following 8 to 10 years. The advantage of such a financial management scheme is that it maximizes IDA's lending capacity,

[15] As in previous simulation exercises for IDA finances, the financial impact analysis that follows assumes that, over time, IDA's lending and grant capacity remains stable at projected IDA13 level (SDR 17.6 billion) in real terms.

and minimizes the upfront costs to the donors,[16] but this is necessarily based on a presumption that IDA remains a "going concern".

38. Table 1 below provides short- to long-term financial impact analysis of various grant scenarios (5%, 10%, 20%, and 40 %). Table 1-A presents the impact of using limited grants on both IDA's overall concessionality and IDA's cash flows. It follows from the structure of standard IDA credit terms that the size of the losses would be small during the normal grace period (i.e., in years 1 through 10). Moreover, given the already highly concessional nature of IDA lending, whether 5 or 40 percent of IDA is allocated as grants would have a relatively small impact on IDA's short-term financial situation. However, in order to keep IDA on a financially sustainable path, Deputies would need to consider the financial impact of IDA's grants in their entirety. In the next 20 years, the financial impact of the 5% and 10% scenarios would still be relatively modest, cash flow losses being $0.8 billion and $1.8 billion, respectively, and representing 2 to 3 percent of otherwise expected repayments. Financial losses to IDA in the 40% grants scenario are of course an arithmetical multiple, amounting to $7.5 billion, which is 12% of the principal repayments IDA would have received, if credit were the only instrument. When IDA enters a "steady state" once the repayment stream from IDA credits committed before IDA13 is exhausted, the proportion of lost repayments will mirror the proportion of grants being made, and will of course amount to 40% in the 40% grant scenario.

39. Table 1-B presents two ways for donors to fund various grants scenarios. If donors chose to take no action until the substantial cashflow impact starts to kick in from year 11, for 40% in grants the additional funding required from donors would be $2.5 billion for each replenishment thereafter, and $0.3-0.5 billion for 5% to 10% grant scenarios. It should be noted that these amounts would be additional to the regular level of IDA replenishment and the reimbursements for the HIPC debt relief costs under the current (pay as you go) scheme. Alternatively, donors could decide to take a longer view of IDA's finances and choose a smoother path to fund the grants proposal by raising contributions immediately -- i.e., to fund the cost of increased grants starting from IDA13 and onwards. In this case a substantially smaller nominal amount of additional donor contributions is called for, ranging from only $70 to $140 million for each replenishment under the 5% to10% grants scenario, to $800 million in the 40% grants scenario.

40. Analysis in Tables 1-A and 1-B is done under a cashflow basis which tends to maximize IDA's capacity and minimize the near-term cost of any grant proposals, as mentioned above. On an accrual basis in IDA's financial statements, however, the entire amount of lost reflows would need to be booked at nominal value, even if not immediately funded by donors. Table 1-C shows this effect based on the assumption that IDA grants are made only in IDA13 period. In this event, the total loss of reflows in present value terms would amount to $0.9 billion in the 10 percent scenario, and $3.7 billion in the 40 percent scenario. The corresponding nominal amounts of lost reflows would be $2.5 billion for the 10% scenario and $10.2 billion for the 40% scenario.

41. In sum, financial projections on a *cashflow basis* for various grant ratios show that reflows foregone because of grants would be relatively small as a percentage of expected

[16] Instead if IDA had adopted a fully-funded scheme, all IDA commitments would have to be fully funded by donors and existing internal resources. Then, IDA would not need long-term projections.

repayments during the first 20 years. But they would reach larger proportions in later decades, because of back loading of IDA repayments and the cumulative effect of grants in subsequent replenishments. On an *accrual basis*, however, the costs of grants are much higher both in nominal and NPV terms.

42. It should be noted that the legal basis of most previous replenishments precludes the use of reflows from such replenishments for IDA grants. In essence, reflows from credits that originated in previous IDA replenishments, in which grants were not authorized, cannot in principle be the source of commitment for grants, because IDA's Articles require them to be used for credits. At this time, however, resources other than reflows constitute about 60% of IDA's resources, and hence the provision of a modest level of grants would not be limited by this factor in IDA13. For the future, however, reflows will form a larger proportion of resources, and further exploration of this issue and its implications is needed.

Financial Impact of IDA Grants

Table 1 A - Cash Flow Impact

Scenarios of Future IDA Portfolios	Overall Grant Element of IDA Program	Short-Medium Term Financial Impact Total Losses in Years 1-10 ($billion)	Medium-Long Term Financial Impact Total Losses in Years 11-20 ($billion)	Projected Financial Losses as a Percentage of Total Expected Principal Repayments (Years 1-20)	Projected Financial Losses as a Percentage of Total Expected Principal Repayments Beyond year 40 (Steady State)
5% Grants + 95% Credits	65%	0.1	0.8	2%	5%
10% Grants + 90% Credits	67%	0.1	1.8	3%	10%
20% Grants + 80% Credits	70%	0.2	3.5	6%	20%
40% Grants + 60% Credits (50% Grants for "IDA Only" Countries)	77%	0.3	7.2	12%	40%

Table 1 B - Impact of Grants on Donor Contributions with a 20-year Horizon

Scenarios	Additional Donor Contributions Required for Each Replenishment			
	5% Grants	10% Grants	20% Grants	40% Grants
If donors defer additional contributions until reflows start being lost (i.e., end of the 10-year grace period), and fund IDA through regular replenishment	**$ 0.28 billion** from IDA16 (FY12)	**$ 0.50 billion** from IDA16 (FY12)	**$ 1.0 billion** from IDA16 (FY12)	**$ 2.5 billion** from IDA16 (FY12)
If donors begin contributing extra resources immediately through regular IDA replenishment (i.e., from IDA13 on)	**$ 0.07 billion** from IDA13 (FY03)	**$ 0.14 billion** from IDA13 (FY03)	**$ 0.4 billion** from IDA13 (FY03)	**$ 0.8 billion** from IDA13 (FY03)

Table 1 C - Cost of IDA13 Grants on an Accrual Basis

	5% Grants	10% Grants	20% Grants	40% Grants
Lost reflows (principal and service charge) for making grants in IDA13 (assuming no grants in IDA14 and onwards)	**$1.3 billion Nominal Value**	**$2.5 billion Nominal Value**	**$5.1 billion Nominal Value**	**$10.2 billion Nominal Value**
	$0.5 billion NPV	**$0.9 billion NPV**	**$1.8 billion NPV**	**$3.7 billion NPV**

Notes:

1/ The simulation analysis in Table 1 B is done with a 20-year horizon of IDA finance and on a cashflow basis. On an accrual basis in IDA's financial statements, however, the entire amount of lost reflows would need to be booked if not immediately funded by donors.

2/ This analysis is done under a set of core assumptions including:
A) lending remains stable at projected IDA13 level (SDR 17.6b) in real terms (assuming a 2.3% inflation rate);
B) donor contributions remain constant in nominal terms at the currently-proposed level for IDA13 (SDR 9.8b);
C) 5% investment return from liquid assets;
D) 5% non-accrual;
E) administrative expenses remain stable in real terms;
F) the share of programmatic lending increases gradually from 25% for IDA12 to 35% for IDA14;
G) IDA continues to receive $300m a year in IBRD net income transfers;
H) HIPC debt relief costs are fully reimbursed by donors by way of additional contributions.

3/ Commercial Interest Reference Rate of 6.3% is used as the discount rate for grant element calculations.

4/ For grants, the service charge (based on outstanding and disbursed balance) would be set at 0%. The commitment fee (based on undisbursed balance) would be set at 0.5%.

6. Conclusion and Issues for Discussion

43. **Summary: Focus and Dimensions of Expanded IDA Grants**. This paper has laid out some principles and criteria that could guide an expansion of IDA's existing grant authority. Such an expansion must be viewed in the context of IDA's role in its client countries vis-à-vis other donors and agencies, and the financial impact of grants on IDA's own finances. IDA's grant capability could be expanded along the lines described above in Sections I and II of the paper to strengthen a limited number of key poverty reduction interventions, building on current lending experience and projected activities in the sectors concerned. Grant support to arrest or reverse severe deterioration could be of the order of $3 billion in IDA13, with the bulk going to the fight against HIV/AIDS and other key communicable diseases -- and with perhaps 10-15 percent of that sum devoted to the global/regional dimensions of the disease effort. A second principle of increased grant financing would be to expand IDA support for important long-term investments for human development goals, especially in education, focusing on disadvantaged groups including poor children and girls. Within the broader framework of IDA's human development strategy, this might account for grant financing of up to $1 billion in IDA13. These amounts would represent a stepping up of IDA's activities in all these areas, which have already been on the rise during the last two years. IDA grants for post-conflict purposes might account for a further $200 million. Taken together against a notional IDA13 replenishment figure of around $22-24 billion (SDR 17-18 billion), these uses suggest grant financing in the 15-20 percent range.

44. Against this backdrop, **guidance is sought from IDA Deputies on the following issues**:

At the Country Level:

1. Do Deputies agree that IDA grants could be usefully deployed in the context of *arresting major crises and dealing with large disasters*? In this regard, do Deputies concur with the conclusion that IDA grants could be used at the country level for combating HIV/AIDS and other health epidemics, and in certain instances for dealing with large natural disasters?

2. Do Deputies agree that IDA grants could be used for interventions with *large and long-term benefits* but for which the governments have *little incentive to borrow*, and the ensuing conclusion of using IDA grants in particular for education for disadvantaged groups in client countries?

3. Do Deputies agree with the continued provision of *post-conflict* grants for emergency recovery and reconstruction when lending is not appropriate, and for possibly expanding such grants somewhat for urgent capacity building and technical assistance?

4. Do Deputies concur that the use of grants more generally *to increase the concessionality of IDA's resources* for the very poorest countries is warranted? Related to this, should IDA use grants for broad sectoral approaches, or for PRSCs?

At the Global/Regional Level:

5. Do Deputies concur that IDA's role for *financing global/regional goods through grants should be primarily focussed on the area of communicable diseases*? Do Deputies agree that such support should primarily be to (i) ensure that country programs have the necessary regional components to be successful (e.g., HIV/AIDS, malaria), and (ii) to eradicate diseases that have little national importance but large global implications (e.g., polio eradication)?

Overall Usage of IDA's Resources and Financial Impact:

6. What is the consensus among Deputies regarding the amount of overall use of IDA's resources as grants, in the context of the above, the anticipated scope for using grants in each of these areas and the operational implications and risks?

7. How would Deputies intend to deal with the impact of grants on IDA's finances, and its implications for additional resources?