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AID EFFECTIVENESS AND FINANCING MODALITIES

Attached for the October 2, 2004, Development Committee Meeting is a note entitled "Aid Effectiveness and Financing Modalities," prepared by the staff of the IMF and the World Bank, and to be considered under Item I of the Provisional Agenda.

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AID EFFECTIVENESS AND FINANCING MODALITIES

I. Background

1. This paper has been prepared in response to requests by the Development Committee and the International Monetary and Finance Committee (IMFC) that the Bank and the Fund undertake a comprehensive review of aid effectiveness, absorptive capacity, and results-based measurement mechanisms. The Committees also requested that the two institutions examine the merits of various options to mobilize the financial resources that are needed over the medium term to make progress towards the Millennium Development Goals (MDGs). This paper follows previous discussions of *Supporting Sound Policies with Adequate and Appropriate Financing* (Fall 2003) and *Financing Modalities Towards the Millennium Development Goals* (Spring 2004), and is based on a longer paper prepared by World Bank staff with contributions from Fund staff[1].

2. Over the past year, several events have had a bearing on the aid agenda. They include (i) the work of the OECD/DAC Working Party on Aid Effectiveness and the Task Team on Harmonization and Alignment; (ii) the Roundtable on Better Monitoring, Measuring and Managing for Results held at Marrakech; (iii) the Task Forces set up by the UN Millennium Project; (iv) a Paris Conference on Financing for Development at the Ministerial level; (v) the Shanghai conference on scaling up poverty reduction; and (vi) discussions at the UN *Summit of World Leaders for the Action against Hunger and Poverty* of proposals for innovative ways of financing development launched by Brazil, Chile, France and Spain and attended by more than fifty heads of state and government.

II. The Need for More Aid and its Role in the Development Process

3. **This paper starts from the premise that adequate, predictable and more effective aid flows are critical to reaching the MDGs by 2015.** This premise is supported by considerable work done by the World Bank, the United Nations and civil society. While domestic savings, government revenues and foreign direct investment together constitute the primary means for financing development, reaching the MDGs will require a significant scaling up of the provision of publicly financed goods and services. Most developing countries cannot mobilize financing for the scale of expenditures required and thus official development assistance is needed. The literature shows that aid can be effective in building up government capacity to undertake needed development expenditure if sound policy frameworks are in place. But larger aid flows are not a panacea. Indeed, increased aid in and of itself can distort incentives – for example by weakening government's resolve to raise and better manage domestic public resources, or by decreasing the incentives for domestic savings and investment. Increased flows should therefore be based on continued improvements in country performance and strengthening of governance.

4. **Addressing the international development agenda requires concerted actions on several fronts, besides mobilizing more aid.** First, developing countries need to pursue vigorously reforms that enhance the climate for private investment – domestic and foreign. At the same time governments need to scale up investment in infrastructure, strengthen the

[1] *Aid Effectiveness and Financing Modalities,* September 3, 2004, SecM2004-0407

management of public resources, enhance the effectiveness of service delivery, and strengthen governance at all levels. Equally important are efforts by developed countries to provide increased access to their markets, improve the way aid is delivered, including by making it more predictable, and reinforce the complementarity of aid with other forms of support such as that for capacity building.

III. A Stronger Framework for Aid Effectiveness

5. **A new aid framework is taking shape, which takes account of the foregoing considerations to make aid more effective. The first element of this framework is better policy environments in developing countries.** Real economic growth has accelerated for many developing countries since the 1990s, as a result of stronger macroeconomic policies and better management of public resources. There has also been an overall strengthening of country policies and institutional performance as measured by the World Bank's Country Policy and Institutional Assessment (CPIA) and similar indices of economic and institutional performance[2].

6. **Through the Poverty Reduction Strategy Paper (PRSP) framework, country development strategies are increasingly aimed at poverty reduction.** This effort is nowhere near complete, but it has markedly changed the framework for aid by sharpening the focus of governments and their external partners on the essential policies to make progress toward the MDGs, although growth-enhancing policies need greater attention.

7. **Aid is being aimed increasingly at poor countries and good performers**. For better-performing countries, there is also a concerted effort among donors to align and link support to the PRS through better coordination of budget support and sector-wide assistance projects. Increased performance-based allocations do, however, pose bigger challenges for low-income countries under stress (LICUS), which, with the exception of post-conflict countries, have received less aid (in both absolute and per capita terms) than other low-income countries, even after controlling for income level, population size, and quality of the institutional and policy environment. Aid to LICUS is also twice as volatile as to other low-income countries.

8. **There has been a shift in aid management and implementation practices toward stronger alignment with country policies and programs, stronger harmonization and a greater focus on results.** Partner countries' and development agencies' approaches are converging on core principles and results-based policy agendas. Also, there is a broad-based global effort underway to foster cooperation between the multilateral development banks (MDBs) and donors in the OECD/DAC. This cooperation includes commitments to align assistance around country strategies and to harmonize donor policies, procedures, and practices. Almost 60 partner countries and at least 40 bilateral aid agencies and multilateral institutions are engaged in these efforts.

9. **Despite considerable progress, much remains to be done**. Evaluations by the World Bank's Operations Evaluation Department (OED) provide evidence on the slow progress donors have made in improving their aid practices. A large gap continues to exist between donor

[2] Such as the Heritage Foundation/Wall Street Journal Index of Economic Freedom, the International Country Risk Guide, and the Economist Intelligence Unit Country Risk Service.

statements on the need to improve the delivery of aid and the actions by donors to implement these agreements. The 2nd High Level Forum, planned for early March 2005 in Paris, presents an important occasion to enhance political support for accelerating implementation.

IV. Absorptive Capacity

10. **Increased aid will only be effective if there is adequate absorptive capacity or if such capacity can be developed in tandem with higher aid flows**. Absorptive capacity is a complex and dynamic concept, about which there is still much to learn. At any point along the resource transfer chain there are many factors that can potentially limit the effective use of aid: constraints can arise due to the macroeconomic impact of aid flows, in the allocation of aid to expenditures, or in the service delivery at the local level. Absorptive capacity also varies significantly between sectors, with implications for financing modalities and frontloading. Some infrastructure projects – power generation for example – have a high import content, making them more amenable to expanding supply without reaching serious absorptive capacity constraints. By contrast, there is likely to be less scope for frontloading to rapidly expand supply of health services, for which service norms and skilled labor requirements can make human capital constraints a more limiting factor.

11. **For many countries absorptive capacity is not a serious problem, whereas in others it is a significant obstacle to aid effectiveness.** In-depth studies of country conditions (such as the 18 background studies prepared for the 2003 Development Committee Report) confirm that many countries are currently well placed to manage a doubling in aid without reaching serious capacity constraints. However, there is little confidence that increased aid can be used effectively in countries with weak institutional and governance indicators.

12. **Identifying and addressing absorptive capacity constraints requires formulation of country specific-strategies**. Potential macroeconomic constraints need to be identified in the context of crafting the overall medium-term assistance program. Efforts need to be made to ensure the sustainability of the fiscal and external accounts, and to minimize risks of eroding economic competitiveness. Institutional and governance constraints, including weak public expenditure management practices or corruption, need to be addressed through institutional strengthening and greater political accountability; these efforts need to be made early on as they may require time to put in place. Physical infrastructure and skilled labor constraints are also key to the pace at which service delivery can be expanded. Importing scarce skills may temporarily bridge gaps, but on-the-ground capacity building (for example through innovative training programs) and measures to help retain qualified staff are essential in the long run. Tackling social and cultural constraints is also critical to effective program implementation, particularly for community-based interventions.

13. **The need to raise absorptive capacity should not, however, be an excuse for holding up on aid mobilization.** Efforts to increase aid can move in tandem with efforts to address the effectiveness of aid by strengthening policy frameworks, building institutional capacity, mobilizing the private sector and NGOs, identifying innovative avenues for service delivery, and improving monitoring and evaluation to learn from international experience.

V. Financing Needs and Mechanisms

14. *Delivering on Aid Commitments*. **At Monterrey, donors agreed to make concrete efforts toward reaching ODA levels of 0.7 percent of gross national income (GNI).** Since Monterrey, ODA has indeed increased, but the increment flowing to poor countries with sound policies and large MDG financing needs has been small because of the predominance of strategic factors, debt relief and larger technical cooperation grants.[3]

15. **The simplest approach to ensuring that more aid is available where it is needed would be for donor countries to increase their aid budgets**. Five countries have laid down a clear timetable for achieving the 0.7 percent target (Belgium, Finland, France, Ireland, and the United Kingdom) in addition to countries that have already attained this target. If all DAC countries were to meet their expressed commitments, the ODA to GNI ratio would increase to 0.297 percent by 2006, and 0.323 percent by 2010 (from 0.22 in 2001), mostly from the European Union.

16. **As rapid and substantial increases in aid face political and fiscal constraints, it is worth exploring whether aid flows can be supplemented through other mechanisms**. *Global taxes or voluntary giving mechanisms* could be used to increase the long-term flow of resources, but establishing such mechanisms would take some time. In the short term, aid could be frontloaded to meet immediate needs for MDG-related flows by establishing a mechanism such as an *international finance facility (IFF).*

17. **Global taxes or voluntary giving mechanisms could increase aid flows over time.** Innovative instruments should be judged by the standard principles of good taxation, with some additional considerations arising from their international nature. Ideally, any such global tax must be efficient in that it does not cause, and perhaps even corrects, negative externalities; it should have broad political support and be simple to administer. Furthermore, an instrument is better the greater and more stable its revenue yield; the more equitable its impact; and smaller the set of countries needed to make the tax viable.

18. **There are important trade-offs among these criteria, and no proposed tax is free of serious weaknesses.**

- A common carbon tax is attractive, as it could generate substantial revenue and correct important international externalities. But the Kyoto process has shown how difficult a tax along these lines would be to implement, even when nations retain the revenues. Given the opposition, it may be better to focus on narrower environmental or "public bad" concerns such as taxes on aviation fuel or maritime pollution.

- Charges for the use of the global commons – such as positioning satellites – are attractive in principle, but have modest revenue potential for the foreseeable future.

[3] From 2001 to 2003, ODA rose in nominal terms by $16.1 billion from $52.3 billion in 2001 to $68.4 billion in 2003. As a percentage of GNI, this was an increase to 0.246 percent in 2003 – a bit more than a third of the way towards the 2006 target of 0.3 percent. The Global Monitoring Report will be the instrument for monitoring the delivery of those aid commitments, and progress on the effectiveness with which they are delivered.

- Taxes whose impact on economic efficiency is questionable – such as those on financial transactions or on world trade, or surcharges on national taxes – should be viewed with caution as they would distort economic activity and impede the overall operation of the tax system.

19. **Measures to enhance voluntary contributions by individuals – such as global lotteries and premium bond schemes – may also offer a way ahead**. Voluntary giving is, by definition, equitable, though some see lotteries as a regressive tax. Difficulties could arise, however, as political support for tax-financed development support could be diverted, and perhaps other activities supported through private donations could be crowded out. An additional challenge is to find ways to channel new voluntary flows through, or in concert with, existing delivery mechanisms.

20. **Most proposals along these lines could be made to work without creating a global tax administration, and many without the participation of all developed countries, but all would take time to implement and would face varying degrees of political opposition**. Many would create incentives for non-cooperative behavior in tax setting and enforcement. Some would have adverse economic effects. These difficulties suggest that revenue from these innovative sources in the near future is likely to be, at best, no more than a complement to traditional finance for development.

21. **Some of the less ambitious proposals – that increase the efficiency of the global tax system – may, however, over the longer term, have a useful role in freeing additional resources to support development.** This reinforces the notion that there is a potential complementarity with an IFF, in that revenues from global taxes might materialize as the period of frontloading due the IFF comes to a close. It would be unwise, however, to allow hope for (now highly uncertain) future revenues from global taxes to allay real concerns about the long-run implications of frontloading assistance through the IFF.

22. **The global tax and voluntary giving proposals under consideration vary too widely to allow generalizations to be made on how they might be introduced.** Some might be undertaken by interested groups of member states. Most, though, require further collective reflection with respect to the merits of the particular proposal and how it might be implemented. The Bank and the Fund have substantial technical expertise to offer in analyzing particular proposals and considering vehicles for utilizing the proceeds for development. But the impetus for further progress must come from member states.

23. *Frontloading Aid: The International Finance Facility.* **Another approach to increasing aid flows quickly would be to bring forward some of the aid increases announced by donors for the future, based on firm donor commitments to increase aid within a definite timeframe.** Frontloading aid disbursements responds to immediate needs for funds for critical development investments, and can help improve the predictability of aid flows. While donors have found ways to make forward commitments on aid flows, including making multi-year commitments via the replenishment of multilateral concessional windows, there has been a search for new mechanisms that could be used to overcome current budgetary constraints.

24. **The most advanced proposal to frontload aid is the IFF, which was assessed in the Spring Meetings paper for the Development Committee as appearing to be feasible from a technical viewpoint.** The IFF is based on four fundamental components, each of which has details that need to be fleshed out and issues that need to be resolved:

- Government backing – the driving force behind the IFF is donor pledges of additional future aid. Donors would make legally binding pledges of future increases in aid commitments without making immediate appropriations or fiscal commitments;

- Bond issuance – a treasury platform would use the donor pledges as backing to issue AAA-rated bonds. This platform, the IFF itself, would rely on donor pledges (not cash) to back the bonds. The excess of pledged amounts over the amount of IFF borrowings would provide the financial enhancement needed to support the AAA rating on IFF bonds;

- IFF governance – bond proceeds would be channeled through existing multilateral and bilateral aid programs. Allocations would be made in accordance with an aid allocation framework agreed under the IFF's governance structure; and

- Bond repayments – the IFF would pay off the bonds drawing down donor pledges.

25. ***Government backing*. A key consideration underlying the IFF is the need to ensure that donor pledges to the IFF are not included in the current budget but are legally binding, and accepted as such by the capital markets.** The IFF would not require universal participation, but to satisfy the requirements that it be independent of donors and robust enough to satisfy capital market scrutiny, the participation of several donors would be required, ideally five or more. The breadth and rating quality of donor participants, and the nature of the contingent commitments to the IFF which they undertake, will be critical to the IFF's viability and financial efficiency, especially in establishing the ratio of AAA-rated bond financing that can be issued relative to the underlying donor pledges.[4]

26. **Pledges to the IFF would most likely be bilateral financial agreements entered into by and between the IFF and each donor country.** Requirements for an aid pledge to be off-budget vary country by country, as does interest in such a mechanism. The fiscal treatment of these contingent liabilities of donors to the IFF will need careful examination to ensure consistency with the principles of fiscal transparency.

27. **In these circumstances, there may be scope for different kinds of support from donors given different fiscal positions and legal structures.** Possibilities could include the use of executory contracts (under which a donor government would enter into a contract with the IFF stating the terms of its support); government guarantees (committing a donor now to pay the IFF later in support of IFF bond obligations); partial or secondary guarantees (backing up other IFF pledges by agreeing to pay IFF bond obligations in the event of default or if other donors were

[4] The efficiency of the IFF structure, and its inherent risks, are reflected in the advance rate, which is the proportion of the amounts pledged that could be borrowed and become available for development financing. Measures that improve the advance rate would improve the overall efficiency of the structure, by supporting higher disbursement levels for a given amount of pledges.

no longer obligated to pay a portion of their pledges); and government purchase of supporting tranche IFF bonds (where a second tranche of IFF bonds would have an equity element supporting the AAA rating of the first tranche, bearing the risk of contingent non-payment by other donors). These options might provide different ways for donors to consider supporting an IFF, with further work needed on technical details.

28. ***Bond Issuance/Treasury Platform*. For the second component, the key question is how efficiently the IFF would be able to issue AAA bonds.** The IFF would consist primarily of a treasury platform that would manage donor pledges and drawdowns; issue and service bonds and deal with rating agencies, regulatory and qualification agencies, underwriters, and fiscal agents to maintain the AAA rating on IFF bonds; manage the flow of the IFF's borrowing and repayment streams; disburse to implementing agencies; tracking expected disbursement levels; and coordinate the IFF's financial reporting across implementing agencies. Taken together, these are significant and sophisticated financial management functions.

29. **The choice of an appropriate structure for the IFF should minimize the cost of its establishment and management, including the level of its expected borrowing rates, and treasury management and cash flow administration costs**. These factors suggest that it would make sense to establish an IFF in close association with the World Bank or other MDBs. One or more international financial institutions could provide these services to the IFF platform, or establish a subsidiary or affiliate that is legally and financially separate, but that would draw on their skilled staff as well as capital market and financial management experience.

30. ***Governance Arrangements*. The IFF's contribution to overall aid effectiveness will hinge on how IFF funds are allocated, an outcome of its governance arrangements**. There is broad agreement that the IFF should not be established as a separate, independent international organization with inevitable accompanying delays and complications, but should instead rely on existing institutions. At the same time, IFF participants will make core decisions (such as funding levels, allocations, and fundamental policies and operating principles) of great interest to recipients and international civil society.

31. **The IFF's core allocation decisions will be a key aspect of its contribution to aid effectiveness.** It is intended to support aid predictability, and so must be backed by long-term funding commitments. It is intended to help achieve the MDGs, and so its funds must flow where they can be absorbed and where they will enhance harmonization and alignment. And as its funds flow in combination with existing flows, it must support country ownership, macroeconomic stability and performance without adding to recipient burden, and any conditions imposed by the IFF will need to be consistent with those of the existing delivery channels.

32. ***Bond Repayments and Impact on Aid Flows*. It is important that using the IFF to frontload aid flows should not result in a drop-off in flows after 2015.** Because of the added cost of establishing and running the IFF and interest paid on its bonds, its effectiveness will depend not only on the impact on the ground of IFF funds but also on what happens as government aid flows are diverted to repay IFF bonds. The build up of absorptive capacity suggests that scaling up aid will need to be managed carefully – and once aid flows increase, they will need to be maintained in the medium term.

33. **A strength of the IFF proposal is that it provides flexibility to mediate between what is needed in terms of disbursements and when donors pay for it, so it can be adapted to support a desired ODA time profile.** The original UK proposal called for a significant short-term increase in aid and then a drop in aid flows post-2015. To ensure sustainable progress toward the MDGs based on the use of frontloaded IFF funds, the IFF should be managed so that the frontloading of future aid flows results in a short-term increase and then a steady flow of funds, through and beyond 2015.

34. **If the international community wishes to move forward with the IFF, the next step would be to work through the details of implementation.** Possible ways to support an IFF, as suggested here, could be fleshed out in detail for interested donors. Further work could be done on creating the IFF as an MDB subsidiary, or on the MDBs providing services to an IFF, to determine if expected efficiencies will materialize. Specific proposals on governance could be examined to find an appropriate balance between its aid purposes and simplicity, between efficiency and wide participation in governance decisions.

35. *Getting More from Aid*. **Innovative mechanisms to leverage aid such as blending arrangements can help produce a bigger impact for a given level of ODA flows.** Development finance, including aid, is delivered from a variety of sources and through a variety of mechanisms. Flows from each source are subject to the priorities and practices of individual donors or multilateral institutions. The terms and levels of available aid are not consistent across donor and recipient countries – whether due to an uneven effort to enhance aid effectiveness by grounding it in country performance levels, or to the extent that aid reflects strategic or other priorities of donors. Efforts could be made to match the terms of aid – the degree of concessionality – better to individual country and project circumstances. Although aid flows have political and historic drivers that are hard to change, the international community as a whole has considerable scope to be much more systematic in how it brings different available financing sources bear on different countries and projects in order to produce the maximum possible impact in terms of poverty reduction and achieving the MDGs.

36. **Better pooling of different sources of funds and matching concessionality to recipient needs can increase the total volume of development finance and preserve the most concessional finance for where it is most needed.** In principle, the multilateral aid system is based on a spectrum of concessionality across countries based on poverty levels. As GNI per capita levels go down, the spectrum runs from middle-income developing countries eligible for MDB lending through blend countries and IDA-only countries to LICUS and post-conflict countries with access to limited, highly concessional financing and grants. In practice, only a part of global aid flows is targeted on the basis of income, with some 40% of total flows of grant and concessional ODA going to middle-income countries (MICs). Moreover, average country per capita incomes may not in themselves be a sufficient guide to appropriate levels of concessionality. Countries face a range of complicating circumstances as they strive to reduce poverty, including their relative institutional capacity, fiscal constraints, the degree of debt vulnerability, progress toward development goals and the MDGs, and access to external finance. Existing flows, in particular grants, could be used more effectively to leverage appropriate levels of development finance to meet specific needs across the spectrum of developing countries.

37. **For *IDA-only countries*, aid terms should be examined carefully in relation to their debt-carrying capacity as suggested by the ongoing Bank-Fund work**. In the IDA14 replenishment negotiations, it is proposed to continue to base country allocations in IDA's performance-based allocation system, but to adjust financing terms in the light of debt sustainability assessments. The IDA14 framework would assess countries on the basis of risk of debt distress, and grant eligibility would be determined accordingly.

38. ***Blend countries* that are eligible for concessional IDA and regular IBRD lending can benefit from increased non-concessional and concessional finance.** Additional non-concessional financing could be a useful measure to encourage MDG investments, and for countries at the lending limit, country-specific partial guarantees from donors might be a low-cost way for donors to spur additional flows. In other cases, blending concessional bilateral finance with extra non-concessional MDB finance could be a way to gain extra leverage in helping these countries make progress toward the MDGs, or to tackle a particular pocket of poverty.

39. **MDBs and bilateral donors acting together could work towards a more systematic approach to addressing the varying needs of gap countries.** These are countries whose GNI per capita is too high for IDA eligibility, and creditworthiness is too poor for access to IBRD funds, are considered as having exceptional access to IDA, and are subject to hardened, but still highly concessional IDA terms.

40. **External development finance to the *middle-income countries* should be better aimed at accelerating progress towards the MDGs.** MICs receive significant aid flows, and large numbers of the world's poor live in MICs, but most aid flows are not at present directed toward MDG purposes, and could be better targeted. Blending flows with other forms of public financing could augment resources for targeted social spending where governments are constrained in financing such spending themselves, due to the lack of revenues or borrowing power. Additional non-concessional MDB lending can help some middle-income countries to increase investment and spending in MDG-related activities, including infrastructure development.

41. The financing approaches discussed in this paper provide elements of a menu to address important aid financing objectives: increasing aid volumes in the short run, enhancing the efficiency of aid, and finding ways of increasing the predictability and financial sustainability of aid flows over the longer term. Further work will be needed on the feasibility and design of specific elements.

42. *Question for Ministers:*

- Do Ministers agree on the urgent need for all parties, donors, multilateral agencies and countries to act quickly to fully operationalize the agreed common agenda to increase aid effectiveness? Do Ministers agree that the priorities of this agenda are better alignment of aid with country programs, harmonization, predictability, managing for results and increased assistance to countries where needed in building absorptive capacity for more aid? Do Ministers agree that IDA14 provides an important opportunity for making progress on this agenda?

- Do Ministers agree that there is a need for urgent action to deliver on the higher volume of aid needed to achieve core development goals?

- Which global tax and voluntary giving proposals do Ministers see as having the most practical potential, and how do they see the Bank and the Fund helping move these proposals forward?

- Do Ministers agree that frontloading mechanisms like the IFF are technically feasible, although not applicable to all donors? Do Ministers agree that work should continue on the issues identified in the paper?

- Do Ministers agree that efforts to match the degree of concessionality better to country and project needs, for example by blending aid with other sources of financing including multilateral bank lending can augment and make more effective the aggregate use of resources to support the MDGs, and that further work on possible approaches would be useful?