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FINANCING MODALITIES TOWARD THE MILLENNIUM DEVELOPMENT GOALS:

Progress Note

Attached for the April 25, 2004, Development Committee meeting is a progress note entitled "Financing Modalities Toward the Millennium Development Goals" prepared by the staff of the World Bank. This item will be considered under Item I of the Provisional Agenda.

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DEVELOPMENT COMMITTEE
APRIL 25, 2004

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Prepared by World Bank Staff
in Cooperation with Fund Staff

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Financing Modalities Toward the Millennium Development Goals: Progress Note

Executive Summary

i. This paper outlines ongoing work with respect to financing modalities that may help mobilize resources to achieve the MDGs. There is broad consensus that an effective international development financing system needs to be further developed if the MDGs are to be achieved. Key objectives include higher levels of assistance responsive to the scale of need and to performance; predictable aid flows to facilitate long-term investment in fundamental development; and more flexible financing mechanisms to accommodate the significant variations in country circumstances.

ii. Financing needs to meet the MDGs are substantial, and are far from being met. Official development assistance is critical, especially for the poorest countries, which receive substantially lower levels than middle-income countries of non-ODA sources of development financing, notably foreign direct investment and remittances. While progress has been made in increased aid pledges to achieve the MDGs, the shortfall remains a major challenge. A concerted push is needed to increase aid volume and to translate the commitments that have been made into usable funds.

iii. Apart from efforts to increase the quantum of available resources, there is a large agenda on ways to use aid more efficiently, and recent discussions of official financing for development have broadened the range of financing modalities under consideration beyond traditional aid. The timeframe of the MDGs – to 2015 – has encouraged consideration of ways to "frontload" future aid commitments based on the premise that the social and economic returns on aid investment are higher than the cost of borrowed funds. The most fully developed of such approaches is the UK proposal for an International Finance Facility. As a way to increase significant aid flows in the near term through existing and delivery channels, the IFF – which in essence involves providing legally binding donor pledges to underpin AAA-rated market borrowings for development purposes – appears technically feasible. Key requirements for the IFF to be feasible in practice would include breadth and strength of political backing for the obligations being undertaken, and resolution of issues on the treatment of pledges from a fiscal viewpoint by national authorities. In further work on these and other technical aspects of the IFF, consideration can also be given to alternative structures based on the same principles.

iv. Global taxation options, another set of proposals for increasing development flows, could in principle provide a way to generate significant flows on a reasonably predictable basis. Given the need to restrict the scope for tax avoidance in international taxation schemes, most of these options would require widespread backing which they have not so far enjoyed.

v. There also needs to be further development of mechanisms improving the flexibility and efficiency of existing aid flows. This is a broad topic, but within the perspective of financing instruments two main areas of work are underway. First, the forms and concessionality of aid need to be tailored to make more flexible financing available to poor countries when they face debt distress or exogenous shocks. Second, more proactive approaches to concessionality for MDG objectives need to be explored, for example by blending financing of different degrees of concessionality for social investments with high regional or global externalities (e.g. disease prevention), or by financing MDG requirements when appropriate in countries not normally eligible for concessional finance. Work on different aspects of this menu of issues within the Bank and the Fund should generate more sharply defined options and proposals over the coming months.

Financing Modalities Toward the Millennium Development Goals
Progress Note

I. Introduction

1. At the 2003 Annual Meetings, the Development Committee called upon "the Bank, working with the Fund, to examine the merits of various policy options, such as an international financing facility, to mobilize the substantial additional resources that are needed over the medium term and can be effectively used to achieve development results and in scaling up progress toward the MDGs."[1]

2. The Development Committee's request was made in the context of broader ongoing work on the architecture of development aid, reflected in the Communiqué of the International Monetary and Financial Committee (IMFC) of the Board of Governors of the IMF. The IMFC called upon "the IMF to cooperate with the World Bank in work on aid effectiveness, absorptive capacity, and results-based measurement mechanisms, and in examining the merits of various policy options and financing mechanisms, such as an international financing facility, to mobilize the substantial additional resources that are needed over the medium term."[2] The joint Bank-Fund work in response to this request is due by the 2004 Annual Meetings.

3. This paper reports on work exploring ways to mobilize financing toward achieving the MDGs. The most obvious source of additional financing would be increased levels of official development assistance, and the paper summarizes what is needed to achieve the MDGs and what is being done toward delivering pledges based in the Monterrey consensus. A second approach would be to frontload aid, as put forth in the International Finance Facility proposed by the United Kingdom, on the premise that social and economic returns on aid investment are higher than the cost of borrowed funds. Third, flows for development could be increased via proposed global mechanisms such as global taxes. Fourth, aid flows can be enhanced by improving the efficiency and flexibility of existing development assistance, such as tailoring concessionality levels to country circumstances and needs. The ongoing work with respect to each of these four approaches to increasing effective financing is explored in turn.

4. It should be noted that this work is being done in the context of a wide range of related efforts. Of particular note is the Global Monitoring Report 2004, also being prepared for the Spring Meetings, which assesses progress on policies and actions needed to achieve the MDGs and related development outcomes. Work is going forward on the idea of tailoring concessionality levels to country circumstances, in the context of the IDA14 replenishment and the Bank's medium-term strategy. Also, further work building

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[1] Development Committee Communiqué, September 22, 2003, para. 3.

[2] Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, September 21, 2003, para. 17.

on the paper "Supporting Sound Policies with Adequate and Appropriate Financing",[3] discussed at the Development Committee meetings last fall, will deepen the assessment of country needs and appropriate financing responses for selected pilot countries.

II. Resources for Development

A. The Challenge of Meeting the MDGs

5. The Global Monitoring Report 2004 to the Development Committee reviews progress on the policies and actions for achieving the MDGs and related outcomes. As that report makes clear, the MDGs present a daunting challenge, one that requires accelerated progress on a difficult agenda. Based on current trends and growth forecasts, the world can achieve the goal of halving extreme poverty. Progress has stalled, however, in some countries, and others are at severe risk of falling short of the goal. Sub-Saharan Africa, in particular, is seriously off-track; only eight countries, accounting for about 15 percent of the population, are likely to achieve the income poverty MDG.

6. Global and regional trends hide considerable variation across countries, and East Asia provides a good example. At one end, the region includes countries such as China and Thailand that will soon meet several of the MDGs; at the other end, prospects are poor for low-income countries such as Cambodia and Papua New Guinea.

7. Middle-income countries are in general better positioned than low-income countries in terms of their prospects for achieving the MDGs, with many of them having met some of the MDGs or well on their way. A number of them lag behind, however, in relation to the non-income MDGs such as child mortality.

8. Nevertheless, development successes of the past give grounds for optimism. Policies in developing countries are clearly improving, and indicators for the past five years show improvement in all regions, though to varying degrees. Improving policy frameworks are creating a more conducive environment for better and more effective use of development assistance. While this is encouraging, the pace of reform will have to be accelerated if the MDGs are to be achieved, especially in the low-income countries and in Sub-Saharan Africa. There is also broad agreement on the development framework needed to achieve the MDGs at the country level. In many countries, the quality of policies, institutions and governance is such that large and immediate infusions of external financing can accelerate progress towards the MDGs. In others, a combination of policy improvements and the provision of more and better quality aid will go hand in hand with faster progress towards the MDGs. For yet another group, policies and governance will have to improve substantially so more aid can be used effectively and productively.

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[3] DC2003-0016, Sept. 13, 2003.

B. What Will It Take to Achieve the MDGs?

9. The drive to achieve the MDGs, and the role of external official finance and aid, which is the main focus of this note, should be viewed in the context of all significant flows to developing countries. In the long term, poverty will be reduced through secure, dynamic growth, the critical drivers remain private flows of capital and earnings. As is widely recognized, expanding and liberalizing trade will produce substantial benefits for both developing and developed countries, and generate important increases in real income worldwide. Foreign direct investment (FDI) supplies the largest amount of external financing to developing countries. While FDI flows to developing countries are important and prospects for increasing flows are favorable, they are highly concentrated in a relatively small number of middle income developing countries. In addition, worker remittances are the second largest financial flow to developing countries after FDI, more than double the size of official flows. Remittances, unlike FDI, have been a fairly stable and growing source of flows into developing countries, although they are also unevenly distributed across recipient countries.

10. The promotion of secure, dynamic growth is at the center of the strategy to achieve the MDGs and related development outcomes. Growth directly reduces poverty and expands (and frees) resources for use toward the non-income goals. Economic growth will therefore have to be stronger in many developing countries than in the past.

11. This is ambitious, but possible. Since 1990, developing countries have on average grown faster in per capita terms than developed countries. In Sub-Saharan Africa, 15 countries have grown at rates exceeding 4 percent since the mid-1990s. What is needed is to accelerate policy and governance reforms in all developing countries to boost private investment and growth. Developing countries also need to increase investments in infrastructure and in social spending.

12. Infrastructure plays a key dual role in the effort to achieve the MDGs. It is an important element of the investment climate; reducing poverty by increasing growth is one channel through which infrastructure contributes to the achievement of the MDGs. In addition, the availability of reliable and affordable infrastructure contributes directly by providing or supporting the delivery of key services. Yet, as the Global Monitoring Report makes clear, there are large gaps in the availability and quality of key infrastructure services in developing countries. These gaps are particularly large in low-income countries, and they are sizable in middle-income countries. Narrowing gaps in access and quality will require significant increases in investment and associated spending.

13. Spending on education, health and other human development activities in developing countries has risen over the past decade. The rising trend signifies a growing commitment on the part of developing country governments to human development goals. Further increases in spending on these sectors along with spending on related priority infrastructure such as water and sanitation will be necessary to meet the MDGs, especially in the low-income countries.

14. The bulk of resources to meet these financing requirements will need to come from domestic resources, which underscores the importance of growth and domestic resource mobilization. Private flows, including foreign direct investment and remittances, can be important supplementary sources of finance especially for middle-income countries. For the poorest countries, official development assistance (ODA) is the most important source of external finance and accounts for 12 percent of investment financing. In contrast, the relative contribution of ODA has steadily declined in middle-income countries. ODA and net borrowing from multilateral banks now account for less than 2 percent of investment outlays in middle-income countries.

C. The Role of Official Development Assistance

15. Official development assistance has been a catalyst helping to shape change, and cross-country evidence shows that it has been effective in good policy environments; it has played an important role in supporting, cementing and often helping shape reform efforts to deliver poverty reduction in recent years.

16. Low-income countries need aid the most, they need the most aid, and they are likely to need it beyond 2015. Most of these countries are in Sub-Saharan Africa. They are far from achieving the MDGs, they face debt sustainability risks, and they are vulnerable to shocks. Different countries will have different capacities to manage and absorb higher aid flows but policy frameworks have been improving steadily. Many countries will be able to use higher aid flows effectively in the short-run, others will need more time to invest in capacity and strong delivery systems.

17. In the LICUS and post-conflict countries, the challenges go well beyond the social agenda: large amounts of aid are likely to be ineffective, but non-governmental channels can be used to target aid towards basic human needs, while building up capacity to absorb larger amounts of aid efficiently.

18. The challenge of appropriate concessional finance also extends to blend countries and to “gap” countries at or above the cut-off point for normal IDA eligibility, but with low creditworthiness for IBRD lending. Given the wide-ranging circumstances of countries within this group, a first step will be to carry out a more systematic analysis of their needs so as to derive a taxonomy of countries. This will then serve as a basis for developing financing approaches that are better tailored to their situations and enable them to accelerate their progress towards market-based approaches.

19. The middle-income countries have very large pockets of poor and large needs on the social agenda, including social infrastructure. They have relatively good policy frameworks and can build on track records of success. Many, however, face fiscal constraints and still have relatively low per capita income levels. Well-targeted aid in these countries too can be a powerful catalyst in accelerating progress on the MDGs.

Aid Flows

	Population	GNI per capita	Proportion of world's poor (below $1/day)	Net official flows (including grants)
Country Groups	In billions	USD	In %	USD billions
	2002	2002	1990s	2001
MIC	2.6	1,967	30	8.2
Blend (IDA & IBRD)	1.6	501	40	5.5
IDA	0.7	354	20	13.1
IDA/LICUS	0.3	331	10	1.4

20. The Bank's September 2003 report to the Development Committee (*Supporting Sound Policies with Adequate and Appropriate Financing*), concluded that, as a conservative estimate, an initial increment of at least $30 billion annually could be used effectively by recipient countries. As countries improve their policies and governance over time and upgrade their capacities, the amount of aid that can be used effectively in the medium term would rise into the range of $50 billion plus per year.[4] Finance is also needed to help cushion low-income countries from the impact of exogenous shocks, and for financing key global public goods, adding to this total. Work is underway to assess the financing gap more accurately.

21. The experience and feedback from poverty reduction strategy papers and a review of sector priorities such as in health and education suggest that there is much greater opportunity now than ever before for scaling up assistance to help meet the MDG agenda. One lesson drawn from recent country and sector level experience has been that, even where there is agreement on the needs and focus for financing, and agreement that it will be effective, sufficient aid is still not being made available on the scale required. It takes time for aid flows to become fully operational and to have an impact on the ground. The most urgent need is to increase traditional ODA now to make a difference by 2015.

22. It is clear that we need significant increases in additional aid: more aid, more aid up front, better quality aid and predictable and sustainable aid. Early and secure commitments would help create a virtuous circle by encouraging and sustaining deeper reform that would make aid still more productive.

[4] Other estimates suggest $50 billion or more is likely to be necessary to support adequate progress toward the MDGs. The Report of the High-Level Panel on Financing for Development (Zedillo and others 2001), Goals for Development: History, Prospects, Costs (Devarajan, Swanson, Miller 2002); Interim Report of the Task Force I on Poverty and Economic Development (2004) of the Millennium Project.

III. Options for Mobilizing Resources toward the MDGs

23. Fundamentally, then, the best way to increase aid flows is simply to have more aid – for the international community to increase ODA and deliver on the pledges made around the Monterrey consensus, in which developed countries were urged to make concrete efforts towards the target of 0.7 percent of gross national product as ODA to developing countries.[5] It is clear, though, that there is a gap between needs and absorptive capacity on the one hand and prospective aid flows on the other. After summarizing the prospects for increased aid flows, this section reviews current ideas and work in three areas: proposals to bring forward future aid commitments; global taxation for development purposes; and ideas for greater flexibility in the form and concessionality levels of existing aid.

A. Delivering on Monterrey

24. After falling substantially in the second half of the 1990s, aid volumes rose in 2002. Net ODA flows, as estimated by the Development Action Committee (DAC) of the OECD, rose from $52 billion in 2001 to $58 billion in 2002. The ratio of ODA to donors' GNI, which fell from 0.34 percent in the early 1990s to 0.22 percent in 2001, rose to 0.23 percent in 2002. Aid volumes are set to rise further as DAC members start delivering on their Monterrey commitments. These pledges, subject to future legislative action by each donor country, are a substantial and promising improvement in the prospects of adequate funding toward the MDGs. If the commitments made by donors at or since the Monterrey Conference of March 2002 are realized, total ODA would increase by about $18.5 billion over the 2002 level (32 percent in real terms), that is, from $58 billion to $77 billion.[6] That would raise the ODA to GNI ratio to 0.29 percent by 2006.

25. While encouraging, the indicated increase is well short of what is needed. Moreover, a much higher proportion of aid will need to be provided in the form of cash, in flexible ways, and at predictable levels, so that it can be deployed in accordance with country priorities to finance the costs of meeting the MDGs. As reported in the Global Monitoring Report 2004, the proportion of aid provided in cash and with flexibility has fallen steadily from 60 percent in the early 1980s to less than 30 percent currently.[7] This trend needs to be reversed.

26. There is also great scope for increasing the effectiveness of aid by better aligning it with recipients' development priorities as manifested in country-owned and -led poverty reduction strategies and other development frameworks – and by harmonizing donor policies and practices. There is widespread agreement that cooperative multilateral

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[5] Final Outcome of the International Conference on Financing for Development, adopted by acclamation at the Summit Segment of the International Conference on Financing for Development on March 22, 2002 in Monterrey, Mexico.

[6] OECD 2004. Amounts are at 2002 prices and exchange rates.

[7] Global Monitoring Report 2004, ch. 11, Figure 3.

approaches lower the transaction costs and rigidities of having multiple donors acting in parallel. In this context, the replenishment of existing multilateral concessional facilities is fundamental to translating aid commitments into MDG results. Donors are currently in the midst of this process, with a coincidence of important discussions. Negotiations for both the Fourteenth Replenishment of IDA and the Tenth Replenishment of the African Development Fund began in February 2004. Negotiations to replenish the Asian Development Fund (ADF IX) are underway, with the third meeting having taken place March 9-11, 2004. Donor commitment to increase aid flows through these institutions is a critical step toward providing adequate funding toward the MDGs.

B. Frontloading Aid Flows: The International Finance Facility

27. Against the backdrop of a large need for extra resources to help meet the MDGs, the case has been made for exploring ways to bring forward some of the increases in aid flows committed or projected for future years – so-called "frontloading". The case for frontloading to increase the funds available to spend on aid now is first the urgency of the MDG agenda, and second the premise that the economic and social returns to well-allocated and well-targeted aid are well above the cost of borrowing.

28. The primary proposal to frontload aid is the International Finance Facility (IFF), put forward by the United Kingdom in January 2003.[8] The IFF would provide a way to increase aid levels between now and 2015, to be paid by donor countries after 2015. It would be established as a financing mechanism that would securitize pledged increases in future ODA through the bond markets. The IFF would increase the funds available to spend on aid now by using market borrowing to bring forward increases in future aid commitments, given the urgency of the MDG agenda and based on the premise that the return on aid investment is higher than the cost of borrowing funds.

Structure of the IFF

29. The International Finance Facility consists of four basic components: First, donors pledge future financing commitments without having to make immediate appropriations or fiscal commitments. Second, a treasury platform uses the donor pledges as backing to issue bonds that are AAA-rated. Third, the bond proceeds are channeled through existing bilateral and multilateral aid programs. Finally, payments on the bonds come due and are made by participating donors.

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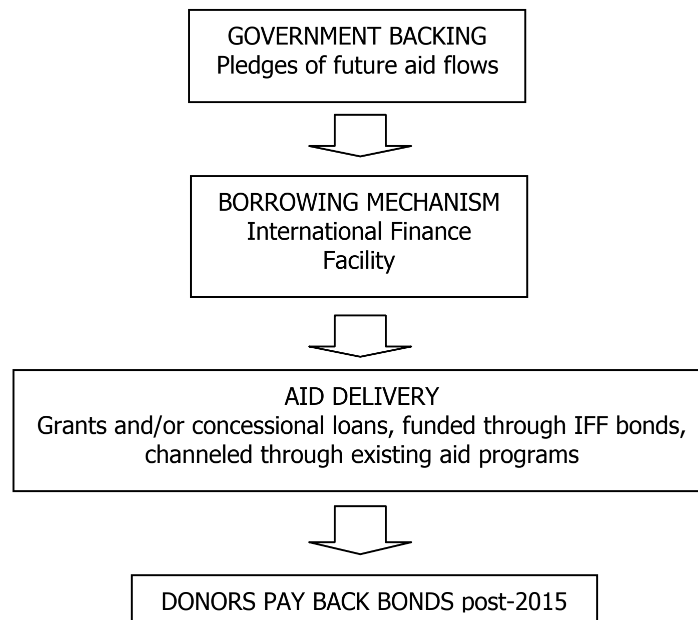
[8] “International Finance Facility”, UK Treasury and DfID, January 2003.



(1) Government Pledges of Future Financing Streams

30. The first of the four components of the IFF is the pledge by donors of future flows. A critical aspect of the proposal is that donor pledges must be legally binding so that they will be accepted as backing sufficient for the IFF to support the issuance of AAA-rated bonds.

31. The most systematic exploration of fiscal treatment of IFF pledges – in particular, how to allow for increased aid spending without an immediate budget impact – has been done with respect to the EU countries. In the scheme as outlined by the United Kingdom, the structure of the IFF is intended to support having only annual cash payments by donors recorded in donors' fiscal accounts while the pledges of future flows would remain contingent, off-balance sheet liabilities. The fiscal treatment of these contingent liabilities will need careful examination to ensure consistency with the principles of fiscal transparency that the Fund and the Bank advocate in their advice to member countries.

32. It is expected by the IFF's proponents that there would be two fundamental requirements if donor pledges to the IFF are not to be treated as liabilities on EU government balance sheets. First, the contingent nature of donor payment on pledges would have to be defined by a "high-level financing condition" based on the expectation that recipient countries meet fundamental conditions of good governance in order for donor tax-payers to continue to make payments to the IFF. The UK proposal is that the condition should be that there be no arrears by a beneficiary country of six months or more with the IMF. If the condition is not met – that is, if a recipient country is in protracted arrears to the IMF – donors would not be obligated to make payments to the IFF for assistance volumes related to that specific country. The second requirement for

treating the IFF apart from participating governments' current fiscal balance sheets is that the IFF's governance structure be independent from any single donor government.

33. Beyond the analysis undertaken with respect to EU countries, a number of major non-EU donors have identified substantial issues with respect to their national accounting treatment and legislative processes, and donor-by-donor assessments of the IFF's feasibility would have to be undertaken for the IFF to be established as a global funding vehicle.

(2) Borrowing Platform

34. The second aspect of the IFF is the establishment of a treasury platform to issue bonds that will provide development funds. One advantage of the IFF proposal over possible alternatives is that it relies on pledges rather than cash, capital or other collateral to back the bonds. The excess of pledged amounts over the amount of borrowings supports the AAA rating on IFF bonds. This means that there is no direct opportunity cost associated with borrowing less than the pledged amount – the effect of relying on pledges to ensure AAA status is just to reduce the degree of frontloading, or the level of inter-temporal substitution of aid volumes. That is, the IFF would issue bonds only to cover the needed volume of aid disbursements, not the full amount of donor pledges. This would avoid a build-up of liquidity in the IFF and associated opportunity costs for donors.

35. One issue to consider is how efficiently donor pledges can be translated into AAA bond issuance; another point to note is that the cost of establishing the IFF, along with payment of interest on the bonds, will reduce the amount of resources available to developing countries through the mechanism.

36. Bonds issued by the IFF must be able to secure a AAA rating; issuing bonds at a cost higher than AAA rates would be inefficient compared with G7 governments issuing sovereign securities directly.[9] This requirement is proposed to be met by borrowing only a prudent proportion of donor commitments to the IFF. By issuing IFF bonds in volumes of less than 100 percent of donor pledges, the IFF would have excess backing sufficient to cover risks of non-payment, primarily arising from the possibility of extended borrower arrears to the IMF reducing donor obligations to pay. This excess backing is only on paper – if, as time goes by, the rate at which countries actually go into arrears with the IMF is less than anticipated, then the unused excess backing can be reincorporated as part of a new commitment stream.

37. 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 can be borrowed and become available for development financing. Assuming that a defaulting recipient country would exit IMF arrears after 4 years (or 7 years), in order to maintain a AAA

[9] IFF bonds would likely be issued at a small premium to AAA sovereign bonds, but within the range of rates for AAA securities.

rating on IFF bonds, about 76 percent (or 66 percent) of donor pledges could be translated into bond issuance.[10] The UK has obtained assurance from an internationally recognized rating agency that the proposed IFF structure will support the issuance of AAA bonds at these estimated advance rates.

38. The model developed to assess the IFF's advance rate has been tested to assess the impact of changing key parameters, such as borrower default frequencies and the composition of donors.[11] Testing of the IFF's financial structure, efficiency and risk characteristics are continuing.

(3) Aid Delivery/Governance

39. The third component of the IFF relates to its governance structure and how it would ensure the development effectiveness of aid flows. Particularly if the IFF were to generate substantial additional aid flows, aid effectiveness for the frontloaded flows would depend critically on how aid is allocated, delivered and monitored. To avoid inefficient duplication of aid delivery, IFF funds are expected to flow through existing aid channels. The allocation of IFF flows to aid delivery programs could shift the balance between bilateral and multilateral flows, and thus affect the overall global strategy for aid delivery.[12] Such shifts could be constructive – for example donors joining the IFF could be required to meet certain principles of aid behavior, such as providing untied aid or aid in medium term predictable programs. Thus, the governance structure of the IFF is a critical aspect that would need to be thought through with care.

40. As proposed by the UK, the IFF would be a legal entity owned by participating donors. Governance issues have not been thoroughly explored and a range of approaches could be developed. The UK has suggested that IFF could work, for example, on a replenishment model basis, providing periodic opportunities for civil society and developing country voice to be included in policy setting, although it would mean another set of replenishment discussions. Some major donors have expressed concerns about the cost-effectiveness of establishing the IFF as a separate international organization, as well as how to ensure efficiency and accountability in its governance structure. How decisions would be made, and how the views of core donor participants, recipients, and civil society would be reflected, is a debate eliciting significant interest.

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[10] Assisted by Goldman Sachs and Standard & Poor's, the UK Treasury has run Monte Carlo simulations using IDA-eligible countries as putative IFF recipients and assuming donor funding from G7 countries.

[11] It should be noted that the assumptions underpinning the base case default rate and the model used to determine the base case and the sensitivities were developed outside the Bank.

[12] See "The International Aid System 2005-2010: Forces for and Against Change," Rogerson, Hewitt and Waldenburg, January 2004, pp. 30-31.

(4) Repayments

41. The fourth phase of IFF structure is the repayment period. One concern expressed about the IFF repayment structure is the risk that aid flows, having increased over the next decade, could fall off after 2015 as donors begin to use part of the aid budgets toward IFF bond payments. While important progress toward the MDGs can be made by frontloading aid, the need for continued substantial ODA is likely to remain. As the IFF is intended to frontload aid, and as it would not provide truly additional flows, it is estimated that for several years after 2015 there would be a decline in aid flows. However, it is important to note that the IFF is intended to capture only the additional aid commitment made post-Monterrey. The IFF would frontload only those incremental pledges, which to date amount to about 0.06 percent of OECD GNI. Also, the timing of IFF borrowings would be flexible, depending on pre-existing pledges rather than donor appropriation and encashment cycles. Thus, the stream of IFF disbursements could be managed in accordance with the desired amount of frontloading and expected ongoing disbursement needs.

42. Despite the economic case for frontloading aid for development, donor governments participating in the IFF may face political pressures as they begin to use part of their aid budgets to repay IFF bondholders. The extent to which the governance structure of the IFF reflects wide ownership may help with political perceptions of its usefulness at the bond repayment stage.

Variations on the IFF Structure

43. Assuming that frontloading aid makes economic sense, and that donors are able and willing to make legally binding pledges of future aid flows, variations on the IFF structure could be considered. The component elements of the IFF could potentially work together in different ways. With respect to the first component – the pledge of future aid flows – the IFF as proposed would provide a way for EU member countries to make off-budget pledges. Donors unable to take advantage of that specific mechanism may have other ways to participate, for example through guarantees, authorization without appropriation, or otherwise.

44. As to the second component – the IFF itself – there may be different ways to establish or use the required borrowing platform. Creation of a new international entity is not a small task. As an alternative, using the existing treasury platforms of the MDBs, which issue AAA bonds and deal with currency-mismatched portfolios, might be an efficient way to implement the IFF. Such an approach would have the advantage of using existing entities with relevant expertise and substantial market presence, although it would entail careful structuring to avoid impacting the existing capital structure of the MDBs. Alternatively, relying on the donor backing supporting the IFF structure, it might be possible to place the IFF within the concessional windows of the MDBs. This could facilitate close alignment with the fundamental purposes of the concessional institutions, while minimizing transaction costs as IDA and the concessional windows have access to the existing MDB treasuries, and have some balance sheet value as additional backing.

Another variant would be to establish the IFF as a subsidiary or separately administered entity of one or more of the MDBs.

Summary

45. The fundamental premise of the IFF – frontloading aid to achieve the MDGs, based on the assumption that the return on development investments is higher than the cost of AAA borrowing – holds considerable attractions. As proposed, IFF flows would help meet development requirements, would rely on existing aid delivery channels, and could add to flow predictability in the medium term. The proposal, subject to the accounting, legislative and other circumstances of individual donors, appears technically feasible – the structure would support the issuance of AAA bonds to provide development funding. Further work and issues remain with respect to the feasibility of other donors making legally binding but off-budget pledges, and with respect to basic issues of governance and efficiency.

C. Global Taxation Proposals[13]

46. The international community is also exploring ways to increase other flows for development, resulting in a range of proposals. A number of the proposals for innovative sources of development finance are for taxes that their proponents believe would be desirable even if the proceeds were not used to finance development, but which for various reasons countries do not have the proper incentives, or practical ability, to impose unilaterally. Prominent among such proposals are:

- **Environmental taxes** of various kinds – most prominently a **carbon tax** (or, broadly equivalent, a system of tradable permits[14]) addressed to the mitigation of climate change. These taxes are likely to be set too low in the absence of international coordination, both because some of the damage caused by one country's emissions is felt by others and/or for fear of disadvantaging domestic producers. Revenue from such sources could be considerable: a carbon tax equivalent to 4.8 cents per US gallon of gasoline would raise about $60 billion even if – in order to mitigate adverse equity effects – it were levied only on developed countries.

- A **currency transaction ('Tobin') tax.** In its simplest form (there are many variants), a tax on spot transactions in foreign exchange is seen by its advocates as counteracting a tendency to excessive exchange rate volatility, enabling monetary policy to focus more on domestic concerns while doing little to discourage long-term capital flows. Implementation of such a tax, however, is problematic without participation of at least the major financial centers, since transactions will otherwise move offshore to intermediaries not liable to the tax. Revenue could again be very substantial: a tax in the order of 0.02 percent might raise $35-50 billion per annum.

[13] This section was prepared by Fund staff in cooperation with Bank staff.

[14] Initial steps to pilot such an approach have been initiated, an example being the Prototype Carbon Fund.

The tax may however also discourage beneficial hedging and other transactions. Experience with various domestic transactions taxes suggests that traders will prove adept at finding ways of avoiding or evading it. Moreover, by thinning markets and discouraging stabilizing speculation the tax could actually increase volatility.

- **Coordinated increases in taxes on internationally mobile businesses and capital.** Increases in international tax rates that are excessively low because of international tax competition could undo the erosion of global revenues brought about by tax havens. The revenue potential of enhanced corporate and capital income taxation is considerable. Previous efforts at coordinated tax increases of this kind have had made little political progress, in part reflecting concern at the 'third country' problem that arises when significant competitors remain outside the agreement. Some argue that international tax competition serves a useful purpose in curbing wasteful government expenditure. Other proposals include coordinating increases with respect to taxes on **aviation fuel** and/or **air transport** (reflecting also environmental concerns, and with the latter raising perhaps $20 billion per annum), on **shipping**, or on **arms exports** (in the order of $1.5 billion per annum, at a 5 percent tax rate for 1999-2000).

- Another set of proposals envisages **taxing resources that are common property** of the world as a whole, not of specific countries. Here, taxation may serve to correct over-exploitation, and the associated revenue is by its nature seen as attributable collectively rather than to particular countries. Suggestions here include charges for the **positioning of satellites** or for the exploitation of **mining rights in international waters** or in **Antarctica**. The potential yield of such taxes has been little studied, but seems likely to be modest for the present.

- In similar spirit, as an exercise of global sovereignty – requiring an international consensus that there is a global liquidity problem, as reflected in a supermajority of voting power at the IMF – is the proposal to **create and voluntarily redistribute additional Special Drawing Rights (SDRs) to developing countries** (or to a fund operated on their behalf). If developed countries were to loan these SDRs to developing countries, this would effectively provide the latter with access to hard currency via termless, low-interest loans. If developed countries donated their SDRs, the transfers would be akin to grants. However, developed countries would continue to pay market rates on the SDRs they lend or donate. Such an allocation of SDRs would require approval by 85 percent of the votes of the Fund membership, and a finding that there was a long-term global need for additional international liquidity. Similar proposals made in the past have not met with wide support.

47. Other proposals – a **global lottery, savings schemes with a lottery element in return**, a **surcharge on national income, a minimal fixed charge on credit card transactions** or other taxes (compulsory or voluntary) – are essentially candidate 'good ideas' that countries could to a large degree implement unilaterally. These require closer study, one question being why, given that they appear to raise no special coordination

issues across countries, they have not already been adopted as sources of domestic finance.

48. Administrative and institutional issues would need to be worked through to move forward with these proposals, although much could probably be done without creating any global tax-collecting agency. The more far-reaching tax-based measures would require an unprecedented degree of international cooperation in a particularly sensitive area of policy. Another challenge would be ensuring additionality: net payers might offset increased development assistance from such sources by reducing (or increasing less) their other contributions. Even for taxes on global commons – for which the world as a whole is the natural recipient of revenue – the increased collective assistance may crowd out national contributions. Nonetheless, innovative tax ideas offer the attractive prospect of simultaneously improving the functioning of the international tax system and providing a relatively sizeable and predictable source of development support. Many of the technical issues that they raise appear broadly soluble, the key issue being that of political acceptability.

D. Increasing Aid Responsiveness and Flexibility

49. 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, to blend countries with access to both MDB and concessional loans, to “IDA-only” countries eligible for concessional lending, to LICUS and post-conflict countries with access to further enhanced concessionality.

50. To deliver the MDGs, even with desired aid volumes being available, will require additional flexibility. The existing spectrum of concessionality needs to be more finely tuned to the very diverse countries that need help achieving the MDGs. Poverty levels provide a baseline, but countries face a range of complicating circumstances as they strive to reduce poverty, including their relative institutional capacity, policy performance, progress toward development goals and the MDGs, debt distress and access to external finance, and vulnerability to exogenous shocks.

Vulnerability to Debt and Shocks

51. Substantial work is going forward on ways to tailor aid terms to respond to debt distress and exogenous shocks, two areas of wide concern for low-income countries. The work on debt sustainability is relatively further along, animated by the realization that more flexible approaches are needed for countries which suffer from continuing vulnerability to debt distress, a vulnerability which puts fragile MDG achievements at particular risk. A framework for assessing debt sustainability in low-income countries has been developed jointly between the Fund and the Bank, intended to help guide both borrowing decisions and lending and grant-allocation decisions of official creditors and

donors, with better performing countries able to sustain higher levels of indebtedness.[15] Important next steps in this work will be to look more systematically at how financing instruments can be used to provide external assistance in adequate volume and with appropriate concessionality.

52. Another area of concern is exogenous shocks, which disproportionately affect low-income countries, especially the poorest. Although the range of country circumstances with respect to shocks such as drops in commodity prices or natural disasters is more varied, the same sort of creativity may be needed to ensure timeliness and flexibility of development assistance. While the global community has provided assistance to low income countries in preventing and mitigating the effects of exogenous shocks, most of this assistance has been largely *ad hoc* and sometimes outside a timeframe responsive to the urgency of the situation. In the Bank, preliminary work is underway to explore the feasibility and benefits of instruments that may have the potential to increase the predictability of financing or augment the level of financing in the face of a shock. Debt service can be reduced in response to a shock, and three mechanisms are being explored in this context: commodity-linked repayments, inflation-indexed local currency lending, and deferred repayment schemes. For all of these instruments the design crucially hinges on how to set eligibility criteria in a way that would benefit countries while continuing to encourage appropriate adjustments to permanent and recurrent shocks. Each instrument entails risks to providers of financing, as well as raising financial management issues. Experience to date in the use of financial instruments that include an automatic response to shocks has not been satisfactory, limiting expectations about the practical application of these instruments.

53. The IMF Executive Board considered on March 31, 2004, various alternatives to assist members to respond to external shocks.[16] The Board endorsed augmenting access to the Poverty Reduction and Growth Facility (PRGF) in those countries where a PRGF-supported program is already in place and subsidizing emergency assistance for natural disasters, if adequate funding is available. The Board asked Fund staff to consider further the possibility of establishing a stand-by-like "window" within the PRGF and PRGF-HIPC Trusts using the PRGF resources. The IMF Board also reviewed the Compensatory Financing Facility, created to help members to cope with temporary export shortfalls caused by exogenous shocks, and decided to continue to make the facility available to Fund members under its current terms.[17] In evaluating these options, the Board underscored that, for the weakest, most vulnerable members, Fund financing may not be the right response to shocks; these members should have access to grants by other donors. Aside from providing technical assistance, the Fund's role in such cases should be limited to drawing attention to the member's financing needs and helping to ensure that assistance is used effectively.

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[15] Debt Sustainability in Low Income Countries – Proposal for an Operational Framework and Policy Implications, joint Bank-Fund paper, February 2, 2004.

[16] The Fund's Support of Low-Income Member Countries: Considerations on Instruments and Financing (SM/04/53, February 24, 2004).

[17] Review of the Compensatory Financing Facility (SM/04/43, February 19, 2004).

Tailoring Concessionality

54. More closely matching country needs to appropriate levels of concessionality will require as a foundation a country-by-country assessment of relevant characteristics, circumstances and core development needs. If needed aid flows materialize, levels of concessionality appropriate to country circumstances, including with respect to poverty and debt distress, can be provided by tailoring the financing terms of external assistance. In many circumstances, this will mean raising the proportion of grant financing in overall flows to countries. Such an approach entails a more comprehensive view of aggregate external financing for vulnerable countries. It also poses new issues for the multilateral concessional windows, which traditionally have extended only concessional loans but have recently introduced some degree of grant financing.

55. Where sufficient aid flows are not available to meet a country's development needs at appropriate levels of concessionality, other ways can be explored to leverage funds and provide opportunities for additionality. One possibility is the use of blending or buy-down arrangements, by which the effective terms of development lending can be softened by blending standard lending products with additional grant financing from donors. For example, donor funds can be used via a buy-down to reduce a standard IDA credit to grant terms. Upon the achievement by the borrower of performance conditions (such as children being vaccinated), the donor pays an amount equal to the net present value of the credit to IDA, which cancels the credit. A buy-down can also be used to reduce an IBRD or other MDB loan to concessional terms, either paying down loan principal or subsidizing interest payments. The primary use of blending mechanisms would be to achieve target levels of concessionality across the market-to-grant spectrum of financing terms.

56. Blending arrangements need to be carefully designed and targeted to avoid inappropriate signals to borrowers, such as reinforcing the incorrect view that returns on social sector expenditures are low, or undermining country-owned investment choices. Buy-downs also can raise particular risks unless funding is additional to existing aid flows. For example, if a buy-down is used to bring a non-concessional loan to concessional terms, it could divert funding from poorer countries. Buy-downs through concessional windows carry a risk of eroding future lending capacity, since they reduce nominal future commitment authority levels. Such issues argue for a well-designed approach to blending arrangements.

57. Appropriately crafted, blending arrangements could support a finer gradation of concessional terms from very poor through low-income to blend and middle-income developing countries. Blending could be appropriate in three contexts: to address global or regional externalities in low-income countries; to increase the flexibility of financing for debt-distressed countries; and to extend concessionality beyond traditional country income cutoffs to encourage MDG investments in blend and middle-income countries.

58. Global/Regional Externalities. In IDA, the credit buy-down mechanism was developed specifically to finance health sector activities with significant positive cross-border externalities on appropriate terms, and to take advantage of resources available from donors. The mechanism responds to situations where, from the perspective of a poor country, it is rational to invest less in the provision of a public good than what is optimal from a global perspective.[18]

59. Debt Distress. In the debt sustainability context, debt buy-downs could be used to increase the volume of assistance to countries where the financing level may be constrained by debt sustainability considerations. For instance, where a country would be eligible for a set level of IDA financing given its policies and performance levels, but is limited in its ability to sustain additional lending, partnering with another donor could enable the full allocation of IDA to be provided without increasing the level of indebtedness of the recipient country.

60. Targeting Key Sectors. Blending arrangements could be used to encourage countries to make special efforts in selected sectors as part of the push to achieve the MDGs. The primary example of this was the use of donor resources to increase the concessionality of IBRD lending in the two projects incorporating buy-down elements undertaken with the UK Department for International Development in China.[19] Country eligibility for such targeting would need to be carefully aligned with a structure of financing terms that established the desirability of subsidized funding for blend or middle-income countries in specific circumstances.

[18] Credit buy-downs were used for polio eradication projects in Nigeria and Pakistan with financial support from the Gates Foundation, the United Nations Foundation and Rotary International. Successful completion of the projects triggers the buy-down, releasing resources from a trust fund to purchase and cancel the credit, effectively turning it into a grant.

[19] Tuberculosis Control Project (March 21, 2002) and Basic Education in Western Areas (September 9, 2003).

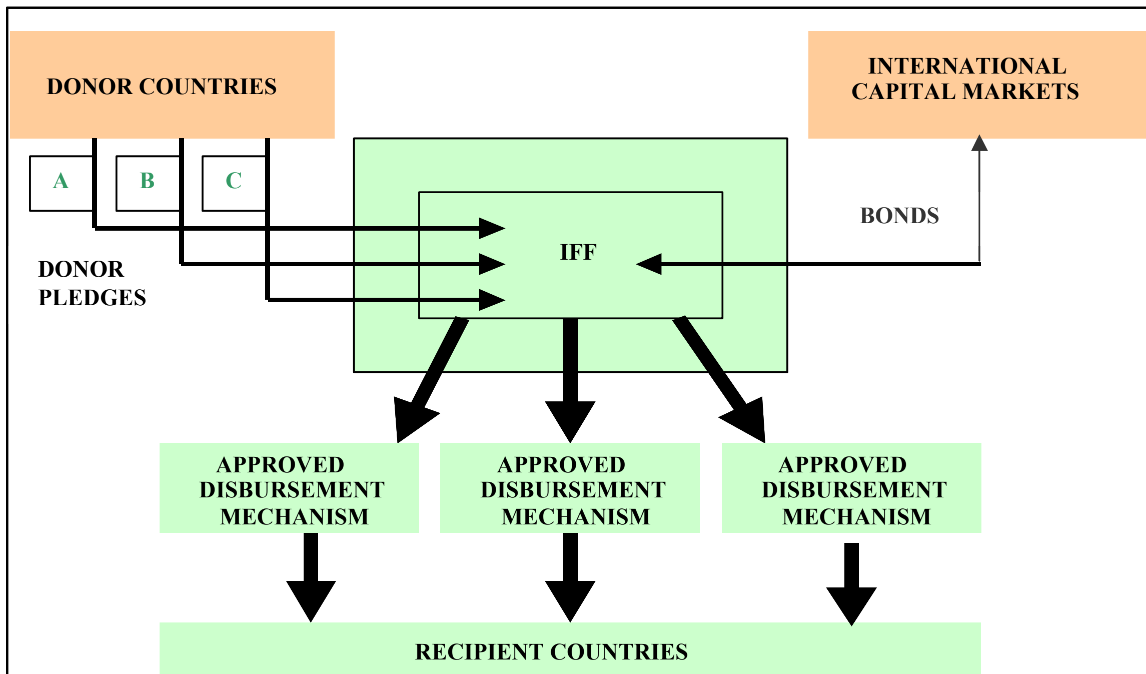
IV. Ongoing Work

61. This note reports on the status of work on a range of approaches to increasing aid flows and improving aid flexibility in order to meet the MDGs. With respect to proposals for frontloading aid such as the IFF, a need for further technical work has been identified in four principal areas: the scope for donor participation, especially regarding differences in national accounting and legislative treatments of IFF-type obligations; financial efficiency under different assumptions, including the contingency of donor obligations; the IFF's governance structure; and possible variant models or platforms for achieving IFF-like purposes. This fuller assessment will be reported by Bank and Fund staff for the Annual Meetings, in the context of the broader ongoing work on the architecture of development aid requested in last September's Communiqué of the International Monetary and Financial Committee of the Board of Governors of the IMF. By the fall, other elements covered in this note – notably approaches to increase aid flexibility and better tailor concessionality to MDG objectives in different country circumstances – should also be further advanced for Ministers' consideration.

The International Finance Facility

1. The proposed International Finance Facility (IFF) would be a financing mechanism established as a separate legal entity with basic treasury functions.[1] The IFF would issue bonds in the capital markets, backed by legally binding pledges of future ODA flows (see Chart 1). Borrowed funds would be channeled through existing multilateral and bilateral development institutions and programs to finance the achievement of the MDGs. Incremental aid funded from the IFF would consist largely of grants but could also include lending on concessional terms, in which case reflows from lending could be used to help donors repay the bonds. IFF pledges by donors would occur through periodic replenishment cycles, which would enable the IFF to issue bonds based on the amount committed in the cycle. Each cycle would result in annual payments by donors to the IFF over a number of years.

Chart 1: Overview of the International Financing Facility

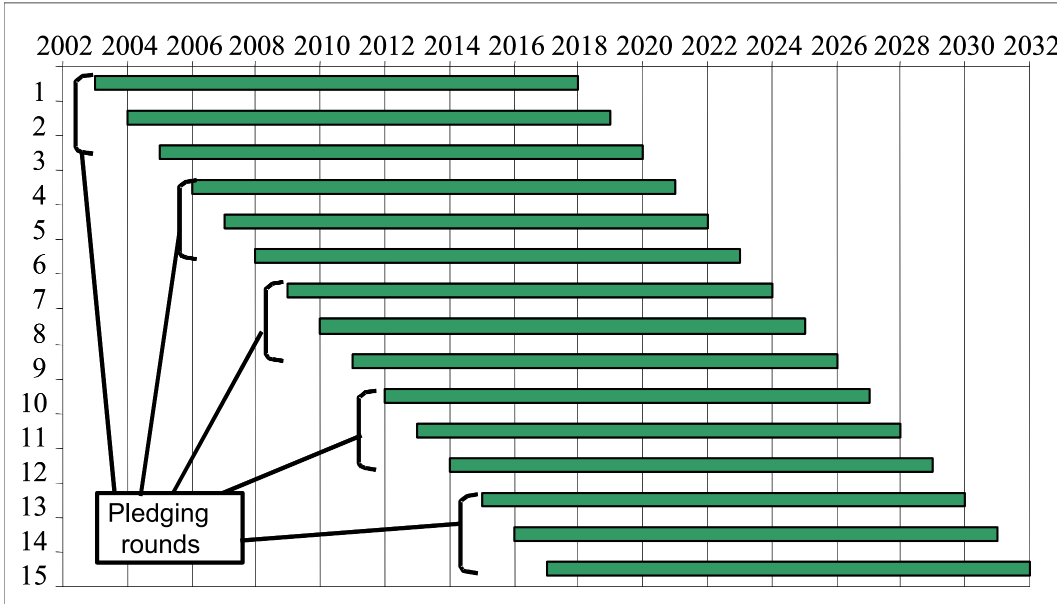


Source: UK Treasury and DfID

2. The IFF, as currently proposed, would provide a temporary framework to raise additional funds for a period of about 15 years through the capital markets. Capital market borrowings would be repaid over a period of about 30 years. Donors would provide pledges of ODA flows to the IFF through 15 consecutive annual pledging rounds, with each round covering payments to the IFF over a 15-year period (see Chart 2).

[1] See "International Finance Facility", HM Treasury and DfID, January 2003.

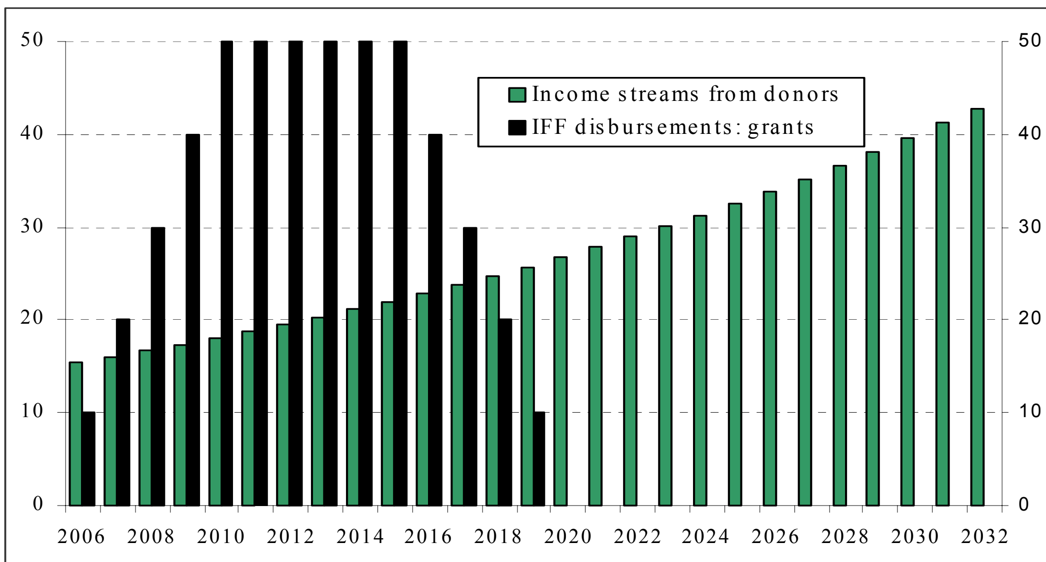
Chart 2: Illustrative Donor Commitments to the IFF



Source: UK Treasury and DfID

3. Annual payments of donors to the IFF would rise over time. One possible profile of donor payments is shown in Chart 3, where annual donor payments rise continuously. In contrast, IFF disbursements of aid monies to implementing agencies would be front-loaded during the first 15 years.

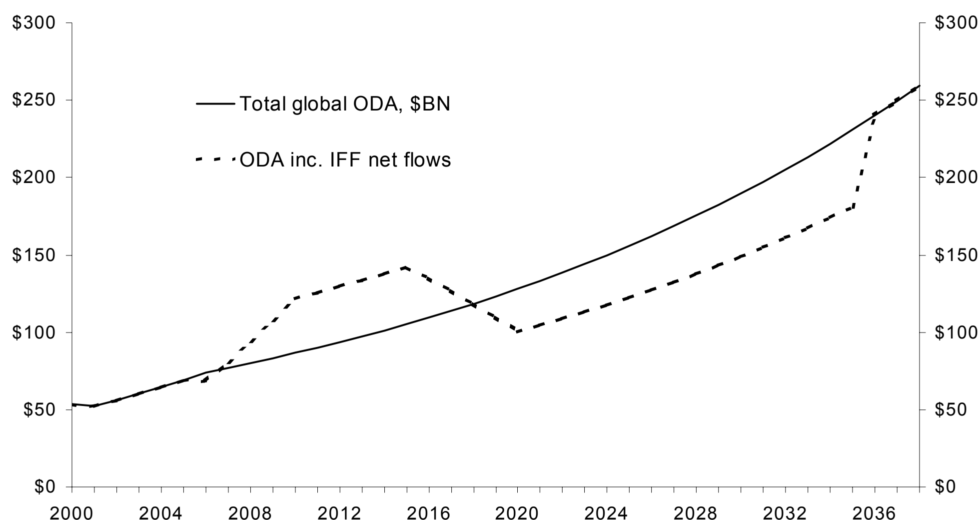
Chart 3: Illustrative IFF Income and Disbursement Patterns (in $ billion)



Source: UK Treasury and DfID

4. In the illustrative example in Chart 3, net incremental ODA flows resulting from the IFF would be positive during the first 12 years of the IFF since IFF disbursements for aid projects exceed donor payments into the IFF. After that, as IFF disbursements for aid come to zero and all monies raised through bond issuance have been provided to implementing agencies, the IFF would reduce ODA flows during the second half of its life when bonds are due for repayment. The impact of the IFF on total ODA flows is illustrated in Chart 4.

Chart 4: ODA including Monterrey Commitments Rising by 4 percent per annum



Source: UK Treasury and DfID

5. The IFF proposal entails the establishment of a treasury platform to borrow bonds that will provide development funds. Bonds issued by the IFF must be able to secure a AAA rating; issuing bonds at a cost higher than AAA rates would be inefficient compared with G7 governments issuing sovereign securities directly. (IFF bonds would likely be issued at a small premium to AAA sovereign bonds, but within the range of rates for AAA securities.) This requirement would be met by borrowing only a prudent proportion of the net present value of donor commitments to the IFF. By issuing IFF bonds in volumes of less than 100 percent of donor pledges, the IFF would have excess backing sufficient to cover risks of non-payment, primarily arising from the possibility of extended borrower arrears reducing donor obligations to pay.

6. The efficiency of the IFF structure, and its inherent risks, are thus reflected in the **advance rate**, which is the proportion of the amounts pledged that can be borrowed and will be available for development financing. Assisted by Goldman Sachs and Standard & Poor's, the UK Treasury has run Monte Carlo simulations, using IDA-eligible countries as IFF recipients and assuming donor funding from G7 countries. Assuming that recipient countries exit IMF arrears after 4 years (or 7 years), in order to maintain a AAA rating on IFF bonds, about 76 percent (or 66 percent) of donor pledges could be

translated into bond issuance. With the passage of time, the required leverage discount would be reduced as bonds near their final maturity.

7. The IFF estimated advance rate depends on a number of assumptions, including the composition and rating of participating donors; risk of default by aid recipients thus of non-payment by donors to the IFF under the high-level financing condition; the estimated time in arrears by a defaulting recipient; and also the composition of financing. Also, it is assumed that IFF flows will be extended as grants. If they are used instead for loans, the extent of any available repayments from non-grant assistance by the IFF would increase leverage.

8. The model developed to assess the IFF's advance rate has been tested to assess the impact of changing key parameters, such as borrower default frequencies and the composition of the donors. (It should be noted that the assumptions underpinning the base case default rate and the model used to determine the base case and the sensitivities were developed outside the Bank.) Initial results suggest that the base case default rate is most sensitive to the **assumed average time in arrears.** The base case assumes that borrowers remain in default for a period of four years. Increasing the default period by two years (which is in line with experience of the IMF and IDA) lowers the advance rate by approximately six percentage points. The outcome of the model is also very sensitive to the **default probabilities** of individual recipient countries. In addition to the default probabilities themselves, therefore, the assumptions on borrowers' ratings (most of the countries that would benefit from IFF funding are not rated by the main rating agencies) and the distribution of exposure across borrowers are very important in determining the advance rate.

9. A number of scenarios have been examined with **combinations of changes** in key parameters. Some of these scenarios have a substantial impact on the advance rate. For example, combining higher default probabilities with a default period of eight years reduces the advance rate by almost 20 percentage points.

10. The results of the model are less sensitive than one might expect to changes in the assumed **correlation** of default across borrowers. The base case default rate includes same region and global correlation coefficients. However, even very large changes in these coefficients have a relatively limited impact on the advance rate. Against this background, Bank staff are looking at possible alternative ways of incorporating correlation into the model.

11. Future testing of the IFF's financial structure, efficiency and risk characteristics are continuing.