

Grants for the World's Poorest: How the World Bank Should Distribute Its Funds

Steve Radelet*
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Time to put to rest the stale debate over whether the World Bank should disburse grants or loans to the world's poorest countries. It is critical that the Bank provide more of its funding as grants, but in a more rational manner than has been the case to date. A third Bank window should distribute grants – and grants only – to very poor countries, for example, with incomes below \$500 per capita. Shifting to grants-only for the very poorest countries would ensure they never again find themselves with unpayable debt burdens, and would allow them to re-invest resources into their own economies rather than repay the Bank.

Debate has swirled recently about how and when the World Bank should provide grants rather than loans to the world's poorest countries. Because the Bank has written down many of its loans to low-income countries since 1996 and is likely to do more of the same in the next few years, there are growing questions about the extent to which it should continue to lend money to poor countries. It is critical that the Bank provide more of its funding as grants, but it should do so in a more rational manner than has been the case to date.

The Bank operates through two main windows: the International Bank for Reconstruction and Development (IBRD), which provides loans on near-market terms to middle-income countries, and the International Development Association (IDA), which disburses highly subsidized loans to poorer countries. Countries are classified for IBRD or IDA funding based on two criterion: (i) income levels, with the IDA cutoff at approximately \$900 (with a few exceptions), and (ii) creditworthiness, based on Bank staff judgments about a country's ability to borrow on private capital markets. In 2004 the Bank committed about \$20 billion in new funding, of which \$11 billion (55%) were IBRD loans and \$9 billion (45%) were from IDA. Traditionally, IDA provided its financing almost exclusively as highly subsidized loans, but it began to expand its use of grants in 2003, and in 2004 it committed grants worth \$1.7 billion (19% of IDA's total commitments).

The Origins of the Shift to Grants

The grants debate heated up in the late 1990s in tandem with debates about debt relief for the poorest countries. In 2000, the Congressionally-appointed Meltzer Commission proposed that IDA provide a mix of grants and loans: grants for health, education, and infrastructure activities and subsidized loans for institutional reform programs. Clinton Treasury Secretary Lawrence Summers made the first official U.S. proposal on grants at the annual meeting of the IMF and World Bank in Prague in September 2000, calling for "the creation of a 100 percent concessional window for the provision of pure grant finance within IDA" – that is, for a subset of IDA funds (that he did not explicitly define) to be provided as grants. Ten months later the new Bush administration adopted a modified version of this proposal as its own. President Bush, in a speech at World Bank headquarters in July 2001, called for 50% of IDA funds to be provided as grants for education, health, nutrition, water and sanitation.

Why Grants Make Sense

Providing grants rather than loans to the world's poorest countries makes sense for several reasons:

- Loans are based on the idea that the funds invested will generate enough resources through economic growth to repay the loans. But the very poorest countries, by definition, have not been successful in generating sustained growth, sometimes even with improved policies. Even when funds are invested wisely, the country may not always be able to repay loans, since the poorest countries tend to be the most vulnerable to (and be less able to cushion against) climactic and commodity price shocks. Progress in one area may be more than offset by unexpected setbacks elsewhere. Until countries have a proven record of sustained growth, grants are far more prudent than loans.

*Steve Radelet is senior fellow at the Center for Global Development.

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- When investments do yield financial and economic returns, these resources should be ploughed back into these countries, not repaid to the World Bank just to be re-lent back to the country or to a neighbor.
- In many cases the countries are only able to repay by sacrificing key social spending, which is already very low. For example, public health spending in Africa averages a paltry \$7 per African, far from what is needed to establish a sound health system.
- Lending to countries that cannot be expected to repay introduces a damaging and costly cycle of lend and forgive and lend again – a sorry pattern that harms both creditor and borrower and undermines the healthy formation of a credit culture. The Bank should provide grants until countries can realistically service debts, then switch to concessional loans and actually impose penalties when countries fail to repay them.

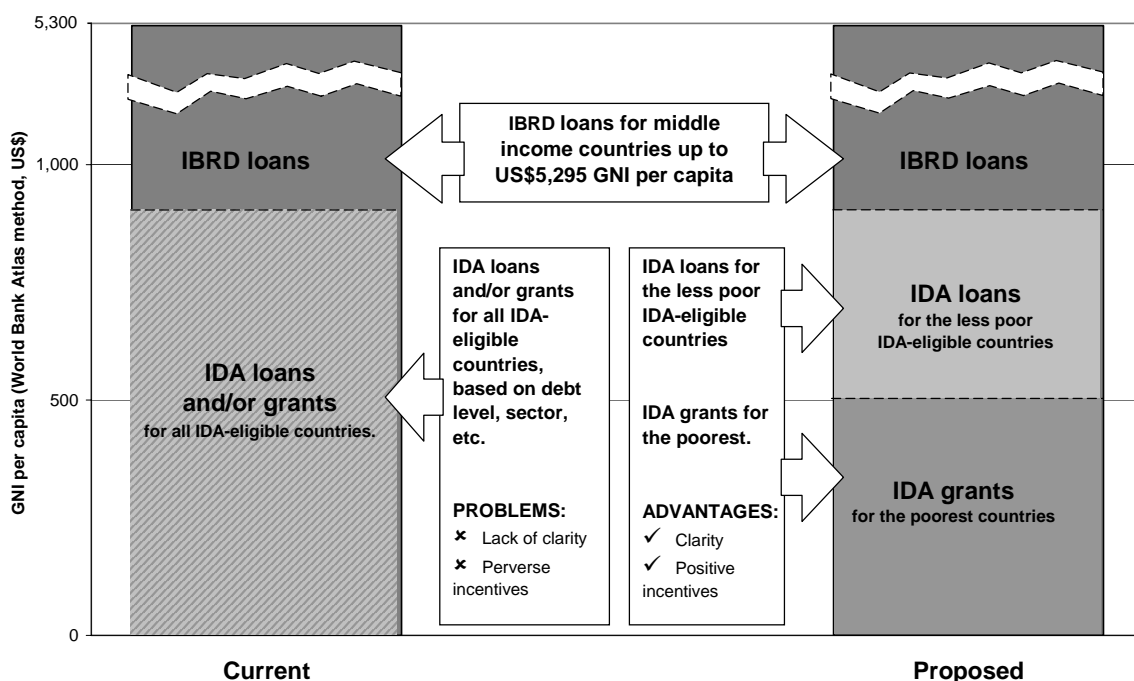
The main arguments usually provided against grants – that loans somehow are critical to distinguish the

Bank from the UN, or that the very poorest countries need to gain skills in debt management even though access to private capital markets may be a generation away – simply are not compelling. For these reasons, almost all bilateral donors (except Japan) provide exclusively grants, leaving the World Bank and regional development banks essentially alone in providing loans to the poorest countries.

Initial Guidelines on IDA Grants

The Bush administration was right to push for more grants, but its proposal encountered some early problems. The U.S. did not sufficiently consult with other shareholders before the announcement, and its blunt approach clouded the substantive debate and significantly undermined initial support. Also, it did not make a commitment for additional funding to compensate the Bank for the lost revenue until several months later. As a result, unfortunately many

Eligibility for World Bank Funds: Grants or Loans, Depending on Income



Grants should not be giveaways. Projects and programs financed by grants should be thoroughly vetted for technical merit before funds are disbursed.

staff and shareholders saw the grants proposal as a Trojan Horse in which the administration's real objective was to effectively shrink the Bank, making them very cautious to embrace the grants idea. More substantively, the initial proposal that 50% of IDA funds be provided as grants was somewhat arbitrary, and left open for debate which countries should get grants, under what circumstances, and for what purposes. The negotiations led to an initial fuzzy compromise during the IDA-13 replenishment¹ in 2002 in which the World Bank Board decided that 18-21% of IDA funds would be used for grants for a smorgasbord of purposes: post-conflict reconstruction, natural disasters, HIV/AIDS, education, health, water and sanitation. This led to a less-than-satisfactory outcome in which countries would receive grants for some activities and loans for others.

Recognizing these problems, the Board amended the guidelines in March 2005 to make debt sustainability the basis for the allocation of grants.² The Bank, together with the IMF, will use their joint Debt Sustainability Framework (DSF)³ to develop country-by-country analyses of the risk of debt distress, based on (i) country-specific thresholds for debt burden indicators, which in turn will depend on the quality of policies and institution, vulnerability to shocks, and to a lesser extent income levels, and (ii) actual and projected behavior of these debt burden indicators.

According to the DSF framework, countries have a greater risk of debt distress if they have lower debt capacity thresholds (e.g., from poor policies or greater vulnerability to shocks) and higher levels of actual or projected debt (relative to exports or GNI). The greater a country's risk of debt distress, the larger the share of financing it will receive as grants. Countries will be grouped into three categories that will determine whether they receive zero, 50%, or 100% of IDA funds as grants. Under these guidelines IDA will provide about 30 percent of its total funds as grants.

The debt-based guidelines are an improvement over the IDA-13 sectoral allocations, and both are a large step forward from three years ago when few grants were available to any country. But they are

far from ideal. Using debt levels as the basis for grant allocations introduces significant moral hazard problems. Countries that have managed their debts well will be "rewarded" by receiving more loans, whereas those that have amassed more debt will receive grants. Moreover, the more a country borrows, the more likely it will begin to receive grants in the future. Under the guidelines, a country that will initially receive 50% or all of its funds as loans will be able to take on new debt until it reaches its threshold level, at which time it will switch to grants.

In addition to the problem of perverse incentives, there will be administrative difficulties. Country-by-country assessments will rely heavily on Bank/Fund staff appraisals of both risk of debt distress and projections of debt burdens. Past projections have been widely off the mark: a Fund staff analysis revealed that GNI growth projections in dollar terms between 1990-2001 were overly-optimistic by almost 5 percentage points a year, a huge margin of error.⁴ Debt levels should be one consideration in determining grants, but not the primary one.

A Better Grants Policy

The right solution is far simpler: grant allocations should be based primarily on income levels, with a secondary reference to creditworthiness, the same principles that now guide the allocation between IBRD and IDA loans. More specifically, the Bank should open a third window to provide all financing as grants to countries with per capita income less than \$500, except for the small number that have access to private credit markets.

The logic is straightforward: loans make sense when the recipient's economy can grow fast enough to generate the funds to repay the loans. But countries with incomes below \$500 have never achieved sustained economic growth – not for hundreds of years. Until they do, grants are far more sensible than loans. Moreover, the very poorest countries are least able to cushion themselves against shocks, making it more difficult to repay loans, even following good investments. Given very scarce resources, any funds generated by strong investments should be re-invested locally, not repaid

to the Bank. It makes little sense for the Bank to make new loans to allow countries to repay old ones, as it now does. And it should not lend money to these countries for water, health, and education projects where the economic return may not be realized for decades. It is for these reasons – according to the Bank and Fund analyses – that the poorest countries systematically run into debt difficulties, even at lower levels of debt.⁵ Until the poorest countries achieve sufficient sustained growth to reach this minimum income level of \$500, all donors, including the Bank, should provide only grants.

Countries with 2004 GNI per capita less than \$500

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| Afghanistan | Madagascar |
| Bangladesh | Malawi |
| Burkina Faso | Mali |
| Burundi | Mauritania |
| Cambodia | Mozambique |
| Central African Rep. | Myanmar |
| Chad | Nepal |
| Congo, Dem. Rep. of | Niger |
| Ethiopia | Nigeria |
| Eritrea | Rwanda |
| Gambia, The | Sao Tome and Principe |
| Ghana | Sierra Leone |
| Guinea | Somalia |
| Guinea-Bissau | Tajikistan |
| Haiti | Tanzania |
| Kenya | Togo |
| Kyrgyz Republic | Uganda |
| Lao PDR | Uzbekistan |
| Liberia | Zambia |

Source: World Bank data

¹ Every three years representatives of both donor and borrower countries make recommendations to the World Bank Board on the replenishment of IDA resources for the subsequent three years. The thirteenth replenishment (IDA-13) was completed in February 2002, and the fourteenth replenishment (IDA-14) was completed in February 2005.

² See "Additions to IDA Resources: 14th Replenishment," March 10, 2005, http://siteresources.worldbank.org/IDA/Resources/14th_Replenishment_Final.pdf

³ For more on the DSF see "Debt Sustainability in Low-Income Countries—Proposal for an Operational

Countries with per capita incomes between \$500 and \$900 should receive IDA loans, as they do now, and shift to IBRD financing as their incomes grow. Countries on the cusp between grants and IDA loans could receive blended financing during the transition period, as could some higher income IDA countries with very high debt levels as they transition out of debt difficulties.

Grants should not be giveaways. Projects and programs financed by grants should be thoroughly vetted for technical merit before funds are disbursed. Each grant should be accompanied by specific performance targets, with future financing contingent on achieving these goals. The Bank should couple increased grant financing with a stronger push to holding countries accountable for achieving results.

Providing grants to the world's poorest countries is a much simpler and sensible way to allocate grants than based on debt levels. This system would be administratively easier, much fairer in avoiding the problem of perverse incentives, and would ensure that grants are channeled to the poorest countries. It would also be fully consistent with the way the Bank now delineates countries for IBRD and subsidized IDA loans. Shifting to grants-only for the very poorest countries would ensure that these countries never again find themselves with unpayable debt burdens, and would allow them to re-invest resources into their own economies rather than repay the Bank.

Framework and Policy Implications," February 3, 2004, <http://www.imf.org/external/np/pdr/sustain/2004/020304.htm>

⁴ Ibid, page 13, footnote 10.

⁵ Ibid, page 23, footnote 25.