Development Grant Financing: More Aid per Dollar

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by

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It is a privilege to address the Joint Economic Committee.

One of the most controversial of the Meltzer Commission's proposals is the change in the format of development aid – the replacement of traditional subsidized loans (zero-interest credits) by grants for infrastructure and social service projects. This is a core issue in the discussion of the effectiveness of aid. Although the concept of grants is familiar, the new model is a hybrid variety.

Grants are a gift, but a gift with strings attached. They make possible the funding of a program in full, but are paid only after audited proof of concrete results. They reinforce discipline by demanding a current co-payment by the recipient. And they leverage every dollar of scarce aid resources by drawing upon the capacity and skills of the private sector. Even a decade ago, the capital markets did not imagine what they offer routinely today – sheer size, sophistication in instruments, and the willingness to tolerate the risk which once deterred projects in the developing world.

Loud and determined voices have risen in protest of the grant concept, all with one recurring theme: Grants will mean less money for the world's poorest.

Secretary Summers wrote in the Financial Times: "This would dramatically reduce the total amount of resources that can be brought to bear in these (developing) economies and require an unworkable system for delivering such assistance." World Bank President Wolfensohn in a letter to Commission Chairman Meltzer deemed grants "unrealistic" and went on to write: "In a time of severely constrained foreign aid budgets, it is highly doubtful that donors would be able to provide and to sustain the needed level of funding."

Clearly, the analysts at the Treasury and the World Bank have misunderstood the economics of grant financing and have ignored the potential of the private sector. A $100 million World Bank loan does not require $100 million in grants to achieve the same result. Every dollar of annual grants replaces 17 dollars of loans for the nations that need it most. The effective use of the $133 billion in equity resources already at the World Bank will generate an annual grant stream of $10.4 billion and support $185 billion in aid programs or 78% more than is currently provided to the poorest nations. Each new appropriation will yield 140% of its dollar value.

<u>How do grants replace loans?</u>

The economics of the Commission's grant financing proposal permits the development banks to leverage resources by drawing upon the vast capacity of the private sector. The only true aid component of development assistance and the only cash requirement of this new format in a world of sophisticated financial markets is the small grant or subsidy that fills the gap between what impoverished recipients can afford to pay and the real cost of supplying the service. This ranges from 90% of cost to 10% depending upon the nation's per capita income and capital market access.

An example will clarify the grant-loan equivalency. A $100 million 20 year project can be financed through a traditional World Bank 20 year subsidized credit. This would require $100 million of aid resources. Alternatively, the project could guarantee annual payments of $13 million upon delivery of results. If the income level and capital market access of the recipient qualify for 50% grant aid, the World Bank would enter into a direct contract to pay $6.5 million per annum to the provider upon delivery of service. The recipient government would enter into a similar contract with the provider to pay the remaining $6.5 million per year. The service provider would utilize the two contracts as security to obtain private sector funding. The financeable value of the direct World Bank revenue stream at a 9% yield is $59.3 million. The financeable value of the recipient country revenue stream at a 15% yield is $40.7 million. The private sector will provide the requisite $100 million in funding with only a $6.5 million per annum commitment of the World Bank.

Financing role of the private sector

Some may fear that the private sector will not provide the requisite resources because most truly poor countries are not creditworthy. This impediment is eliminated by the structure of the Commission's tools. The supplier is paid directly by the development bank upon independently verified delivery of service for its share of the cost. In the case of very poor countries with no access to the capital markets, the direct payment obligation of the World Bank will equal 90% of total cost. This eliminates 90% of the political/credit risk for the provider and hence its banker. A contract directly with the World Bank is eminently financeable in the private sector. The credit risk for the capital markets is therefore that of the service provider – major international contractors and non-governmental organizations – not the aid recipient. The favorable cost of this funding will be incorporated into the user fee rates.

As the income level or capital market access of the recipient nation increases, the share of the World Bank payment in total cost declines but the ability to finance the recipient's contractual obligations in the private sector rises.

<u>Where will the grant funding come from?</u>

The World Bank has $133 billion in paid-in equity resources. Paid-in capital and retained earnings on the Bank's balance sheet amount to $29 billion. IDA, its aid arm, holds $104 billion in resources. If this endowment is invested in market instruments at a conservative 8% return, an income of $10.6 billion will be earned annually. After deducting $200 million in administrative expense, the existing resources in the Bank will generate a stream of $10.4 billion in annual grants in perpetuity.

The Commission has proposed two development bank tools: loans to promote institutional reform with subsidized interest rates based upon the Bank's cost of financing and grants covering a portion of user fees on infrastructure and social service projects. The extent of the interest and user fee subsidies will vary between 10% and 90% based upon the income level and capital market access of the recipient. The institutional reform loans would funded through the issuance of debt secured by the Bank's investment portfolio.

The $10.4 billion annual grant flow would be utilized to pay the interest subsidy on institutional reform loans and the user fee subsidy on infrastructure and social service projects. Utilizing the Bank's guideline of 25% of programs devoted to institutional reform, the grant system under existing resources will support $185 billion in aid programs for the world's poorest countries. This is 78% more than the current $104 billion maximum under IDA's prevailing system of subsidized credits. The proposed structure has the additional benefit of reducing the Bank's capital at risk to the poorest countries by 55% because the endowment and grant revenue stream are unaffected by the financial condition of the recipients. The current level of IBRD non-aid lending can be maintained and supported by the callable capital of its industrialized members and a portion of the Bank's equity and investment portfolio.

The endowment would start at $50 billion representing the IBRD equity capital and undisbursed funds at IDA. As each $100 of existing IDA credits is repaid, instead of relending it, it would be added to the endowment. This would create investment income of $8 and provide grants that would leverage $140 in new development programs. Similarly, each new appropriation would increase the endowment and raise total aid programs by 140% of the new funds provided.

Any modifications of the assumptions underlying the analysis including changes in financing rates, investment returns and amortization schedules will not alter the basic results significantly.

Effective Financing of World Bank Programs

Based Upon Existing Resources

($ amounts in billions)

	IDA Existing System of Credits	Proposed Grant System
Total World Bank paid-in capital	$133	$133
IBRD loans	$117	$117
Return on capital	n.a.	8%
Annual income	n.a.	$10.6
Administrative expense	n.a.	$0.2
Net income available for grants	n.a.	$10.4
World Bank borrowing for aid institutional reform loans	n.a.	$46
Capital at risk	$104	$46
Institutional reform resources	$26 (25%)	$46 (25%)
Project resources	$78 (75%)	$139 (75%)
Total aid resources	$104	$185

Assumptions:
1) Private sector financing costs: World Bank direct payment: 9%
   Recipient payment: 15%
2) World Bank cost of borrowing: 7% (incl. administrative expenses)
3) Internal World Bank amortization schedule of grants: 20 year level total payment
4) Average grant element: 50% of user fee/interest cost

From a financial standpoint, the Commission's proposal is straightforward. The proposal is making effective use of scarce development funds and of sophisticated financial markets.

The appendix provides an analysis of the sources of World Bank income. In contrast to the Bank's public statements, its income does not arise from lending activities. Interest rates on loans only cover the Bank's borrowing costs plus administrative expense. There is no link between loans to middle-income countries and transfers to the poorest members. The Bank's net income is derived from two sources unrelated to its development mandate: the investment of its equity capital and donor funds and the profit from the reinvestment of borrowed funds in market instruments.

APPENDIX

Sources of World Bank Income

It is a well-kept secret, but open to anyone who cares to scan the group's Annual Reports, that, totally independent of its development mandate, the Bank has been quietly accumulating earnings each year that now total over $27 billion. This income does not arise, as spokesmen aver, from proceeds on traditional lending programs. Interest rates on loans only cover the Bank's borrowing costs plus administrative expense. The link is fictitious; loans to Poland and Mexico are not bankrolling transfers to Burkina Faso and Nicaragua. Instead, like a foundation with an endowment, the Bank has been placing the funds provided by member nations in interest bearing assets.

The Bank costs its members a hefty $9 billion in cash each year, yet it pays no interest or dividends to the nations that own its resources. Instead, the investment of the zero-cost $29 billion of equity capital garners $1.8 billion in net income per annum. Then there are the "spread banking" profits. Based upon the guarantees of its industrialized members, the Bank enjoys very favorable interest rates in the financial markets. The proceeds of Bank debt issues are then reinvested at higher yields in mortgage-backed securities, commercial bank deposits, and government and agency bonds. As of June 30, 1999, $30 billion in market investments were held on its books, equal to 1½ years of lending programs. Arbitrage profits were $300 million last year. IDA is also an active investor in market instruments prior to disbursement to poor countries. Total holdings amounted to $8 billion in June 1999 and generated a $500 million profit in fiscal 1999.

It all adds up to $2.5 billion each year in income independent of the Bank's development mandate. If World Bank lending were to cease entirely, these three profit centers would continue to provision resources for the global poor.