

## **GRANTS: A BETTER WAY TO DELIVER AID**

by

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**Performance-based grants would cost the same as traditional loans but they would deliver more benefits to the global poor. Grants would make programs effective, monitor output, pay only for results, prevent accumulation of unpayable debt, forestall diversion of funds for unproductive ends and protect donor nation contributions from risk of loss. The same taxpayer dollars can be spent to far greater effect.**

Soon, the World Bank will seek replenishment funding for the International Development Association (IDA), the arm of the Bank dedicated to lending at near zero interest rates to 72 of the globe's neediest nations with less than \$1500 per capita income. The amounts will be significant: three years ago it was \$11.5 billion (U.S. share \$2.4 billion).

There is a growing consensus that rich countries must commit ever more resources to building a better life for the world's poor. In all the dialogue, scant attention is paid to the sad record of past aid during the last 50 years of World Bank stewardship of \$500 billion in flows from the industrialized nations. Giving wisely, effectively and directly for the benefit of the poor and providing incentives for countries to use aid productively remain elusive goals.

By the Bank's own reckoning, less than one out of three of its projects in the poorest countries yields satisfactory and sustainable results. Forty-two needy countries now carry a load of \$175 billion in official debt. These nations have suffered a 25% decline in their standard of living since 1980. They are clearly unable to repay. (See table: Performance of World Bank Projects.)

Numbers like these led the Administration to propose a major shift in the delivery of aid. In speeches to the World Bank and the G7 governments, President Bush outlined a plan to transform part of IDA assistance from loans that disburse funds whether or not results are achieved to outright grants that pay only for performance.

### ***The New Grant Format***

Grants are a gift with strings attached. Counter to the trend of lending blanket sums for indeterminate government plans, grants will be project-linked and executed under competitive bid with payments shared by the Bank and the beneficiary. For the easily quantified basic needs that improve the quality of life and are the preconditions for economic growth--health, primary education, water and sanitation--the grant system would count by independent audit and pay for output: numbers of babies vaccinated, children that can read and water and sewer services delivered to villages. No results: no funds expended. No funds diverted to off-shore bank accounts, vanity projects or private jets.

Performance of World Bank Projects

Failure Rate of Projects to  
Achieve Satisfactory Sustained Results

	<u>1990-93</u>	<u>1994-97</u>	<u>1998-99</u>	<u>1990-99</u>
Adjustment Lending	55%	45%	37%	47%
Investment Lending	60%	59%	56%	59%
Africa	75%	74%	68%	73%
South Asia	66%	56%	60%	61%
Latin America	51%	50%	37%	48%
East Asia	38%	36%	48%	39%
Low Income	73%	69%	66%	70%
Lower Middle Income	48%	50%	46%	49%
Upper Middle Income	45%	36%	31%	39%
High Income	27%	30%	28%	28%
Total	59%	56%	53%	57%

Source: World Bank

The poorer the country, the greater the need for grants. Under IDA, all recipients benefit from the same subsidy in funding, although some are clearly less poor and others can generate resources domestically and from the capital markets abroad. If all IDA loans were converted to grants and the aid element varied according to need--from 90% for the poorest to 50% for those nearing graduation--an average 70-75% subsidy would result; this is identical to the current aggregate level of subsidy in IDA loans. However, the distribution of aid would be more equitable.

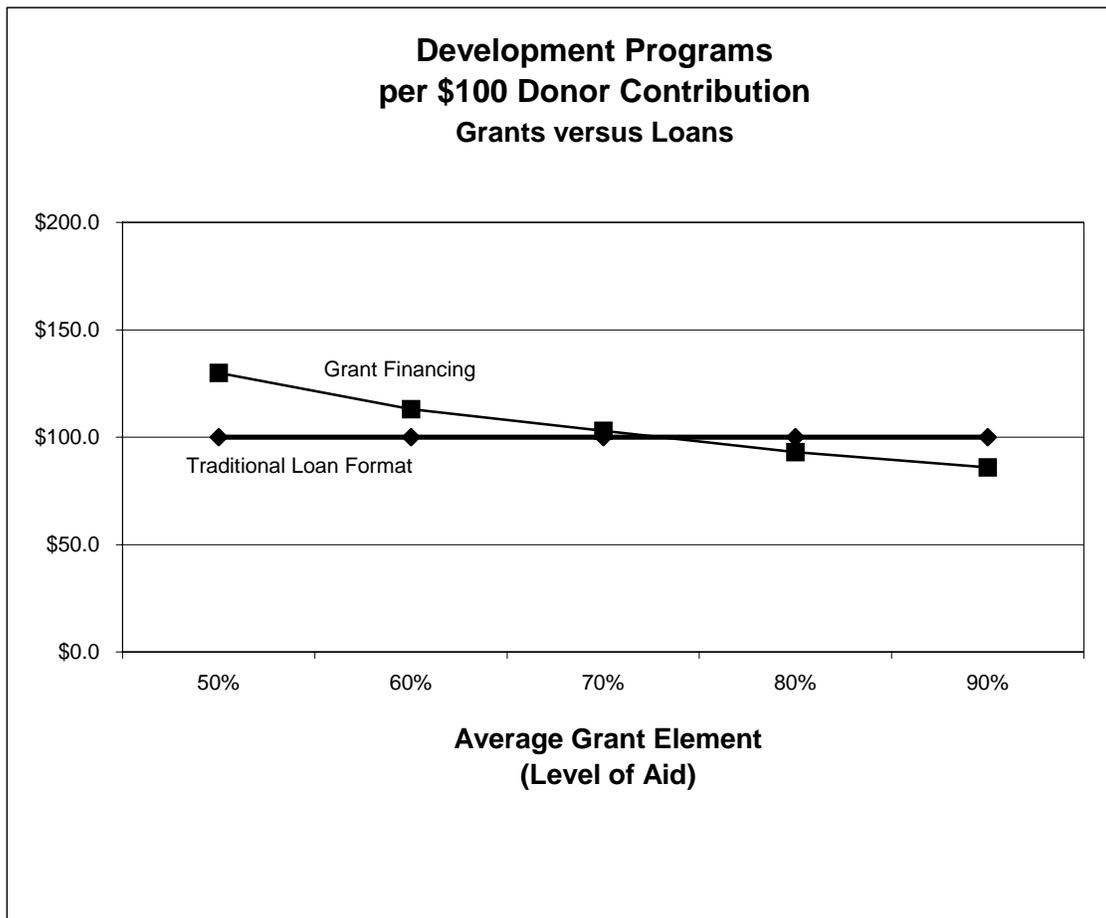
Poor countries would not be passive bystanders in the grant process. They would choose the programs and share a current co-payment obligation. Because there are no loans, there cannot be unsustainable debt. Recipient countries would be insulated against risk. Under pay-as-you-go grants, subject to performance audit, there can be no outlay without benefits and no continuing financial liability if projects fail. Performance risk would be transferred to the private sector.

Opposition to the use of grants has been orchestrated by the World Bank around the faulty argument that grants will deplete its resources, together with its ability to help the poor, unless they are partnered with an immense infusion of new funding--\$800 million more each year from the U.S. alone.

***The Real Costs: Grants versus Loans***

It would seem logical that if money is given away, instead of being lent, the stockpile of funds will eventually vanish. Not so. Grants can deliver the same amount of aid, make every dollar more effective, provide a permanent exit from debt for the poorest countries that are clearly unable to repay, protect donor contributions from risk of loss--all without diminishing the funding pool and without asking for more taxpayer monies from the industrialized world than current programs demand.

Grants will not cost more than loans. The funding requirement is the same when the level of aid is the same. Donors will not have to give more unless they wish to give more aid. (See chart: Development Programs per \$100 Donor Contribution: Grants versus Loans.)



IDA now extends 40-year loans that carry an interest rate of 3/4%. This near zero charge reduces the present value of these payment promises to 27 cents on the dollar and translates into a gift component equal to 73% of their value. There is an additional hidden cost to lending: the poorest borrowers seldom repay loans in reality. Grants avoid the long process leading to debt relief that has culminated in the current initiative for the heavily indebted poor countries (HIPC).

Straightforward arithmetic refutes the Bank's misleading claims. An IDA loan that has a 73% subsidy cannot cost more than an outright grant that pays 73% of program outlays. In both cases, countries pay the remaining 27%. How can lending \$100 and asking for only \$27 to be repaid be any different from giving \$73? In order to discredit the grant concept, confuse the G7 members and justify increased resources, the World Bank has exchanged apples for oranges. Their calculations assume aid levels 37% higher by comparing grants covering 100% of program costs with traditional loans that contain only a 73% grant element. Again, if the same level of assistance is maintained, grants cannot cost more than loans.

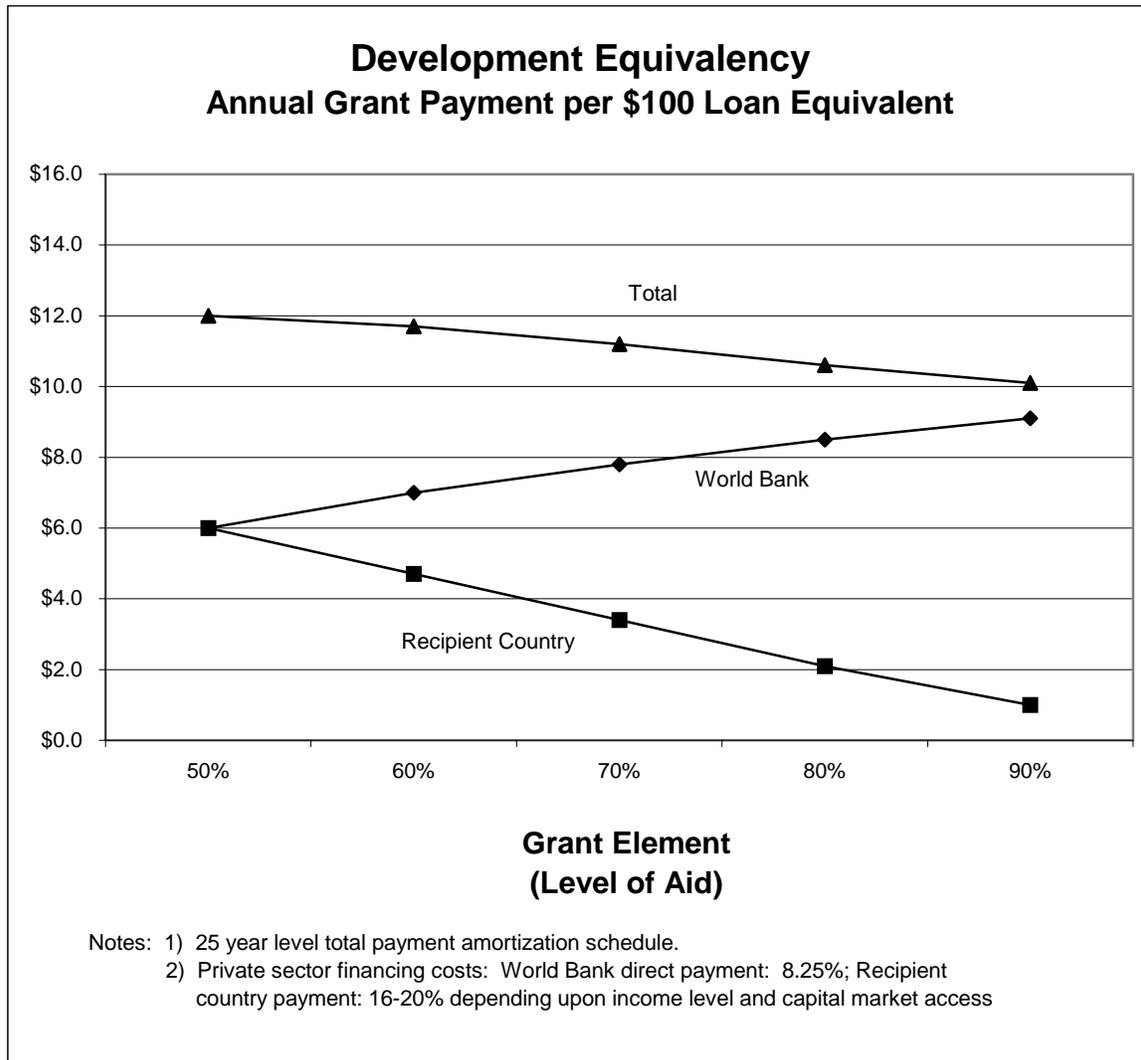
### ***Demand for Funding***

The elimination of repayments of old loans into a circulating aid pool is always advanced as a reason to block the shift from loans to grants. The argument is that the pool will shrink. Real life practices give the lie to this reflow claim. Many loans are never truly collected. Most debts are simply recycled to the same borrowers with added funds to cover interest payments. Ultimately, many debts must be forgiven, as in the current relief initiative that covers 41 of the neediest nations. Whether recycled or forgiven, loans are simply grants in disguise.

Grants will maintain the Bank's capital intact. The pool of donor funds now used for lending, and future cycles of contributions, would be transformed into an endowment that invests in the capital markets and produces the income to supply a stream of payments for services. Only the income earned on the endowment would be disbursed as grants. There are already \$108 billion of rich country contributions on IDA's balance sheet, partly in loans and partly in cash. These cash balances, augmented by future loan repayments, would be invested at a conservative 8.25% return and eventually yield \$8.4 billion in grants each year after administrative expense.

The advent of sophisticated financial markets makes the difference. Grants of \$100 million are not required to accomplish the same ends as \$100 million of IDA loans. An annual grant of \$8 million will suffice if aid is maintained at the current 70-75% level.

Poor countries will not be compelled to borrow to finance the implementation of projects. Instead, the \$8.4 billion annual stream will be leveraged by the private sector which will provide financing for projects based on service contracts in which the Bank's direct responsibility for the lion's share of every payment greatly reduces risk. Thus, an identical \$108 billion in outstanding development programs would be sustained in perpetuity. (See chart: Development Equivalency: Annual Grant Payment per \$100 Loan Equivalent.)



As IDA moves from lending to grants over a 40-year transition span, the volume of development programs and the flow of financial resources to poor countries would match what would have been delivered by traditional loans. Failures to repay old loans would reduce resources but no more so than under classic lending.

### ***The Moment for Change***

Lack of basic arithmetic skills cannot explain the Bank's continued defense of an outdated method for delivering aid, designed at a time when direct loans were the only option. There are now capital markets able to provide financing and willing to tolerate the risk that once deterred projects in the developing world. The institution does not welcome a career change from an elegant banker dispensing large volumes of largesse to a development agency with a gritty and

demanding workload. And it harbors a well-founded fear that, with grants, it must stand up and be counted for the effectiveness of its programs.

Giving to needy nations is a continuing obligation but so is the responsible use of taxpayer funds. Legislators should consider a proviso for the use of grants when making their new contributions. The increased effectiveness of aid might then encourage them to give more and with good conscience.

A detailed blueprint of how grants would function in the field and how financing is generated under a system of varying subsidy follows in the Appendix.

## APPENDIX

### *I. Effective New Grants: User Fees and Payment for Performance*

For the globe's truly poor, the provision of rudimentary levels of health care, primary education and physical infrastructure remains the starting point toward a better living standard and the precondition for economic growth. Yet these are the very countries where corrupt and inefficient environments undermine the ability to benefit from aid and to repay debt.

It is easy to quantify primary education skills, vaccination rates, miles of passable roads, provision of electricity, delivery of water and sanitation and specify contracts for competitive bid. Skilled international suppliers in the service sectors and non-governmental organizations are increasingly mobile and would welcome a structure of concessions and delivery contracts paid in large part by a AAA-rated agency.

The share of the World Bank grant in the total cost would depend upon the income level and capital market access of recipients. The poorest nations without capital market access would receive grants equal to 90% of the service cost while the development agency's contribution would fall to 50% as the income level or access to private sector resources rises toward automatic graduation from IDA aid.

An example:

A country of \$250 per capita income qualifying for 90% grant resources determines that vaccination of its children against measles is a desired goal. If the development agency confirms the need, the government would solicit competitive bids from private sector agents, non-governmental organizations such as charitable institutions and public sector entities such as the Ministry of Health. If the lowest qualifying bid is \$5 per vaccination, the World Bank would agree to pay \$4.50 (90%) for each child vaccinated directly to the provider. The government would be responsible for the remaining \$0.50 (10%) fee. Payments would only be made upon certification by an agent independent of all participants--the government, the World Bank and the provider of vaccinations.

Under a system of user fees, grants are paid after audited delivery of service. No results; no funds expended. Payments would be based upon number of children vaccinated, kilowatts delivered, cubic meters of water treated, students passing literacy tests, miles of functioning roads. This system eliminates the distortionary effects of financing cost subsidies (traditional development bank loans and guarantees) by maintaining the relative prices of inputs. It creates a revenue guarantee for agents that provide execution substantially free of political risk through the World Bank's direct payment obligation.

Since payment is ensured directly to the concessionaire, the private sector will generate the necessary funding. From the concessionaires' standpoint, the proposed system has the distinct advantages of allowing them clear responsibility to deliver a product they understand while eliminating the need to negotiate financing with a myriad of official lenders.

Other benefits accrue from the grant format. Because they are an outright gift, citizens of impoverished nations will no longer accumulate debt and be forced to service and repay often ill-considered borrowing agendas. Grants will sidestep the classic pitfalls of corruption, wanton waste and incompetence because no money is disbursed without results. Loans may default but with grants there can be no losses for donor taxpayers; the pool of resources for future aid remains intact, independent of the financial fortunes of the recipients. And grants increase discipline by demanding a current co-payment, no matter how small, rather than a repayment obligation 20-40 years away.

The reliance of the proposed grant system on international contractors and non-governmental organizations for execution may be thought by some to obstruct the growth of local institutions which are the long range goal of development effort. Rather, as basic needs are satisfied at lowest cost, local labor skills and entrepreneurs will be fostered. At the same time, an independent program of institutional reform loans can equip countries to develop domestic capabilities, both governmental and private, to compete for future contracts and, in time, to become self-sustaining.

## ***II. Development Equivalency: New Grants and Traditional Loans***

Grants of \$100 million are not required to accomplish the same ends as \$100 million of IDA loans. An annual grant of \$8 million will on average suffice if the level of aid is maintained at the current 70-75% benchmark. The only true aid component of development assistance, and the only cash requirement of the grant format in a world of sophisticated financial markets, is the subsidy that fills the gap between what impoverished recipients can afford to pay and the real cost of supplying the service. This should range from 90% to 50%, depending upon the nation's per capita income and ability to attract private capital. Poor countries will not be compelled to borrow to finance the implementation of projects.

Under the traditional loan system, a \$100 million 25-year average life project, when financed through a 40-year amortizing IDA subsidized credit, requires \$100 million of aid resources. Instead, if the income level and capital market access of the recipient qualify for 70% grant aid, the identical project would be provisioned through 25 annual payments of \$11.2 million upon certified delivery of results. The World Bank would enter into a direct contract to pay the service provider \$7.8 million per annum. The recipient government would enter into a similar contract to pay the remaining \$3.4 million each year. Together, the two contracts would constitute the security needed by the service provider to obtain private sector funding.

In the capital markets, the financeable value of the direct World Bank revenue stream at an 8.25% yield is \$81.5 million. The financeable value of the recipient country obligation at an 18% yield is \$18.5 million. Thus, a \$7.8 million per annum commitment by the World Bank would be leveraged by private sector lenders to supply the requisite \$100 million in funding. The annual World Bank grant payment that equates to \$100 of traditional IDA credits varies from \$6.0 to \$9.1 as the grant rises from 50% to 90% of the total payment. Additional resources,

mobilized from donor and host governments, would be equally forthcoming under the grant format. (See chart: Development Equivalency: Annual Grant Payment per \$100 Loan Equivalent.)

### ***III. Capital Markets: Core Contribution***

Leverage is what makes possible the transformation from loans to performance-based grants 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.

The low credit-worthiness of most truly poor countries and the lack of immediate profit potential in projects of social value have long been advanced as obstacles to private sector funding of development. The direct World Bank contract removes these impediments.

For very poor countries with no access to the capital markets, the direct payment obligation of the World Bank would equal 90% of total cost, eliminating 90% of the political/credit risk for the provider and hence its banker. The risk for the capital markets is therefore that of the contractor--major international firms and non-governmental organizations--not that of the host country. Investors would bear the recipient's credit only on its 10% share. As the income level or capital market access of the beneficiary increases, the share of the World Bank payment in total cost would decline, to as little as 50%, but the ability of the economy to attract private lenders and to generate domestic resources rises.

### ***IV. The Development Bank as Foundation***

An annual grant stream of \$8.4 billion can be generated in perpetuity without depleting existing IDA resources. IDA holds \$108.1 billion in paid-in capital and retained earnings. If this \$108.1 billion endowment were invested in market instruments at a conservative 8.25% return, it would earn gross annual income of \$8.9 billion. Net income would reach \$8.4 billion after deducting \$500 million for administrative expense.

IDA's annual income would be utilized to provide grants covering a portion of user fees on infrastructure and social service projects. The subsidy would vary between 50% and 90% based upon the income level and capital market access of the beneficiary. It must be underscored that IDA's capital would remain intact, only the annual income would be used for financing grants.

The \$8.4 billion annual net income stream would provide user fee grants for \$108 billion of infrastructure and social service projects if the existing 70-75% level of aid is maintained. A grant system would therefore support an identical volume of aid programs for the world's poorest countries as IDA's prevailing system of subsidized lending. The proposed structure would eliminate IDA's capital at risk to the poorest countries because the endowment and income stream would be unaffected by the financial condition of the recipients. Defaults and

debt relief on existing loans would have the same impact on the grant and conventional loan delivery systems. (See chart: Development Programs per \$100 Donor Contribution: Grants versus Loans.)

### ***V. Transition from Loan to Grant Framework***

The transition would not impact the flow of aid. For any level of donor resources throughout the 40-year transition period, and when the transformation to a grant-based institution is complete, the same volume of development programs, gross annual flows and net annual flows for the poorest countries would be supported under the grant structure as under the traditional loan delivery system.

The grant program endowment would start using the \$3.3 billion now available in IDA undisbursed, uncommitted funds. As borrower reflows repay past IDA credits, these resources would be added to the endowment rather than disbursed as new loans. Similarly, new donor contributions would be invested in market instruments to generate income for grants rather than lent to recipients. The relationship is linear. Each \$100 increment, regardless of origin, would produce \$8.25 in additional annual investment income providing \$7.8 in grants each year in perpetuity, after administrative expense, to support \$100 in new programs if the current level of aid is maintained.