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Soft Lending without Poor Countries

Recommendations for a New IDA

Final Report of the Future of IDA Working Group

Jean-Michel Severino
Todd Moss, chairs
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Contents

Foreword

Fifty-two years after its creation, the International Development Association (IDA) is facing a watershed moment. Drastic changes in the supply of and demand for the World Bank's concessional finance mean that IDA's purpose, tools, and broader role within both the international aid system and the World Bank Group need to be reconsidered. Even under conservative assumptions, IDA will face a wave of likely client graduations over the next 10 to 15 years. Its client base will soon be much smaller, more fragile, and almost entirely African, creating major implications for its operational model, future replenishments, and its relationship with other multilateral development institutions.

The global circumstances in which the World Bank operates are also changing. Most of the world's poor now live in middle-income countries (MICs). Aid budgets are tightening, and the need for financing global public goods is increasingly urgent. An IDA created more than half a century ago may not be ideally suited to the new set of development challenges. The World Bank, under new leadership, needs to adapt its mandate and business model to new realities. The IDA-16 midterm review begins in fall 2012, unofficially launching the negotiations for the IDA-17 replenishment. Instead of lobbying for ever-increasing replenishment envelopes and tweaking at the margins, shareholders and bank management should push for bold and creative ideas to modernize IDA.

Last fall, CGD convened the Future of IDA Working Group to start thinking through some of the ways IDA could adapt to its changing clientele and the changing economic environment. The purpose of the group is to provide an independent voice to the replenishment process, laying out innovative ideas and encouraging IDA deputies to take a long-term look at IDA's future and consider bold changes. To the extent that CGD's consultation around this report has sparked debate about IDA, the working group can already claim some success.

We hope that this report will inspire the World Bank's shareholders to undertake serious discussions about the future of the institution with a view beyond the next three-year replenishment cycle. The World Bank has so far proven to be one of the most effective and efficient channels for development assistance, and it is incumbent upon shareholders to undertake the reforms necessary to ensure it continues to lead in the 21st century.

This effort builds on a series of CGD working groups that have provided strategic recommendations for incoming leaders and key transition periods at the World Bank (June 2005, June 2007), the African Development Bank (September 2006), the Inter-American Development Bank (January 2006), and the Global Fund to Fight AIDS, Tuberculosis and Malaria (October 2007).

The Future of IDA Working Group and this report were made possible in part by support from the Norwegian Ministry of Foreign Affairs. As always we are grateful to our founding chair Edward Scott for his support of our work and to our other funders for their contributions to our mission to reduce global poverty and inequality.

Todd Moss
Acting President
Center for Global Development

About the Future of IDA Working Group

In 2011, the Center for Global Development launched the Future of IDA Working Group to bring together serious scholars, practitioners, and policymakers to explore specific options for World Bank management and shareholders to consider. The group was tasked with thinking through the implications for the business model of the International Development Association as many of its client countries, including some of its largest and best-performing, prepare to graduate from its assistance. This work follows previous CGD reports to shape the World Bank, including *The Hardest Job in the World: Five Crucial Tasks for the New President of the World Bank* and *The World Bank's Work in The Poorest Countries: Five Recommendations for a New IDA*, a report prepared ahead of the IDA 15 negotiations. This report summarizes the conclusions of the working group discussions. All members of the working group participated as individuals and provided feedback to this report. However, their input and participation does not imply endorsement of every option or recommendation contained in this report.

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Summary Recommendations

1. **Think beyond the next replenishment and don't allow IDA to sleepwalk into the future.** IDA was built in a different age for a purpose that is rapidly becoming outdated. A perfect storm of reduced supply and demand for IDA will hit during the next replenishment round. The IDA-17 talks should begin a hard-headed appraisal of IDA's purpose, systems, and financing.

2. **Adapt IDA to the new world.** At a minimum, shareholders should revisit IDA's performance-based allocation system and the World Bank's working relationship with the African Development Bank, and they should drop the IFC net-income transfer. This will require independent input beyond World Bank staff.

3. **Declare success and don't be afraid to let IDA shrink.** If per capita flows are kept constant, IDA-20 could be the final replenishment round for regular contributions (not including debt-relief compensation). World Bank presidents have frequently defined their success through ever-larger replenishment campaigns, but this is no longer an appropriate expectation. Shareholders should encourage incoming leadership to focus on IDA's mandate and business model rather than replenishment size.

4. **Embrace potential new donors—and consider changing contribution rules.** Shareholders should consider improving the transparency of IBRD fees and explore alternatives to the current system of scoring new IDA contributions.

5. **Consider creating a transitional "IDA+" window.** To smooth countries' graduation from IDA and help attack lingering pockets of poverty in middle-income countries, the World Bank Group could create a modest transitional window, with its own special rules, between IDA and IBRD.

Introduction: The Future of IDA in a Changing World

In 1960, the shareholders of the World Bank opened a new concessional financing window to help meet the capital needs of the dozens of newly independent countries unable to borrow on international markets or from the core International Bank for Reconstruction and Development (IBRD). With the impending collapse of the French and British empires, the bank broadened its mandate from European postwar reconstruction to include development more globally. The new mandate of the World Bank's International Development Association (IDA) was to provide low-cost financing to the world's poorest countries.[1]

To enable IDA to make 40-year loans at close to zero percent interest, shareholders have been asked to contribute funds every three years. The first-such "IDA replenishment" was in 1964; we are currently in the midst of IDA-16. Each of these replenishment negotiations provides opportunities for the world's major economies to consider how to adapt IDA to changing circumstances and development imperatives. One of the unique strengths of IDA, as a multilateral organization owned by member governments, is that its policies and procedures may be adjusted by its shareholders while allocation of resources is rule-based and largely depoliticized.

In the fall of 2012, IDA deputies will meet to review progress on IDA-16, effectively kicking off the next round of replenishment negotiations for IDA-17. But tweaking IDA with a three-year time horizon no longer seems sufficient. After 52 years of operating on more or less the same model, IDA is facing a perfect storm of reduced demand and slackening support for supply that requires longer-term thinking about the institution, its role in the international system, the tools at its disposal, and its overall business model. Clients that currently account for more than 30 percent of IDA assistance are on the cusp of graduating. At the same time, the World Bank is increasingly tasked with addressing complex global challenges, but its instruments remain largely unchanged and geared toward lending to

1. IDA's Articles of Agreement state its purpose as: "to promote economic development, increase productivity and thus raise standards of living in the less-developed areas of the world included within the Association's membership, in particular by providing finance to meet their important developmental requirements on terms which are more flexible and bear less heavily on the balance of payments than those of conventional loans, thereby furthering the developmental objectives of the [World Bank]." Article I in IDA's Articles of Agreement (adopted September 24, 1960), available at www.worldbank.org/ida/what-is-ida.html.

countries. Without a new vision and model, IDA will merely continue to make marginal changes and find itself, fairly soon, facing an existential crisis and slipping into irrelevancy.

A Rapidly Changing Context for IDA

In the early years of IDA, the dominant model for aid was of a small number of rich countries allocating resources to many poor countries, but the IDA of today faces a wholly different set of circumstances: a rapidly changing client base, a new geography of poverty, and structural global macroeconomic shifts.

IDA is evolving into a facility for small fragile states

The total number of IDA-eligible countries stands at 81, but countries that currently account for more than 30 percent of IDA's flows—India, Vietnam, Nigeria, and several others—are on course to graduate within the very next replenishment period. In fact, nearly all of IDA's biggest and best-performing borrowers are approaching the income threshold for eligibility (currently $1,175 per capita) and should graduate within the next 10 to 15 years (see figure 1).[2]

According to CGD projections,[3] the number of IDA clients will be half as large in 2025 as it is now. By 2025, 37 of 68 currently IDA-eligible countries will have

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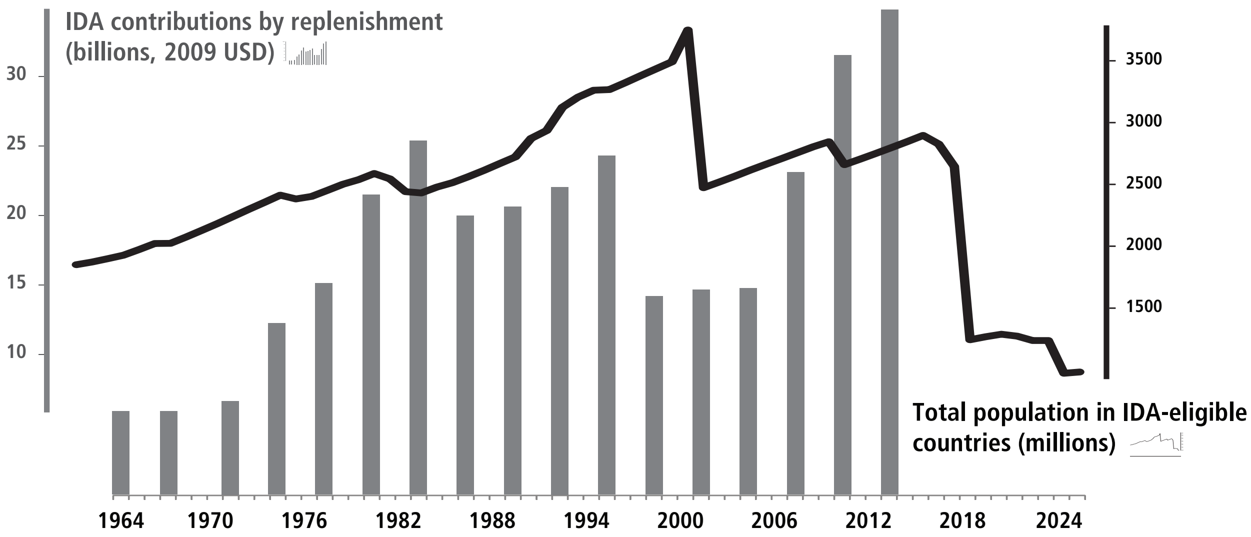
2. These projections assume the graduation rules remain unchanged. Current IDA eligibility is determined by two factors: (1) gross national income (GNI) per capita below a pre-established threshold; and (2) lack of creditworthiness that prevents borrowing from commercial sources and from the World Bank's commercial lending window, the IBRD. In practice, countries do not immediately graduate after breaching this income-based threshold. In making its own internal predictions, IDA includes a five-year delay between exceeding the threshold and the cessation of new IDA lending. This delay allows country authorities adequate time to plan for their changed borrowing status. It is also designed to prevent reverse-graduation as a result of short-term volatility in income levels and creditworthiness. While IDA has relatively clear rules governing its membership in theory, in practice World Bank management exercises significant discretion over who graduates, when, and how blend and hardened terms are applied. Much depends on the bank's judgment of a country's creditworthiness—a black-box decision that reflects the bank's confidence in the country's ability to borrow from the IBRD and international markets. Lack of creditworthiness explains why countries like Moldova and Bolivia continue to receive IDA funds under hardened terms despite having incomes significantly over the threshold. See IDA, "IDA Eligibility, Terms and Graduation Policies" (2001) and IDA, "A Review of IDA's Long Term Fiscal Capacity and Financial Instruments" (2010), 29.

3. For a complete account of the assumptions and projection methods, see Todd Moss and Ben Leo, "IDA at 65: Heading toward Retirement or a Fragile Lease on Life?" CGD Working Paper 246 (Washington: Center for Global Development, 2011), bit.ly/RE6AbI. Small island countries are excluded from the projections because their eligibility for IDA is discretionary and unpredictable. Kosovo is also excluded because of data limitations.

Figure 1. Historical Donor Contributions to IDA and Projected IDA-Eligible Population



Sources: CGD calculations based on the IMF World Economic Outlook database. UN Population Division projections (available at http://esa.un.org/unpd/wpp/unpp/panel_population.htm), and World Development Indicators (World Bank).

graduated, reducing the total population of IDA-eligible countries by nearly two-thirds. More than 80 percent of the remaining countries will be African, and nearly 60 percent will be those currently considered fragile or postconflict (see box 1).

The change to IDA's client base is not a marginal one. While exactly which countries will graduate and when will be subject to the whims of the global economy (and ample management discretion), the overarching trends are inescapable. As its larger, better-performing clients graduate, IDA will become a facility for small fragile states. Adapting to its new clientele will require a fundamental reassessment of the way IDA does business.

The new geography of poverty

A direct result of countries growing wealthier and joining the middle-income ranks is that a growing fraction of the world's poor no longer lives in poor countries. Twenty years ago, 94 percent of the world's poor lived in low-income countries; today, only 25 percent do.[4] While the graduation of China and India to middle-income status accounts for most of this shift, the trend will only be

4. Andy Sumner, "Where Will the World's Poor Live? An Update on Global Poverty and the New Bottom Billion," CGD Working Paper 305 (Washington: Center for Global Development, 2012), bit.ly/PB7wJO.

Box 1. IDA in 2025

Half as large in client numbers. More than half of current clients (37 out of 68) will graduate by 2025, even after allowing for a five-year lag and conservative economic-growth projections. This includes all countries except two currently classified as "blends" or borrowing under "blend" terms and 18 currently IDA-only countries.

One-third its current size by population. The majority of IDA's largest recipients will graduate, including India, Vietnam, Pakistan, Nigeria, Ghana, and Kenya. These countries account for 60 percent of current IDA allocations. The total population of IDA-eligible countries will fall by nearly two-thirds, from almost 3 billion to roughly 1 billion.

Nearly exclusively African. Of the remaining countries, more than 80 percent (25 out of 31) will be African. The only non-African countries will be Afghanistan, Bangladesh, Myanmar, Nepal, Haiti, and Timor-Leste.

Much more difficult and lower performing. Countries currently defined as fragile or postconflict will account for nearly 60 percent of clients (18 out of 31). Today, these 18 countries account for just 8 percent of IDA flows. Of the 31 remaining countries, only five (Bangladesh, Myanmar, Timor-Leste, Nepal, and Zimbabwe) have not been classified as highly indebted poor countries (HIPCs).

reinforced as large Asian and African countries such as Vietnam, Nigeria, and Pakistan cross the threshold. This new geography of poverty means that the World Bank will have to change how it engages with the bulk of the world's poor as middle-income countries (MICs) with large pockets of poverty lose eligibility to IDA's concessional finance.[5]

End of the Gleneagles era of aid?

Still reeling from the 2008–09 financial crisis, a sputtering recovery, and the European sovereign-debt risks, IDA's traditional donors are under increasing pressure to slash spending abroad and at home. At least for the near future, the era of ever-rising aid budgets is likely to end as donors seek ways to cut back.[6] Reduced contributions

5. Ravi Kanbur, "Aid to the Poor in Middle Income Countries and the Future of IDA," Cornell University Department of Applied Economics and Management Working Paper 2012-02.

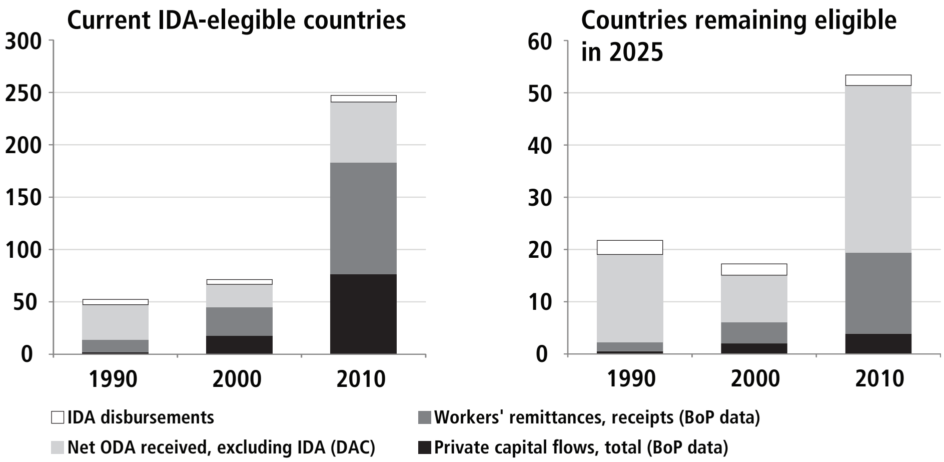
6. Global official development assistance (ODA) fell 3 percent in 2011 compared to 2010—the first fall since 1997, but almost certainly not the last. Aid budgets of the United States, Canada, and a majority of European nations took sizeable hits in recent budget battles, while even the United Kingdom's 0.7 percent pledge is again a source of internal British debate. The UK House of Lords recently released a report urging

to IDA are possible, especially with graduations from IDA reducing demand for concessional financing and with other sources of capital becoming available to developing countries. It's simply not an IDA world anymore. A proliferation of donors means that IDA is losing its relative dominance within the aid system, and the rise of private capital flows into developing countries is cutting the relative importance of aid as a source of capital for low-income countries (see figure 2).

Rise of new donors

While Western donors are tightening their belts, a new breed of cash-rich emerging donors is rising. Brazil, China, South Africa, and India are transitioning from aid recipients to aid donors, and their emergence poses both challenges and opportunities for the current system. The new cohort is likely to craft their own development approach, without necessarily following the traditional donors' aid agenda or model.[7] Whether IDA is able to engage new donors—that is, more specifically, to entice them to make larger contributions—will depend on the willingness of major shareholders to be flexible on World Bank governance and cede additional voting shares.

Figure 2. Selected Financial Flows (billions, 2005 USD)



Sources: CGD calculations based on the World Development Indicators / Global Development Finance database and the OECD's International Development Statistics.

the government to scale back its 0.7 percent commitment. See House of Lords, "The Economic Impact and Effectiveness of Development Aid." Economics Affair Committee, Sixth Report (2012), www.publications.parliament.uk/pa/ld201012/ldselect/ldeconaf/278/27802.htm

7. Vijaya Ramachandran and Julie Walz, "Brave New World: A Literature Review of Emerging Donors and the Changing Nature of Foreign Assistance," CGD Working Paper 273 (Washington: Center for Global Development, 2011), bit.ly/PZu2yx.

What Happens if Nothing Changes? Implications of a Status Quo IDA

A future IDA that continues business as usual will face two likely alternatives that depend on the political environment and how the donors respond to replenishment requests.

An ever-toughening case for more of the same

IDA could maintain its current allocation system and continue to argue every three years for replenishments at the current or possibly even higher levels. With fewer countries in the pool, per-country allocations would increase. Simply raising the IDA income-eligibility threshold is an option that, although easy to implement, would face intense opposition from many shareholders and merely delay making tough strategic decisions. The major implications of maintaining the status quo include the following:

- **Requirement of extraordinary political support.** Maintaining the status quo would require significant political capital from donors to justify substantial increases in per-country allocations and a major political effort every three years to defend requests for shareholders to contribute to IDA in lieu of other development or even domestic spending options. It may be unrealistic to expect IDA's coffers to grow or even hold steady as more of its clients graduate.

- **Justification of ballooning financing levels.** IDA's own baseline projections (which assume modest 2.6 percent nominal increases—or 0.6 percent real—in IDA capacity per year) translate into tremendous increases in assistance for the remaining country clients, as much as 300-500 percent in real terms by IDA-21 in many cases.[8] For example, Niger would be slated to receive well over $500 million annually, more than what it received from all development assistance committee (DAC) donors combined in 2009, while Tanzania would receive more than $2 billion per year, more than $30 per capita in real terms.

8. Ben Leo and Todd Moss, "IDA at 65," table 5 (see footnote 3). IDA's own financial projections come from IDA, "A Review of IDA's Long Term Financial Capacity."

- **Solving the fragile states conundrum.** IDA's current operational and allocation model focuses explicitly on high-performing countries. IDA addresses postconflict, poorly performing, and fragile states through special side facilities. Countries coming out of conflict are financed through carve-outs that bypass the normal performance-based allocation system; nonconflict poorly performing and fragile states are allocated modest funds. Worryingly, the World Bank has long struggled with the challenges of working in and providing staffing for fragile states. A 2007 Independent Evaluation Group review noted that efforts in fragile states were focused on areas of "traditional weakness," showed a lack of selectivity and have not yet overcome human-resource problems. With fragile and postconflict states soon to become a majority of IDA clients,[9] this problem will no longer be a marginal and lagging side business. Instead, fragile states could become the raison d'être of IDA. While the World Bank is working to address this issue,[10] its business model and current systems do not yet appear adequate to cope with this reality.

- **Rationalizing IDA's relationship with the African Development Fund.** As IDA's client base becomes almost exclusively African, World Bank management will need to revisit its relationship with the African Development Fund (AfDF), the soft-loan window of its sister organization, the African Development Bank. Current ad hoc arrangements are insufficient. For the sake of efficiency and to justify to donors having two separate institutions with nearly identical client bases and mandates, IDA will have to work with the AfDF differently. Although competition between the two institutions is healthy and greater collaboration would be constructive, a clearer division of labor may make sense—perhaps with the AfDF leading on infrastructure, regional public goods, and private-sector development while IDA focuses on financial management and social sectors.

Accept a smaller IDA as a natural (and successful) evolution

Given the pressure for budget austerity, donors could opt to keep IDA more or less as-is and just scale down resources to meet the needs and size of the smaller client base. The implications of this scenario include the following:

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9. Countries currently defined as fragile or postconflict will account for 18 out of 31 remaining countries.

10. The 2011 World Development Report addressed this issue, while a new World Bank Group–wide fragile-states strategy is reportedly underway. World Bank, *The World Development Report 2011: Conflict, Security, and Development* (Washington: World Bank Group, 2011).

- **IDA-20 as the last replenishment?** After decades of subsidizing IDA, shareholders could identify an end date for new contributions, possibly aiming for when IDA could become self-sustaining without replenishment injections. Based on CGD's estimated projections, if IDA's real per capita flows to recipients are held constant, IDA-20 could be the last replenishment for regular donor contributions. (Compensation for debt relief would likely need to continue at least through IDA-23). A shrinking IDA will still have to cope with the implications of its new fragile and overwhelmingly African client base; it would also have consequences for the role of donors within the World Bank and for the bank's role in the broader development agenda.

- **Shareholder savings (graduation dividend).** In theory, the savings from future IDA replenishments could be reallocated to other spending objectives. This may be politically appealing, especially in times of fiscal austerity.[11]

- **Decreased donor influence over World Bank Group policies.** IDA replenishment negotiations, particularly donor contribution pledges, have historically been the avenues through which shareholders exert their influence over World Bank policies, for IDA and the World Bank Group as a whole. Although it may arguably be a benefit, without the need for new replenishment contributions, donors will lose significant leverage to push management to implement reforms.

- **Confirmation of IDA as a facility to help poor countries rather than poor people.** Focusing in on its remaining clients would effectively divorce IDA from the majority of the global poor who now reside in MICs.

11. For countries with fixed long-term aid commitments, this could also have the effect of pushing capital into other multilateral organizations or into bilateral channels.

Considering Bold Alternatives

In consideration of other options for the future of IDA, three core questions must be answered: What and whom is IDA for? How will funds be distributed? Who will pay? IDA deputies answer these questions every three years either actively through reforms or passively by letting the status quo continue. Any serious reconsideration of IDA's future business model will need to address its purpose, its allocation, and its financing. Below, we propose some alternatives to the status quo.

Defining the purpose: what and whom is IDA for?

Currently, IDA is built for poor countries, as defined by gross national income (GNI) per capita. However, given the changing geography of poverty, and the fact that countries graduating out of IDA retain large pockets of poverty, one option for IDA could be to reassess its focus.

Poor people, not poor countries?

One alternative is to target poor people, regardless of the countries in which they live. Putting this into operation could take many forms. We present two below:

- **A transitional graduation window.** IDA could smooth the graduation process for countries by creating a clear adjustment period between IDA eligibility and full graduation (more on the "IDA+" proposal is presented in the conclusion below). Although this smoothing happens in practice through the use of blended and hardened terms, it is done on an ad hoc basis and is not part of an explicit phased approach.

- **Explicit subsovereign lending allocation.** Alternatively, IDA could provide direct funding in grants or credits to local governments or even nongovernmental organizations in regions with per capita incomes below the IDA threshold, even if the country's average income level is above the threshold. This could be one way for IDA to target money towards poverty alleviation in lower-middle-income countries (LMICs) and adapt to the changing geography of poverty without fundamentally altering its model. This is already happening in practice, (e.g., India does back-to-back lending from IDA to federal government to states), but institutionalizing this approach with an explicit allocation may not work well in nonfederal systems (and might be perceived as an instrument targeted specifically to large recent graduates like India). Moreover, IDA would need to demonstrate convincingly that LMICs remain financially unable to absorb a market-based financing model for their ongoing development needs.

Move from country programs to problem solving

Alternatively, IDA could move away from the country model altogether and target instead the global and regional development problems that disproportionately affect poor countries and poor people. With the number of low-income countries rapidly declining, many of the great remaining challenges—energy, technology, regional infrastructure, agricultural research, and vaccines—will be beyond any single country's investment strategy. Two options here include the following:

- **Turn IDA into a global-public goods facility.** Given the challenge of global collective action, the World Bank's current global reach and technical capacity, and the potential savings that will be created as countries graduate from IDA, the World Bank could potentially embrace the global public goods challenge. The World Bank could create a Global Public Goods Window, either to replace or operate alongside a traditional IDA model, to tackle global problems of particular relevance to poor countries—even if the expenditure has to take place outside of those countries. Such an approach would take advantage of IDA's existing replenishment mechanism and leverage the bank's role as a trusted manager of international funds. It may also be a way to engage new donors. However, the legitimacy of a Washington-based institution for such a facility may be challenged by some donors. [12]

- **Focus IDA on green growth.** More narrowly, and perhaps more legitimately, IDA could be used to "green the growth" of its client countries by using concessional finance to encourage low-carbon economic output. IDA could continue carrying out its poverty alleviation mission but commit to doing it zero-carbon by specifically subsidizing energy efficiency and a sustainable-energy sector. IDA could thus contribute to the green-growth agenda while maintaining its poverty mandate and country-allocation system.[13] This approach could marshal support from many, but not all, of IDA's largest existing donors.

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12. Nancy Birdsall recommends that any new arm of the World Bank for global public goods be based in an emerging-market (new donor) country. See Nancy Birdsall, "The World Bank and Global Climate Change: Forever a Big Fish in a Small Pond?" CGD Policy Paper 007 (Washington: Center for Global Development, 2012), bit.ly/QLcvIS.

13. "Achieving climate resilient development" was one of the "special themes" of the IDA-16 Replenishment negotiations. Participants and management expressed commitment to contribute to "green growth" in IDA countries, but the effort remains ad hoc and piecemeal rather than a comprehensive strategy. IDA, *IDA16: Delivering Development Results,* Final Report of the Sixteenth Replenishment (2011).

Determining allocation: who receives?

Depending on the answers above, the way IDA distributes financing will also have to be reexamined. The following are three alternatives to the current model.

Overhaul the performance-based allocation system

While one of IDA's strengths is its performance-based allocation (PBA) system, it is not clear that the PBA is currently accomplishing its intended purpose. The spirit of the PBA—to allocate funds on the basis of performance to ensure shareholder value and create incentives for recipients to reform policy—has gotten lost in the arcane formulae. The original country policy and institutional assessment (CPIA), which is the core of the PBA, has become obscured by additions and carve-outs that have stripped out most of the original intended benefits.[14] Knowledgeable critics have repeatedly called for the PBA to be either significantly modified or entirely overhauled.[15] An alternative (or complementary) proposal is to experiment with including final outcome indicators into the PBA.[16]

The PBA is particularly ineffective in fragile states; as IDA's client base becomes increasingly fragile and postconflict, the PBA will become even more obsolete. The current PBA system weighs CPIA performance strongly, but lacks a clear incentive for performance at the project level. Fragile states tend to perform poorly in ratings of project success compared to other IDA countries. In fragile countries, therefore, development finance could be treated more like venture capital: the few projects that succeed need to have the capacity to be scaled up and copied. IDA could consider complementing performance-based allocations to fragile states with a Performance Tranche for scaling up successful projects.[17] To achieve this, project evaluation will have to be shortened from the current 7- to 8-year feedback loop to something closer to real-time.[18]

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14. In replicating the PBA, we started with the CPIA and then applied thirteen additional steps.

15. Ravi Kanbur, "Reforming the Formula: A Modest Proposal for Introducing Development Outcomes in IDA Allocation Procedures," CEPR Discussion Paper 4971 (Centre for Economic Policy Research, 2005); Patrick Guillamont and Sylviane Gullaumont-Jeanneney, "Accounting for Vulnerability of African Countries in Performance Based Aid Allocation," African Development Bank Group Working Paper 103 (Tunis: AfDB, 2009).

16. Kanbur, "Reforming the Formula."

17. For a detailed proposal see Alan Gelb, "How Can Donors Create Incentives for Results and Flexibility for Fragile States? A Proposal for IDA," CGD Working Paper 227 (Washington: Center for Global Development, 2010), bit.ly/QLcRzn.

18. Ibid.

Abandon the PBA and move to a foundation model

Instead of having predetermined country allocations, IDA could adopt a foundation-type model where it accepts project proposals from eligible countries and funds the ones it determines will have the best development impact. The risk with this project selection model is that it could become politicized and nontransparent. Better metrics for comparing different projects against each other would have to be developed. However, making bids publically available and open to public scrutiny could do much to prevent politically motivated project selection. Moving to a foundation model could also result in a handful of countries with higher institutional capacity capturing the majority of available IDA resources.

More clearly segment concessionality by income group

Given the fiscal space created as more countries graduate, IDA could shift more of its financing to grants for the poorest countries.[19] IDA already provides some of its lending as grants, but only in an exceptional fashion to countries that are at a high risk of debt-distress. Switching to a system where very poor countries (for instance, those with per capita incomes below $500) automatically receive grants until they cross that income threshold might be clearer and avoid the moral hazard inherent in using debt sustainability as a determinant of grant eligibility.[20]

Finding financing: who pays?

Depending on the purpose and system chosen above, different financing models could also be implemented. Currently, IDA's financing comes from a combination of donor replenishments, transfers from IBRD and the International Finance Corporation (IFC), reflows from past IDA loans, and other internal resources such as investment income (see figure 3).

There is considerable scope to consider changing these sources to better meet a new mandate. Some issues for consideration follow below.

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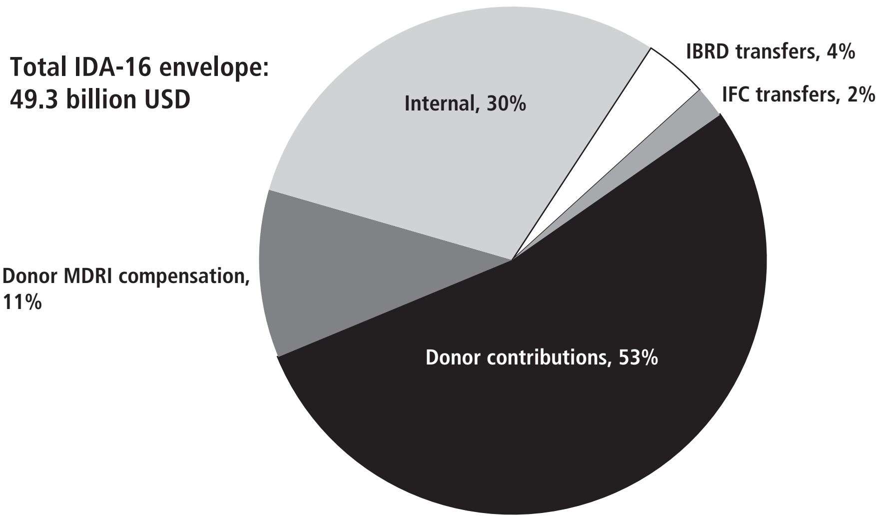
19. For a more detailed proposal of why IDA should give grants to the poorest countries see Steve Radelet, "Grants for the World's Poorest," CGD Note (Washington: Center for Global Development, 2005), and Nancy Birdsall et al., *The Hardest Job in the World: Five Crucial Tasks for the President of the World Bank,"* CGD Working Group Report (Washington: Center for Global Development, 2005), bit.ly/T3ZLNv.

20. Currently IDA applies 20 percent upfront volume discounts on IDA grants to cover the cost of the forgone interest rates. Presumably, grants given to low-income countries under this option would also contain a volume discount, although newly freed fiscal space from graduations could in theory be used to finance the extra cost and provide a net-present-value increase to the poorest countries.

Figure 3. Sources of Funding for IDA-16 Replenishment



Note: MDRI = Multilateral Debt Relief Initiative
Source: IDA, *IDA16: Delivering Development Results,* Final Report of the Sixteenth Replenishment (2011).

Redirect or cancel the IFC new income transfer

Since 2006, the World Bank has been transferring part of IFC profits to IDA to help lessen the financing burden for shareholders. The size of the transfer varies significantly: in the current replenishment round, it amounted to $1 billion, down from the last replenishment's $1.9 billion. Yet if one objective of the World Bank Group is to promote private-sector investment in low-income countries, it makes little sense to transfer funds from private investments that crowd-in private capital (IFC) to a facility that lends to the public sector (IDA). A simple step would be to merely end this practice. However, canceling the transfer should be accompanied the IFC's pursuing an increased investment mandate in low-income countries. One potential approach could be to redirect the saved transfer into an IFC venture fund with a specific mandate to be highly aggressive in IDA countries.

Be more transparent about the IBRD transfer as a backdoor subsidy to IDA

Shareholders have consistently pressed the IBRD to make contributions to IDA. This is one way to reduce the regular replenishment request, but is also an implicit transfer from IBRD borrowers (who pay IBRD lending charges that generate net income) to IDA countries. The link between IBRD fees and IDA transfers is opaque, but some IBRD borrowers argue that they are in fact subsidizing IDA without receiving any credit. Traditional IDA contributors, however, view the IBRD transfers to IDA as forgone dividends from their investments in IBRD. Alternatives that may satisfy both camps include sequestering IBRD funds into

Table 1. IDA Voting Shares of Selected Emerging Donors

	Total voting power, percent
Brazil	1.58
China	1.93
India	2.59
Russia	0.30
South Africa	0.23

Source: IDA, *IDA16: Delivering Development Results,* Final Report of the Sixteenth Replenishment (2011).

special purposes such as attacking pockets of poverty in LMICs or simply making IBRD transfers more transparent as contributions from MICs to IDA with some compromise over how such credits are scored as shares.

Revisit the use of reflows

The repayments that IDA receives from previous loans should be expected to increase substantially in coming years as countries cross the income thresholds, triggering accelerated obligations including a doubling of principal repayments. This creates a short-term disincentive for countries to graduate and potential new fiscal space for IDA. To lessen the debt-service adjustment for graduates, IDA could either ease the double-payment requirement or earmark those additional revenues from accelerated repayment to other purposes that may be more attractive to graduates.

Bring new donors into IDA

China, Brazil, South Africa, and other emerging economies that are becoming donors could also be supporters of IDA, bringing not only new capital but also valuable development experience. However, new contributors will also expect increased voice in decision-making. The current practice of basing voting shares according to the stock of all past IDA contributions is a large disincentive for new contributions because of the massive time lag (see table 1). This is by no means a new issue, but it is increasingly pressing as some emerging countries are seriously considering a new development bank as an alternative to the World Bank.[21] If IDA's traditional donors are serious about bringing new players into the fold, some changes are required. Two options worth exploring are below:

- **Weighing new flows greater than past stocks.** As per the 2008 Zedillo Commission recommendations, a discount could be used to alter the gover-

21. Prasanta Sahu, "World Bank Open to Partnering BRICs Bank" *Wall Street Journal,* March 30, 2012.

nance shares in favor of more recent contributions.[22] A careful balance would have to be struck between providing enough incentives for emerging donors to come to the table, and lessening the burden for traditional donors enough to persuade them to be flexible.

- **Limit credit to three to five replenishment periods.** An alternative that avoids the potentially tricky task of appropriately weighing flows versus stocks of contributions is to simply cap the length of time that contributions count toward a country's voting share. Shareholders for instance could agree to a cap (perhaps four replenishments, or 12 years) that safeguards the predominance of traditional shareholders in the near term but eventually gives emerging donors parity if they sustain significant contributions over a number of replenishments. This would creative incentives for emerging donors to join as partners, while giving the traditional donors enough of a cushion to make it politically less objectionable in their capitals.

22. The High-Level Commission on Modernization of World Bank Group Governance [Zedillo Commission], *Repowering the World Bank for the 21st Century* (2009), available at http://go.worldbank.org/2I98FYWNJ0.

Conclusion: Recommendations for IDA Shareholders

1. **Think beyond the next replenishment and don't allow IDA to sleepwalk into the future.** IDA was built in a different age for a purpose that is rapidly becoming outdated for the global challenges of the 21st century. Incentives for World Bank management are to maintain IDA's current business model and to continue to push for steady or increasing resources every three years. IDA management typically provides shareholders with supply-side analysis of IDA's finances, with much less focus on future demand. These forces for the status quo are powerful. Shareholders, however, have a responsibility to both their taxpayers and the world's poor to adapt IDA to the changing conditions. Taking a hard long-term look at the purpose, systems, and financing of IDA requires a broader discussion than the normal replenishment negotiations. The IDA-17 round, with talks due to start informally in late 2012, is a logical place to begin.

2. **Adapt IDA to the new world.** At a minimum, shareholders should revisit IDA's performance-based allocation system and the World Bank's working relationship with the African Development Bank, and they should drop the IFC net-income transfer. Ahead of the IDA-17 negotiations, the shareholders should task bank management to explore *and seek outside independent analysis* of potential options and implications in each of these three areas. For both shareholder and recipient-country interest, such analyses cannot be done solely by World Bank staff.

3. **Declare success and don't be afraid to let IDA shrink.** If the shareholders agree that IDA has been useful but its time is passing, they should not hesitate to allow the model to run its natural course. This would imply that IDA replenishments shrink over time. If per capita flows are kept constant, IDA-20 could be the final replenishment round for regular contributions (compensation under the Multilateral Debt Relief Initiative would continue). The pace at which replenishments shrink could be eased, allowing increases in per capita allocations in remaining IDA countries and extending the end of the replenishment cycle on the basis of negotiated outcomes.

4. **Embrace potential new donors—and consider changing contribution rules.** Greater transparency in the backdoor IDA subsidies by IBRD borrowers and scoring of new IDA contributions are issues that traditional donors are rightly nervous about broaching for fear of losing influence within the

World Bank. Shareholders should begin frank discussions—among themselves first and later with potential new donors—about the trade-offs inherent with new entrants. Concerns from some parts of civil society about weakening safeguards must also be addressed head-on and balanced with the need for IDA to adapt to the reality of new sources of finance.

5. **Consider creating a transitional "IDA+" window.** The current IDA graduation process is anachronistic and unnecessarily bimodal. New graduates, which still have major pockets of poverty, not only lose access to highly concessional financing but are required to double the repayments on their outstanding loans. One option to smooth the transition—and to incentivize new MICs to embrace graduation—is to create an IDA+ transitional window between IDA and IBRD.

   In IDA+, concessional resources would be made available to countries whose incomes fall between the current IDA threshold and twice this threshold.[23] The window would serve as a halfway house between IDA and IBRD, with specific eligibility criteria, hardened loan terms between IDA and IBRD terms, and a new allocation mechanism based on transparent project proposals. IDA+ could require that projects be targeted specifically at poverty alleviation and also have a domestic cofinancing requirement. Mandatory leveraging of MICs' own resources targeted at poverty reduction could make IDA+ more politically palatable with those skeptical of lending to MICs.

   The source of capital for financing IDA+ is critical to its design. A place to start would be to ring-fence the accelerated reflows from new graduates, which will surge as more countries graduate. Countries will likely be less reluctant to graduate and pay accelerated repayments if their additional reflows are recycled into a fund specifically for them. These accelerated reflows could either be directly recycled into IDA+ or used to subsidize additional concessionality (lower interest rates or extended maturity) of IBRD loans, consistent with the idea of a "blended financing facility."[24] IBRD transfers—unpopular with MICs who feel they are contributing to IDA without receiving proper

23. This is close to the historical IDA threshold of $1915, and it aligns with estimates from Martin Ravallion, who finds that there is a natural cut-off at about $2,000 per capita between countries that can feasibly reduce poverty through redistribution and those that would face prohibitively high marginal tax rates on the rich. See Martin Ravallion, "Do Poorer Countries Have Less Capacity for Redistribution?" World Bank Policy Research Working Paper No. 5046 (2009).

24. As proposed in Ben Leo, "Leveraging World Bank Resources for the Poorest: IDA Blended Financing Facility Proposal," CGD Working Paper 214 (Washington: Center for Global Development, 2010), bit.ly/QLdqcf.

credit—could also be used to fund IDA+. MICs are likely to be more willing to see their IBRD contributions transferred to their peer income group through IDA+ than to a narrow cluster of remaining IDA clients.

SOFT LENDING WITHOUT POOR COUNTRIES

RECOMMENDATIONS FOR A NEW IDA

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