



*Inaugural Issue*

## Forgive the World Bank but Don't Forget: Debt Relief Should Fund a Turnaround in Development Aid

By Adam Lerrick

*The American Enterprise Institute is pleased to mark the launch of a new quarterly Outlook series, dedicated to innovative and original research on economic development policy. In the months ahead, Development Policy Outlook will feature original essays by AEI scholars and other distinguished experts on topics such as the relationship between property rights and growth in sub-Saharan Africa, the need for a new aid paradigm for the least developed countries, the rising role of the U.S. military as a platform for economic assistance activities, and the reform of the World Bank—the latter being the subject of this inaugural issue, written by AEI visiting scholar Adam Lerrick. AEI research fellow Vance Serchuk ([vserchuk@aei.org](mailto:vserchuk@aei.org)) is editor of the series.*

*The World Bank, under the guise of debt relief for the globe's poorest countries, has extracted \$46 billion from rich nations to restore resources lost on bad loans. This is the first step in a massive increase in development aid. The record of fifty years of failure of bank lending and the continuing widespread corruption in Africa demand a transformation of the delivery mechanism for aid from loans to performance-based grants where no monies are disbursed without results and no debt can be accumulated by poor countries unable to pay. A restructuring of the bank from a lending institution into an endowed foundation which distributes grants would deliver an identical volume of development programs without the need for more funding.*

In July 2005, the world applauded a promise by the Group of Eight (G-8) nations to forgive the debt of the globe's poorest countries. But "debt relief" was really World Bank relief. Amidst a groundswell of international public guilt that constrained the will of G-8 leaders, the bank seized the moment to extort 100 cents on the dollar for a \$46 billion portfolio of worthless developing country loans on which it has been sitting uncomfortably for more than two decades.

---

Adam Lerrick ([alerrick@aei.org](mailto:alerrick@aei.org)) is a visiting scholar at AEI, an advisor to the Joint Economic Committee of the U.S. Congress, and the Friends of Allan H. Meltzer Professor of Economics at Carnegie Mellon University. AEI research assistant Kathryn Newmark provided invaluable assistance.

The bank assumed the classic stance of a holdout creditor and used its 30 percent blocking minority position in these nations' debts to exact preferential treatment: it demanded an ironclad G-8 commitment to be paid first and in full for losses that should have been recognized long ago. But the bank wanted even more. It had to be proven that the funds reimbursing its bad loans were over and above what the bank views as its entitlement to a never-diminishing "normal" flow of new money from rich nations. Then, the bank, which places full confidence in the promises of bankrupt African regimes, asked the donors to put it in writing. The holdout prevailed no matter how unreasonable the claim. But then, that is why vulture funds prosper in the capital markets.

From the Millennium Accord to the G8 summit, the same uneasy proviso has stood out in every official communiqué on debt forgiveness: the financing capacities of the International Financial Institutions must not be reduced. Yet everyone at each of these meetings knew then and knows now that debt relief for the poorest would have no cost to the multilateral agencies and in no way would impair their ability to perform. The ledgers of the World Bank's poor country lending arm, the International Development Association (IDA), had long been awash in uncollectible loans; real debt forgiveness to the poorest had been granted decades ago, not out of charity but of necessity; and multilateral resources were reduced irretrievably in a time beyond the memory of those who now toil at the bank.

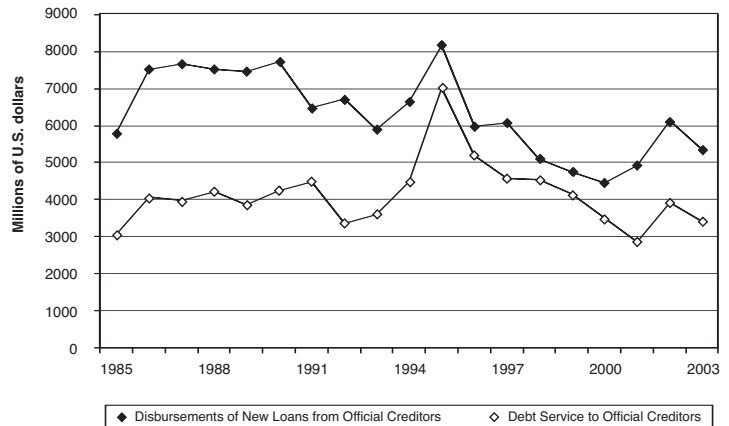
Debt relief did not reduce bank resources. Its past bad lending did. The bank's patent fiction that payment obligations from Niger, Chad, and the like are good-as-gold assets cannot be taken seriously when no sub-Saharan borrower has made a single real transfer of resources to official lenders for more than twenty years. The money was long gone, and the bank's neat schedule of projected reflows from poor debtors would never have been forthcoming to provision IDA's future lending stream.

For more than two decades, the bank has played a shell game with worthless developing nation loans by recirculating funding in what even the UK Treasury describes as "balance sheet fantasies." It had long been clear and deliberately hidden from public view that the multibillion-dollar debt of the poorest economies would never be honored. But the bank never makes a "bad loan" and never has "a loss."

The bank devised a system of "defensive lending" that offset every poor country outflow with an assured balancing inflow. Dates and amounts of payment schedules of old loans miraculously matched disbursements under "new" loans to create a perpetual rollover of defaulted obligations (see figure 1). Over time, adding interest compounded the loans as well as the problem. Although IDA listed total development resources at \$130 billion on its 2005 balance sheet, more than one-third of this apparent stockpile, or \$46 billion, had long been riding the rollover merry-go-round.

Only a name separates rotating defaulted loans in perpetuity from the finality of cancellation. Real IDA resources were *de facto* \$84 billion. It only remained for

FIGURE 1  
DEFENSIVE LENDING: NEW HIPC LOANS FOLLOW DEBT SERVICE



SOURCE: World Bank Global Development Finance Online database, <https://publications.worldbank.org/GDF>.

the bank to stand up, cancel the entire poor country debt, restore reality to its finances and make a forthright case for expanded aid.

Instead, the bank lays claim to some sort of diplomatic immunity from rules and consequences. An institution that poses as the missionary of transparency and accountability in the developing world has now been rewarded by the G-8 for practices that, on levels less lofty, would be punished in the private sector with regulatory censure and more. To make poor nations accomplices in deception sets the worst of examples.

"Debt relief" provided a windfall—a massive stream of development funds on automatic pilot to fill deep holes in the bank's balance sheet and then pour out as unauthorized new aid. Rich country legislatures must now be persuaded to approve a forty-year commitment for annual "debt payments" on behalf of poor countries that had never planned to pay.

Moral hazard is now unconstrained. Many donor nations, among them Germany and Japan which together will pay one-third of the cost, have protested that forgiveness destroys discipline and encourages irresponsible borrowers to be even more profligate. But what of the bank? After fifty years and \$500 billion in aid, the only return has all too often been what World Bankers praise as "a learning experience." Aid has not been the moving force behind the impressive economic gains in China, India, and Indonesia. Now \$46 billion is gone without apology and without penalty for failure.

Even as the bank has touted the vision of a debt-free Africa and has insisted that others pay for its improvident past, it has continued to lend to the same unsustainable economies that galvanized public sympathy for relief. Since the day the world fully endorsed debt forgiveness in 2000, IDA has distributed \$10 billion more in net new loans to the eighteen poor nations that have qualified, raising their indebtedness to the institution by almost 50 percent. Another round of debt relief should be expected in 2020 or before. This addiction to a dead lending paradigm is doubly troubling, for the bank is now positioned to direct and influence new global flows that are a ten-time multiple of its own resources.

## A Mega-Commitment to Africa

As the United Nations millennium goal of halving extreme poverty by 2015 has gained momentum, donor nations are poised to fund an exponential increase in development aid.<sup>1</sup> The \$50 billion annual increase in aid for the poorest nations by 2010 just pledged by G-8 leaders and a second annual \$50 billion increment previewed for 2015 are only the first installments.

To satisfy a global moral imperative, the United Nations demands that rich nations pay an annual levy of 0.7 percent of national income, or \$250 billion each and every year, that would rise with economic growth to over \$300 billion per year in a decade (in constant 2005 dollars). In early 2005, members of the European Union unanimously committed to pay their share, although they are clearly worried about where they will find the funds. They hope to force U.S. consent, and for good reason. Of the massive increase in aid monies, the United States, which heretofore has been responsible for a 20 percent share of world aid, would be compelled to contribute 50 percent. Total world cost would be \$1.6 trillion for the first decade and \$2.8 trillion more to complete the task for the remaining half of the world's poor.

Half of all new aid has been stamped for shipment to forty-three countries in sub-Saharan Africa and, by 2015, the continent would be awarded 62 percent of global development funds or \$125 billion per year. Just two years of this annual mega-commitment exceeds their collective debt accumulated over the last thirty years.

Africa has been the graveyard of development aid. It remains the only continent where the proportion of the population living in extreme poverty is growing—at latest count 46 percent or 313 million in 2001. Even as many once poorer nations outside Africa have climbed out of

poverty, three decades of decline—or at best stagnation—have seen per-capita incomes fall 25 percent. But bank planners promise that this time will be different.

Time and again, master plans to lift up Africa have been founded on a quicksand of wishful thinking. To meet the millennium goals, UN models have postulated overarching assumptions of long-term 9 to 10 percent real annual growth in government revenues—numbers that history denies and current observation rejects. On these assumptions, sustainable debt levels will be calculated and new lending granted. On these assumptions depend UN promises to halve poverty by 2015; its plan is counting on African nations to provide, on their own, one-third and later two-thirds of the necessary resources.

Is this a realistic expectation for countries with a long-term record that falls far short of these targets, nations that are now in many cases plagued by AIDS of epidemic proportions, bloodied by civil strife, constrained by a difficult climate, wanting in industry, dependent on volatile commodity exports, and facing a tidal wave of population growth? Was the new UN model exhumed from the files of the World Bank and the International Monetary Fund (IMF) that postulated twenty years of 6 to 10 percent real annual growth to predict the success of the 2000 Heavily Indebted Poor Country (HIPC) debt initiative? Actual growth rates, so far, have not even reached these predictions by half.

Then there is corruption—not just one of the causes of intractable poverty in Africa, but the root cause. The long litany of contributing factors advanced by recent commission reports to excuse forty years of economic failure—from war to famine, from rotting infrastructure to epidemic disease—are not causes but consequences of pervasive pillage by a long line of leaders gone bad.

Africa's own are voting with their cedis, naira, schillings, and francs, and with their feet. Forty percent of African savings are held outside the continent as compared to 3 to 6 percent in Asia. Skilled and educated workers emigrate at the rate of 70,000 a year. Foreign direct investment is attracted only by mineral wealth at a time of world scarcity.

Africa's leaders have rational expectations. Since 1970, there have been one hundred violent changes in regime in thirty countries.<sup>2</sup> What better personal strategy in a risky environment than to be "short-term greedy," to grab with both hands at an accelerated rate? The stolen dollars stashed in private accounts in offshore banks cannot be accurately tallied: at the low end, Prime Minister Tony Blair's Commission for Africa believes the sum to be

\$95 billion or the equivalent of more than half of poor Africa's external debt; others estimate the level in excess of \$500 billion. The taking has been streamlined. Royalties from oil wells, proceeds from government monopolies of agricultural exports, and even aid monies were all neatly packaged to go. Records are conspicuous by their absence. Leaders who may not have a personal future leave nothing behind for national futures.

Corruption is not unique to Africa, but in other regions, long-term secure horizons foster a less destructive business plan. A consistent levy of moderate tributes has allowed room for development and for elites to maximize profits as the economy prospers.

## A Coverup for Corruption

Every official proposal is now larded with assurances that corruption will be the deal breaker in disbursements of development aid. If standards are enforced, there will be almost no destination marked "Africa" to which a mammoth stockpile of funds can be bundled up and shipped off. Responsible donors should not be swayed by promises or by ministries of corruption or by a few token severed heads on the city gates.

Massive giving in the face of massive corruption requires creativity. *Time* 2005 "Person of the Year" Bono set the message to rock music on late night television when he assured Americans that corruption in Africa has "been taken care of" and that they can now give with confidence.<sup>3</sup> Columbia University's Jeffrey Sachs, the moving force behind the UN Millennium Project, simply reworked the numbers.

Corruption and poverty, Sachs insists, march in tandem (which leads and which follows is not clear), and African regimes are no more venal than comparably poor nations. He adjusts the judgments of two major indexes (the World Bank Governance Indicators and the Transparency International Index) and recalibrates African ratings to take account of relative poverty. In a circular reasoning, a rating system is devised in which African nations are compared mostly to each other.<sup>4</sup> Twenty-six out of Sachs' thirty-three countries that are at the bottom in the original reports move up to "good" or "average." Abracadabra: instant qualification for generous unrestricted aid (see table 1 on the following page).

Finding excuses for corruption is meaningless. Absolute corruption is the issue. There are no success stories of poor but corrupt countries that have blossomed under aid.

If need, in and of itself, is the criterion, Africa is the first place where aid should be directed. It holds the most poor without access to private capital and who must depend on international generosity to underwrite the cost of basic needs. (China may hold more poor but has the resources to take care of its own.) But impoverished Africa is the last place where lending should be repeated. And it is the last place where money should be poured into national treasuries without strict controls.

## Grantphobia

Back in 2000, when the Meltzer Commission submitted its report on the International Financial Institutions to the U.S. Congress, the most controversial recommendation concerned World Bank lending to the eighty-one poorest countries. The commission argued that the bank should end traditional loans to impoverished nations that cannot repay. Instead, it should provide outright grants for the basic improvements in living standards that are the foundation of the climb from poverty to productivity.

Loud voices from high places rose in protest. Then-U.S. treasury secretary Lawrence Summers wrote in the *Financial Times* that grants "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."<sup>5</sup> Then-World Bank president James Wolfensohn, in a letter to commission chairman Allan 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." The formal U.S. Treasury response made it official: grants "would limit the overall availability of financial assistance to the poorest" and "moving to an all grant system would have negative long-term financial implications for the institutions and their shareholders."<sup>6</sup>

When President George W. Bush stood up at the World Bank in July 2001 and proposed that 50 percent of all development bank aid to the poorest nations be distributed in the form of grants, the protest took on an international accent and rose by many decibels.

The debt forgiveness saga has forced a second look at grants and at the same time exploded the dogma that all loans, even bad ones, ensure a reflow that replenishes resources. Now the grant format has been embraced by aid advocates, but at the bank, it seems to

TABLE 1  
CORRUPTION IN AFRICA: GOVERNANCE RATINGS REVISED TO JUSTIFY AID

Country	Sachs' Revised World Bank Governance Indicators Ratings, 2002*	Actual World Bank Governance Indicators Ratings 2002**	Sachs' Revised Transparency International Index Ratings, 2003*	Transparency International Index Ratings, 2003***
Benin	Good	Below Average	NA	NA
Burkina Faso	Good	Below Average	NA	NA
Ghana	Good	Below Average	Average	Bad
Madagascar	Good	Below Average	Good	Bad
Malawi	Good	Below Average	Good	Bad
Mali	Good	Below Average	Good	Bad
Mauritania	Good	Below Average	NA	NA
Senegal	Good	Below Average	Good	Bad
Cameroon	Average	Bad	Average	Very Bad
Central African Republic	Average	Very Bad	NA	NA
Chad	Average	Bad	NA	NA
Republic of Congo	Average	Very Bad	Average	Very Bad
Côte d'Ivoire	Average	Very Bad	Average	Very Bad
Eritrea	Average	Bad	NA	NA
Ethiopia	Average	Bad	Good	Very Bad
Guinea	Average	Bad	NA	NA
Kenya	Average	Bad	Average	Very Bad
Mozambique	Average	Below Average	Good	Bad
Niger	Average	Bad	NA	NA
Nigeria	Average	Very Bad	Average	Very Bad
Rwanda	Average	Bad	NA	NA
Sierra Leone	Average	Very Bad	Good	Very Bad
Tanzania	Average	Bad	Good	Very Bad
Togo	Average	Bad	NA	NA
Uganda	Average	Bad	Average	Very Bad
Zambia	Average	Bad	Good	Very Bad
Angola	Bad	Very Bad	Bad	Very Bad
Burundi	Bad	Very Bad	NA	NA
Democratic Republic of Congo	Bad	Very Bad	NA	NA
Sudan	Bad	Very Bad	Average	Very Bad
Zimbabwe	Bad	Very Bad	Average	Very Bad
Liberia	NA	Very Bad	NA	NA
Somalia	NA	Very Bad	NA	NA

\* Jeffrey Sachs, *The End of Poverty: Economic Possibilities for Our Time* (New York: Penguin Press, 2005), 313–314; and UN Millennium Project, *Investing in Development: A Practical Plan to Achieve the Millennium Development Goals* (New York: UN Millennium Project, 2005), 147. To avoid confusion with the level of poverty of the country, the term “bad” has been substituted

\*\* In the World Bank Governance Indicators, 0 is the mean score. Countries with scores from -0.50 to -0.01 are categorized as “below average,” -1.00 to -0.51 as “bad,” and less than -1.00 as “very bad.”

\*\*\* In the Transparency International Index ratings, countries are rated on a scale of 1 to 10. The lowest score of any country in 2003 is 1.3. If a country's score is between 3.77 and 5.00, the country is categorized as “below average.” Scores between 2.53 and 3.76 are categorized as “bad” and 1.30 to 2.52 as “very bad.”

be with the Wall Street bearhug that crushes in a show of false affection. After a five-year rear guard delaying action against change, plans for the fourteenth replenishment of IDA limit grants to just 30 percent of total programs.<sup>7</sup>

Reliance on official lending is an anachronism in an age when financial power has been transferred to a private sector whose resources dwarf what the multilateral agencies can muster. The small, segmented, and cautious capital markets that were the rationale for the World Bank's founding at Bretton Woods in 1944 have grown exponentially in size, sophistication, and willingness to tolerate the risk that once deterred projects in the developing world. The bank's comparative advantage in lending for development has vanished.

The purpose of aid should not be confused with the mechanics of aid. The bank must accept that it is in the development business, not the lending business. Long ago they were one and the same, but now there are better ways to deliver resources and to help poor countries grow.

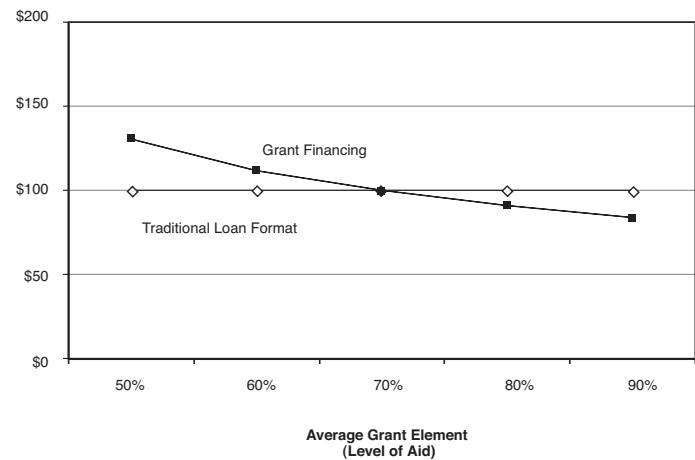
### A Move from Loans to Grants: Dollar for Dollar, the Same Aid

An irrational fear persists that grants will destroy the bank or at the very least force a demeaning dependence upon the whim of U.S. congressional appropriation. It would seem logical that if money is given away instead of being lent, the stockpile of funds will eventually vanish. But this is not so. Grants can deliver the same amount of aid without diminishing the funding pool and without asking for more taxpayer monies from the industrialized world than current programs consume.

Grants will maintain the bank's capital intact. With loans, the pool of donor funds leaves the bank perhaps never to return. With grants, the funds are transformed into an endowment that invests in the capital markets to generate an annual income stream; only the income earned on the endowment would be disbursed as grants. And grants will not cost more than loans. The funding requirement is the same when the level of aid is the same. Again, donors will not have to give more unless they wish to increase aid.

IDA focuses on the World Bank's eighty-one poorest members with a per-capita income of less than \$895 and depends upon replenishments of \$14 to \$15 billion

FIGURE 2  
DEVELOPMENT PROGRAMS PER \$100 DONOR CONTRIBUTION  
GRANTS VERSUS LOANS



from rich countries every three years. Its forty-year loans are structured with a grace period of ten years and an interest rate of 0.75 percent. This near-zero charge reduces the present value of these payment promises to 30 cents on the dollar and translates into a gift component equal to 70 percent of their value.

An IDA loan that has a 70 percent gift component cannot cost more than an outright grant that pays 70 percent of program outlays. In both cases, countries pay the remaining 30 percent. How can lending \$100 and asking for only \$30 to be repaid be any different from giving \$70? Again, if the same level of assistance is maintained, grants cannot cost more than loans (see figure 2).

Leverage is what grants bring to the aid process, expanding the influence of every dollar of scarce official resources by drawing upon the capacity and skills of the private sector. Grants of \$100 million are not required to accomplish the same ends as \$100 million in IDA loans. An annual grant of just \$6.5 million will on average suffice. Every \$1 of annual grants replaces \$16 of loans for the nations most in need.

### Performance Makes the Difference

Most supporters of grants see them at their most simplistic and fail to grasp their full potential. Because they are outright gifts, grants guarantee that citizens of

impoverished nations will no longer be forced to service and repay a burdensome debt. But the Meltzer Commission was looking at larger issues when it endorsed a shift from loans to grants as the delivery mechanism for aid.

The lack of effectiveness of World Bank projects is startling. By the bank's own numbers, 59 percent of investment programs worldwide and 75 percent in Africa failed to achieve satisfactory sustainable results over the decade from 1990 to 1999. Ratings were awarded long before results were known, and the only audits of "performance," although touted as "independent," were staffed by bank employees soon to revolve back into line lending positions.

The poorer the country, the greater has been the failure of aid. 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 a precondition for economic growth. Yet these are the very countries where corrupt and inefficient environments undermine the potential to benefit from aid and the ability to support debt.

To overcome these obstacles, a new but more complex kind of grant is needed—one that is still a gift, but a gift with strings attached. Success would not be measured by outflows of money or by inflows of physical inputs, but by carefully quantified outputs. There would be no disbursement of funds without proof of results. The private sector would be engaged and take on the performance risk. Costs would be divided between the bank and the recipient government, with each assuming a direct obligation for its share of the total payment. To reduce the government's need for scarce foreign exchange, its obligations could be denominated in domestic currency to cover local costs.

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

In contrast to loans, grants would be released after audited delivery of service under a system of user fees. If there were no results, no funds would be expended. Payments would be made based upon the number of children vaccinated, kilowatts delivered to households, cubic

meters of water treated, students passing literacy tests, and miles of functioning roads.<sup>8</sup>

The World Bank's direct payment obligation would provide a revenue guarantee substantially free of political risk. 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.

The greater the poverty, the greater the need for grants. If all IDA flows were converted to grants and the aid element varied according to need—from 90 percent of the service cost for the poorest without capital market access to 50 percent for those nearing graduation—an average 70 percent 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.

The following example illustrates the performance-based grant mechanism: a country of \$250 per-capita income qualifying for 90 percent grant resources wants to vaccinate its children against measles. If the World Bank confirms the need, the government would solicit competitive bids from private sector agents, nongovernmental organizations and public sector entities such as the ministry of health. If the lowest qualifying bid was \$5 per vaccination, the World Bank would agree to pay \$4.50 (90 percent) directly to the provider for each child. The government would be responsible for the remaining \$0.50 (10 percent). Payments would be made only upon certification by an auditor independent of all participants—the government, the World Bank, and the provider of vaccinations.

Reliance on international contractors and nongovernmental organizations for execution has been reproached by many as obstructing the growth of local institutions. On the contrary, in their drive to minimize costs, multinational firms will be educators. They will train local workers and finance local subcontractors rather than import high-cost foreign labor. The local labor force and entrepreneurs will develop the ability to compete for future contracts and, in time, countries will become self-sustaining.

Beyond the absence of debt, a multiplicity of benefits accrues from the grant format. Grants will sidestep the classic pitfalls of corruption, 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 ability to pay of the recipients. There can be no financial liability for developing governments if projects fail. Grants increase recipient discipline by demanding a current co-payment, no matter how small, rather than a repayment obligation twenty to forty years away.

### Leveraging Grants in the Capital Markets

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 percent to 50 percent, depending upon the nation's per-capita income and ability to attract private capital.

The low creditworthiness 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 capital markets, the direct payment obligation of the World Bank would equal 90 percent of total cost, eliminating 90 percent of the political/credit risk for the provider and hence its banker. The major risk for the capital markets is therefore that of the contractor—major international firms and nongovernmental organizations—not that of the host country. Investors would bear the recipient's credit risk only on its 10 percent share. As the income level or capital market access of the beneficiary increases and the ability of the economy to attract private lenders and to generate domestic resources rises, the share of the World Bank payment in total cost would decline to as little as 50 percent.

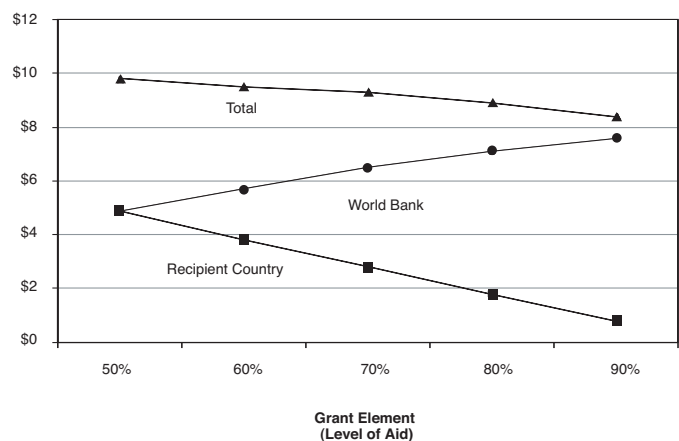
Poor countries would not be compelled to borrow to finance the implementation of projects. Instead, the annual grant stream would be leveraged by the private sector, which would provide financing for projects based on service contracts in which the bank's direct responsibility for the lion's share of every payment greatly reduces risk.

Under the traditional loan system, a \$100 million twenty-five-year average life project, when financed through a forty-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 percent grant aid, the identical project would be provisioned through twenty-five annual payments of \$9.3 million upon certified delivery of results. The World Bank would enter into a contract to pay \$6.5 million per year directly to the service provider. The recipient government would enter into a similar contract to pay the remaining \$2.8 million each year. Together, the two contracts would constitute the security needed by the service provider to obtain private sector funding.

The capital markets will lend \$81.2 million against the direct World Bank revenue stream. This is the present value of the annual \$6.5 million payment over twenty-five years discounted at a 6.25 percent yield. Similarly, the financeable value of the recipient country annual \$2.8 million payment at a 14 percent yield is \$18.8 million. The sum of the two present values is \$100 million. Thus, a \$6.5 million yearly 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 \$4.90 to \$7.60 as the grant rises from 50 percent to 90 percent of the total payment (see figure 3).

FIGURE 3  
DEVELOPMENT EQUIVALENCY  
ANNUAL GRANT PAYMENT PER \$100 LOAN EQUIVALENT



NOTES: 1. 25-year level total payment amortization schedule. 2. Private sector financing costs: World Bank direct payment: 6.25 percent; recipient country payment: 12–16 percent depending upon income level and capital market access.

## IDA as Foundation

With IDA's present holdings of \$140 billion in paid-in capital and retained earnings, an annual grant stream of \$9 billion can be generated in perpetuity without depleting existing resources. If the \$140 billion endowment was invested in market instruments at a conservative 7 percent nominal return, a gross annual income of \$9.8 billion would result. After deducting \$800 million for administrative expense, net income would reach \$9 billion per annum.

The \$9 billion annual net income stream would provision user fee grants for \$140 billion of infrastructure and social service projects if the existing 70 percent level of aid is maintained. A grant system would therefore support an identical volume of aid programs as IDA's prevailing system of subsidized lending provides. However, IDA's capital would no longer be exposed to the high risk of poor developing countries because the endowment and income stream would be unaffected by the financial condition of the recipients (see table 2).

## A Fresh Start for Aid

With debt relief/bank relief, the slate has been wiped clean and an average \$1.3 billion AAA-guaranteed payment will be flowing into IDA each year for the next four decades. What better moment to embark on a new format for the delivery of aid? Dedicate the debt relief compensation, add the reflows on other existing loans, and direct replenishments of donor resources to a new endowment. Invest the funds in the capital markets to generate a multibillion dollar annual grant stream that will support a sixteen-time multiple in projects.

There would be no break in the continuum of aid as loans phase out. The transition to the grant format would be seamless. For any level of donor resources throughout the forty-year transition period, and after 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 a grant structure as under a traditional loan delivery system. The change in the delivery of aid is not irreversible. When development succeeds, countries can be returned to loans by transferring endowment funds back to a lending pool.

TABLE 2  
GRANTS VERSUS LOANS: AID PER DOLLAR OF IDA RESOURCES  
(\$ amounts in billions)

	Existing IDA System of Loans	Proposed Grant System
Total IDA equity	\$140	\$140
Return on capital endowment	NA	7%
Annual income	NA	\$9.8
Administrative expense	NA	\$0.8
Net income for grants	NA	\$9.0
Capital at risk in poor countries	\$140	\$0
Total aid resources for poor countries	\$140	\$140

NOTES: 1. Private sector financing costs: World Bank direct payment: 6.25 percent; recipient payment: 14 percent. 2. Internal World Bank amortization schedule of grants: 25-year level total payment 3. Average grant element: 70 percent

Right now IDA holds \$2 billion in undisbursed, uncommitted funds. As the annual \$1.3 billion of "debt relief" comes in and 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. The relationship is linear. Each \$100 increment, regardless of origin, would produce \$7 in additional annual investment income, providing \$6.50 in grants each year in perpetuity, after administrative expense, to support \$100 in new programs if the current level of aid is maintained.

Grants have a hidden benefit. Soul-searching judgment calls on good governance will be self-solving. Wherever the poor are high on the list of national priorities and wherever reform is in concrete deeds and not in empty words, leaders will welcome the resources, whatever the constraints and work to earn donor trust. As they prosper, the holdouts on their borders will be forced to follow.

Performance-based grants will always have their enemies. They are demanding and intrusive. They block the spoils system in the developing world that, for years, has annexed aid money for personal gain and entrenched political power. Some poor governments may reject the terms without regard for the plight of their people. Public outcry will follow. But if development aid is to succeed, rich donors cannot be more desperate to give than the regimes of needy nations are desperate to receive.

## Notes

1. Extreme poverty is defined as people living on less than \$1 per day.

2. Central Intelligence Agency, *The World Factbook* (Springfield, VA: Potomac Books, 2005); and U.S. Department of State, Background Notes and Country Pages, [www.state.gov/r/pa/ei/bgn/](http://www.state.gov/r/pa/ei/bgn/); British Broadcasting Company, Country Profiles, [http://news.bbc.co.uk/2/hi/country\\_profiles/default.stm](http://news.bbc.co.uk/2/hi/country_profiles/default.stm).

3. Bono, interview with Conan O'Brien, *Late Night with Conan O'Brien*, NBC, October 6, 2005.

4. African nations number thirty-six out of the total of forty-eight governments worldwide that comprise the subset

with per-capita income on a purchasing power parity basis below \$2,500 in 2002.

5. Lawrence Summers, "The Troubling Aspects of IMF Reform," *Financial Times*, March 23, 2000.

6. U.S. Treasury Department, *Response to the Report of the International Financial Institution Advisory Commission*, (Washington, D.C.: Treasury Department, June 8, 2000).

7. International Development Association, *Additions to IDA Resources: Fourteenth Replenishment* (report from the executive directors to the board of governors, March 10, 2005), iv.

8. The distortionary effects of financing cost subsidies (traditional development bank loans and guarantees) would be eliminated by maintaining the relative prices of factor inputs.

---

AEI editor Scott R. Palmer worked with Mr. Lerrick to edit and produce this Development Policy Outlook.