OECD DAC Proposals: Implications for Commonwealth Countries

Commonwealth Finance Ministers Meeting
Washington, D.C., 8 October 2014

Meeting of Commonwealth Senior Finance Officials
Washington D.C., 7 October 2014

Provisional Agenda Item 4 FMM(14)(O)2

The Commonwealth
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Discussion Note

Senior Officials Meeting (SOM)

This year’s SOM will focus on assessing the implications of OECD’s proposed statistical reforms. The OECD is the main agency charged with measuring and monitoring finance flows for development and its membership comprises the world’s largest set of international donor countries. Therefore, we expect the OECD’s contribution - a reform of their statistical system to align with the new financing landscape and a more comprehensive Post-2015 agenda - to make a significant impact on negotiations at the UN’s Third Conference on Financing for Development in June 2015.

The OECD reports that given the more complex financing landscape, new ways of measuring support for development are needed, that: are more relevant to, and inclusive of, different development actors, capture the total picture of efforts to support development, and provide a way better to capture resources flowing to recipient countries. In this vein, the OECD suggests that other concepts that take a wider view of the types of financial instruments for development may spur greater innovation, higher financial flows and an overall greater development effort in support of Post-2015 goals.

OECD DAC Ministers in their December 2012 High Level Meeting (HLM) outlined four main objectives of the ongoing reform: Firstly, to introduce a measure of Total Official Support for Development (TOSD); to modernise the concept of Official Development Assistance (ODA) so as to better reflect donor effort and recipient benefit; to establish a clear definition of “concessional in character;” and to design an eligibility criterion that will ensure that ODA goes to where it is needed most.

To assess the implications of the OECD’s intentions, the Secretariat undertook an analysis of emerging DAC proposals, focusing particularly on those that are likely to be put forward for OECD and DAC Ministers’ discussion and endorsement.

This discussion note is a summary of the technical discussions contained in the CFMM background paper [FMM(14)(INF)1], which provides a full analysis. Senior Officials are advised to consult the background paper for more details.

The purpose of the SOM is to discuss the implications of the proposed OECD reform and to collect the Commonwealth’s perspectives. These perspectives will be formally submitted to the OECD DAC High Level Ministerial Meeting in December 2014. In order to facilitate the discussion, Senior Officials are asked to deliberate on the questions posed in section D.

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A. Review of OECD Proposals

1. The Commonwealth Secretariat review is based on the OECD DAC proposals outlined below, which have been produced in response to OECD DAC Ministers’ mandates of December 2012. The Commonwealth assessment examines possible implications for Commonwealth donor and developing countries, drawing specifically on the DAC proposals likely to be advanced for OECD HLM and UN endorsement. These are anticipated to be (proposals in bold):

   I. **The introduction of Total Official Support for Development (TOSD) as an additional measure for capturing donor efforts towards development** – particularly the provision of development enablers and global public goods as well as the provision of ODA leveraged private finance;

   II. **Modernisation of ODA through a grant equivalent conceptualization**, for the main purpose of better representing donor and recipient benefits (option 1). The grant equivalent would only record the grant component of development loans as ODA, as compared to the current method which reports the gross value as ODA;

   Alternatives here are:
   - **Option 2**: Recognise as ODA only expenditure on development, which result in a flow of resources to developing countries.
   - **Option 3**: Recognise gross disbursements. An option similar to existing ODA measurement but with adjustments (recognising market based instruments) to ensure the catalysing of ODA.

   III. **Harmonisation of OECD and IMF/WB discount rates for assessing loan concessionality with a grant equivalent method of calculation** (option 1). This entails using a risk-free discount rate of 5 percent rather than the current OECD 10 percent rate and using a grant equivalent rather than a cash flow method to calculate concessionality.

   Alternatives here are:
   - **Option 2**: Apply currency-specific OECD differentiated discount rates (DDRs). DDRs represent lenders’ funding costs, but more accurately as they are differentiated by currency and tenor, and updated annually.
   - **Option 3**: Introduce risk-adjusted discount rates. While both the IMF/World Bank and the DDRs are “risk-free discount rates”, the risk-adjusted discount rate would take into account both the lender’s cost of funds and the risk incurred in lending to a particular country (risk premium). They would capture the full costs associated with individual loans.

   IV. **The introduction of a new ODA target aimed at delivering at least 50 percent of total ODA to LDCs** (option 1). Involves donors safeguarding at least 50 percent of ODA for LDCs.

   Alternatives here are:
   - **Option 2**: revising the list of ODA eligible countries by lowering the current income threshold to USD$7,115, the income level at which countries start the graduation process from non-concessional lending provided by the World Bank International Bank for Reconstruction and Development (IBRD).
   - **Option 3**: maintaining the current system.
   - **Option 4**: Targeting countries in “special situations” (group of small states, land locked countries etc.) or fragile states.
B. Assessment of OECD Proposals and the Implications for Commonwealth and Other Developing Countries

TOSD, Proliferation of Private Finance and Debt Sustainability in non-LDC Countries

2. The Secretariat finds that introducing a measure of TOSD may be useful for complimenting the move to ODA modernisation, through incentivising support for enablers of development and global public goods. While not recorded as ODA, spending on development enablers and on global public goods would be valorised under a measure of TOSD, and should therefore help to increase the provision of such resources. TOSD may also be useful in raising the total quantum of development financing, albeit less concessional, by way of also incentivising the use of more market-like instruments that could be used to crowd in private sector investment.

However, the Secretariat also finds that introducing TOSD would raise two interesting questions:

- Firstly, what will be the impact of introducing TOSD on debt sustainability in non-LDC countries?

3. From the perspective of the OECD, TOSD could help to incentivise the development of new financing instruments that would assist in meeting the growing sustainable development needs of developing countries. This would be particularly welcomed given the drive to a more comprehensive agenda as well as to improve on the current system, which does not encourage use of such financial instruments (e.g guarantees and equity), particularly in better-off developing countries. Further, according to the OECD, introducing TOSD could limit the practice by donors of creating programmes around ODA, rather than making use of more advantageous mixes of financial instruments and collaborative opportunities.

4. Combined with the proposal of safeguarding 50 percent of grant funding for LDCs, however, one has to question how the possible proliferation of private financing, through introducing TOSD, will affect debt sustainability in non-LDC countries. As illustrated in Table 3 of the Secretariat’s background paper [FMM (14)(INF)1], just under 70 percent of total ODA receipts comprises grant funding. Since LDCs are only eligible to receive such finance, this suggests that only 20 percent of grant funding in the system will be available to finance development in non-LDCs as well as for providing for other needs including support for the enablers of development and global public goods (which typically are not privately funded). It also implies that the private finance generated through leveraging ODA (most likely through leveraging the 20 percent grants remaining) will be used primarily to fund non-LDCs.

5. Whereas the potential for access to a larger scale of financing would be welcomed by most developing countries, particularly those who are middle-income, there appears to be credible risks to these countries debt sustainability, especially given their already low debt carrying capacity. According to the recent Draft Report of the UN Intergovernmental Committee of Experts on Sustainable Development Financing, “two low income countries are currently considered to be in debt distress, with 14 at high risk and 28 at moderate risk of distress. (Further), debt sustainability is particularly problematic in some small states. In 2013, the average ratio of public debt to GDP of small state developing countries amounted to 107.7 per cent, vs. 26.4 per cent for developing countries as a whole.”

The second question a TOSD introduction raises is:

- What will be the impact of introducing a TOSD target on ODA, will it create a shift in donor incentives?
6. The above seems fairly likely especially in the context of the new development agenda, which will also have to establish targets for tackling sustainable development and climate change, that is, by introducing a target on TOSD.

7. TOSD will capture the total amount of flows in support of development, particularly support for development enablers, global public goods and development finance generated through donor use of market instruments. On the other hand, the direction of travel is for ODA, particularly the assessment of loans, to be modernised to capture only grant components, rather than the gross value of loans as is currently recorded. Here lies the potential shift in incentives. In effect then, donors will not be attributed as much ODA from loans in a new system, whilst they will be recognised for the total gross value of development support through the introduction of TOSD. Hence, should the international community also establish a target on the new measure, in view of motivating support for sustainable development and for climate change, there is the real possibility that donors could be incentivised to choose to focus on the new target. After all, donor efforts even if not recognised as ODA, would be valorised under a measure of TOSD.

Harmonised Discount Rates and Grant Equivalents: Effect on Donor Effort and Loan Financing

8. Supporters for an alignment of the OECD and the IMF/World Bank discount rates argue that countries will benefit from improved donor and IFI coordination; improved clarity and cross country comparison, in terms of loan concessionality. On the other hand, Differentiated Discount Rates (DDRs) or risk adjusted differentiated discount rate proponents claim that the introduction of these will add value through a better reflection of the cost of donor financing, and a more accurate valuation of the risks involved in extending loans to developing countries. In essence, rather than comparing against a notional fixed discount rate, implementing DDRs and adjusted DDRs, would include comparing loan rates with actual currency interest rates and/or lending risks.

9. However, support for DDRs and adjusted DDRs has not received much traction. The main hesitance surrounds the discount rates’ relative complexity and volatility. For instance, both rates would have to be updated annually, and would vary widely by country as well as by debt carrying capacity. Hence, the preference among the DAC for the OECD to align with the IMF/WB discount rate, that is: reflective of current market conditions (based on 10-year U.S currency interest reference rates), is fixed hence simple, and that also takes into account developing country debt sustainability.

10. But what about the effect on donor effort? The Secretariat finds that when combined with a grant equivalent method of calculating concessionality, harmonising the OECD and IMF/World Bank discount rates would have a reducing effect on estimates of loan concessionality, and would thereby require a stronger donor effort, that is, in light of donor commitments to meet current ODA targets. This is because, as the Secretariat shows in Section IV of the background paper [FMM (14)(O)2] that introducing any discount rate lower than the current OECD discount rate, will effectively result in a less estimate of concessionality.

11. Simply then, with a five percent discount rate applied to a grant equivalent methodology, donors would either have to increase total grant resources and/or significantly ramp up their supply of concessional loans to meet the ODA target.

This then begs the question:

- **Could the call for an increase in donor effort cause an increase in loan financing?**

12. In the context of the preceding discussions, the likely answer would be yes. Recalling the request by OECD and DAC Ministers to consider the contribution from all loans; the focus on poverty reduction and the consequent drive to safeguard grant funding for LDCs; as well as the current decline in overall OECD spending [Section I, FMM (14)(O)2], it is very unlikely that donors would respond to the need for an increased donor effort through an expansion of grant financing. Donors are more likely to do one or both of two things: (1) either increase the concessionality of development loans, and/or, (2) increase the scale of less concessional financing so as to record
more ODA. The latter would include increasing the use of market instruments, where the grant components would be recognised as ODA under the grant equivalent system. The former alternative (1) is obviously more desirable for developing countries, while the second alternative, if not managed properly, could create problems for non-LDC debt sustainability.

Assessing the Relative Value-Added of a New LDC-ODA Target

13. To assess the relative value-added of introducing a 50 percent LDC-ODA target, the Secretariat undertook a scenario analysis to compare the benefits of all the OECD DAC options suggested.

14. With respect to option one, lowering the DAC income threshold to US$7115, under varying growth trajectories, a number of Commonwealth and non-Commonwealth countries would be prematurely graduated. The Secretariat finds that this is especially the case should countries perform better than currently projected. The impact of a lower threshold is especially acute for Upper Middle Income Countries (UMICs) in all growth scenarios.

15. In terms of option two – maintaining the current system, the Secretariat finds that there is an evidently smoother graduation process, and a natural shift of ODA from UMICS to Lower Middle Income Countries (LMICs), LICs and LDCs. The Secretariat also finds that the impact on non-Commonwealth developing countries is similar, with a more gradual and distant graduation observed through maintenance of the status quo.

16. With respect to the introduction of new targets (option three), particularly introducing a target based on ODA volume rather than on ODA as a ratio to GNI target, the Secretariat finds that if donors allocated 50% of their ODA to LDCs, it would call for a shift of around US$8.4 billion from non-LDC to LDC recipients. Further, with the assumption of an equal allocation of the increase in ODA across LDCs, it is estimated that the targeting method would create an additional US$176 million per LDC and that the cost to each non-LDC would be approximately US$81.6 million, a reduction that would eliminate aid to some Commonwealth recipients, particularly Small Island Developing States (SIDS) - a great concern given SIDS' debt problems.

17. In summary, this assessment shows that without an overall increase in ODA, targeting 50 percent of ODA to LDCs would imply that some non-LDC countries would have to be eliminated from the DAC list, and the costs of the shift of ODA to LDCs would have to be borne disproportionately by some non-LDC countries. For the Commonwealth membership, the major implication would be a drastic reduction in grant receipts, as only 14 of 53 member countries are LDCs.

18. The Secretariat’s assessment of targeting countries in “special situations” yields similar results. Using the World Bank classification of this grouping, which includes LDCs, Land Locked Developing Countries (LLDCs) and Small States, the data shows that countries in “special situations” already receive around US$68.27 billion, that is, 73% of total ODA. Hence, with no increase in ODA and assuming an equal reallocation of funds to such a group of countries, it is estimated that the quantitative benefit would again be minimal. On the contrary, targeting only fragile states would have significant quantitative benefits for these countries, given their lesser numbers, but would obviously be to the detriment of poverty reduction and other crucial development needs.

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1 Calculated by halving total 2012 ODA receipts and subtracting that number 2012 total non-LDC receipts.
2 Calculated by subtracting total ODA receipts for LDCs from an estimate of 50 percent of total ODA, and apportioning the difference equally across LDCs.
3 Calculated by subtracting the remaining 50 percent that would be allocated to all non-LDCs from non-LDCs total receipts in 2012 and apportioning the costs equally across non-LDCs.
4 Belize, Kiribati, Maldives, Nauru, Tonga, Tuvalu, Botswana, Dominica, Grenada, Jamaica, Malaysia, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines and The Seychelles.
The final questions to be asked then are:

- Given this assessment and with the assumption of no future increase in ODA, how then should ODA be allocated?
- Secondly, if ODA is allocated with an increased focus on LDCs through a volume target, how will the gains be allocated between LDCs?

Figures on ODA receipts to LDCs show large disparities. So even if the OECD does decide to move on with the LDC-ODA target, a huge question will be how to allocate the gains among LDCs.

C. Conclusions

19. The Secretariat’s assessment points to a number of opportunities and risks, and suggests that the DAC will need to give consideration to several questions, as posed in this paper.

20. With respect to potential opportunities, these could be: an improved framework for monitoring financing for development; an ODA measure that overcomes some past criticisms, by attempting to more accurately reflect donor effort vis-à-vis recipient benefit; a possible increase in the scale of development financing, albeit less concessional; and gains in international coordination - with respect to harmonisation of OECD and IMF/WB discount rates.

21. Risks revealed, however, include: a possible increase in risks to debt sustainability; a possible shift in incentives away from the 0.7 percent ODA/GNI target to achieving a target on TOSD; risks to debt sustainability, should the impact of introducing a lower discount rate in combination with a grant equivalent calculation, incentivise donors to increase non-concessional lending; and an allocation imbalance with respect to grant funding between LDCs and other grant funded development priorities.
### D. Questions for Discussion

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<th>Strongly Agree</th>
<th>Agree</th>
<th>Neither Agree or Disagree</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
<th>Explanations</th>
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<td>1</td>
<td>Do countries believe that there is a need to introduce a measure such as TOSD</td>
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<td>2</td>
<td>Would countries welcome an increase in loan and ODA leveraged private financing</td>
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<td>3</td>
<td>Does a grant equivalent methodology have implications for donor effort</td>
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<td>4</td>
<td>Is alignment with the IMF/WB discount rate preferred to risk adjusted interest rates that more accurately account for future risks</td>
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<td>5</td>
<td>Given the likeliness of an increase in non-concessional financing for non-LDC developing countries and the potential for an increase in the total quantum of less concessional financing, is it time for the DAC to considering extending the DAC list to include more MICs</td>
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<td>6</td>
<td>Introducing an ODA target based on volume rather than maintaining the current status quo would be better for safeguarding funds for LDCs</td>
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