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Financing Global Development: Beware of 'End Poverty' Euphoria and Trigger-Happy Reform of Concessional Finance

Summary

The UN Conference on Financing for Development in Addis Ababa in July 2015 will pave the way for the implementation of the post-2015 development agenda. The Briefing Paper series "Financing Global Development" analyses key financial and non-financial means of implementation for the new Sustainable Development Goals (SDGs) and discusses building blocks of a new framework for development finance.

The client base of the concessional finance windows at the major multilateral development banks is shrinking as some of the largest borrowers by volume become richer, more credit-worthy and lose eligibility for 'soft' financing terms. Simultaneously, competition from new donors is growing, as is demand from low-income and lower middle-income countries for market-priced sovereign borrowing, spurred on by prevailing low-interest rates. Pressure to adapt to this changing operational context notwithstanding, the uncertainty facing the development finance industry suggests a gradualist, precautionary and insurance-oriented approach to the future of multilateral concessional windows.

A realistic assessment of medium-term growth prospects suggests that the pool of countries eligible for multilateral 'soft' finance windows will shrink slowly over the coming decade. In such a scenario, the number of people living in extreme poverty by 2025 would still amount to more than half a billion, with a sizable share living in middle-income countries that will be ineligible for concessional finance by current eligibility rules.

This Briefing Paper argues that trigger-happy reform suggestions for shrinking or scaling back multilateral finance are unrealistic and counterproductive: they ignore the option value of preserving international financial institutions and their concessional windows in a world with considerable uncertainty about future poverty outcomes and global governance failures that prevent first-best policy solutions.

Strategic options exist for the shareholders of the World Bank, the African Development Bank, the Asian Development Bank and the International Monetary Fund to attenuate the dilemma they face from their shrinking client base.

These options are:

- redefining concessional fund eligibility criteria, so that it reflect more closely national capacity to raise domestic resources;
- smoothing transition periods by making 'blend status' an explicit step in the graduation process, with funds directed towards measures of social inclusion and redistribution;
- strengthening sub-sovereign allocation, to take account of within-country regional inequalities;
- opening the multilateral soft windows for regional and global public goods, with climate change adaptation and disaster risk management as tracer sectors.

The shrinking client base of concessional finance

The post-2015 agenda offers a transformative vision for ending extreme poverty by 2030 and shifting the world to a carbon-free growth path. Some of the institutions best equipped to finance this agenda, however, face pressure to downsize as borrower countries lose eligibility for concessional finance as they surpass income per capita and credit-worthiness eligibility criteria.

India, for example, is the largest World Bank borrower by volume, and recently became a middle-income country, with income per capita above the threshold for concessional finance eligibility. Other large, fast growing middle-income countries, including Vietnam and Nigeria, are already 'blend' countries, receiving a mix of both highly concessional credits from the World Bank's soft window, the International Development Association (IDA), as well as less concessional hard loans from the World Bank's lending arm for credit-worthy countries.

The graduation from concessional finance of large middle-income countries raises a range of conceptual, political and operational issues for multilateral donors. On the conceptual side, the nature of global responsibility towards poor people living in non-poor countries – particularly those countries that have only just become non-poor – may conflict with political considerations against providing concessional finance to countries that have accumulated high reserves and are turning into emerging donor countries themselves. This raises questions about the future roles, mandates and instruments of the IDA, but also of the African Development Bank (AfDB), Asian Development Bank (ADB) and their respective soft windows (which in the case of the ADB is already in the process of being dissolved and merged with ADB's 'ordinary capital resources'), as well as the International Monetary Fund (IMF) concessional instruments.

Prudence suggests approaching reform of the concessional windows with a precautionary, rather than deterministic, perspective to enable flexible institutional response. That perspective should not only consider future graduation prospects, but also prospects for reverse graduation, e.g., due to disasters, military conflict and governance failures.

Shareholders should not let multilateral soft windows blindly continue business as usual, but also must not allow them to ignore the option value of preserving their financial and institutional strength by 'declaring success' and letting them shrink.

The changing geography of poverty

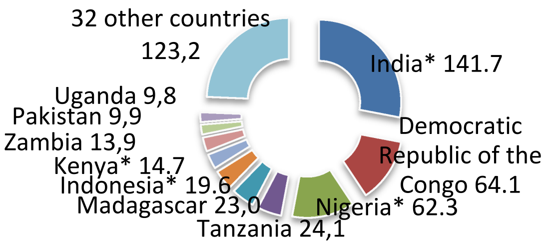
The geographic distribution of people living in extreme poverty is changing due to the recent period of high growth. A number of the largest, faster growing countries continue to have sizable populations living in extreme poverty. In fact, three-quarters of the world's extreme poor today live in countries classified as middle-income countries (MICs), which have limited access to soft finance. Only one-quarter of the world's extreme poor live in the remaining 35 low-income countries (LICs). Some believe that this will be a transitory phenomenon and that by 2025 poverty will become concentrated in fragile and conflict-affected states. Others argue that a sizable share of world poverty could remain in stable MICs, or be concentrated in fragile MICs, such as Pakistan and Nigeria.

Many donors consider that middle-income country status itself is a reason to be reducing or even ending aid. The belief is that it is an affront to middle-income countries for donors to get too involved in their own internal policies, with the justification that distributional issues are fundamentally domestic in nature. A major political decision facing the international finance institution (IFI) shareholders is therefore whether the international aid community should target poor countries, or poor people.

Medium-term poverty reduction scenarios published by the World Bank and others in recent years show that ending extreme poverty by 2030 is possible. The ambition required should not be underestimated, however. The release of the 2011 purchasing power parity (PPP) exchange rates estimated by the International Comparison Program has also prompted unsubstantiated claims that ending poverty may be easily accomplished, due to much lower price levels in developing countries than previously thought. However, although this end-poverty euphoria and optimism is well intentioned, it is misplaced: jumping to conclusions about global poverty based on the new 2011 PPPs is unwarranted and potentially misleading. Leaving aside whether or not the new PPPs are appropriate for measuring poverty, using new PPPs will require re-calculating the poverty line itself to ensure it is the average of national poverty lines used in the poorest countries. The most thorough attempt to do this so far suggests a new global poverty line of USD 1.82 in 2011 PPPs, at which the world is still as poor as we thought, and ending poverty remains as ambitious (Joliffe & Prydz, 2015).

Regardless of which PPPs are used, slow growth over the medium term is the principal reason why ending poverty by 2030 remains highly ambitious. This is also why the high concentration of extreme poverty in middle-income countries is unlikely to be transitory. A study we conducted for the BMZ (German Federal Ministry for Economic Cooperation and Development) (Garroway & Reisen, 2014) forecasts growth to 2025, measuring the impact on extreme poverty and on concessional finance graduation. Figure 1 shows our main result, namely that more than half a billion people will still live in extreme poverty in 2025, the majority in MICs ineligible for concessional finance.

Figure 1: Projected distribution of people living in extreme poverty in 2025, in millions



Source: Garroway and Reisen (2014) based on IMF World Economic Outlook and the World Bank PovcalNet tool
Notes: Shown are the ten largest populations of extreme poor, as we project for 2025. Asterisks indicate countries that will no longer be eligible for concessional finance in 2025.

Redefining eligibility criteria

At present, the multilateral soft-finance windows are all pegged to the IDA 'operational cut-off', which refers to the eligibility ceiling defined by a specific level of GNI (gross national income) per capita (USD 1,195 for FY13). This has been a malleable yardstick in the past; IDA eligibility was initially based on the 'historical cut-off' (USD 1,945 for FY13). High demand for limited IDA resources led shareholders to lower the cut-off in the early 1980s. Most observers agree that the cut-off itself is arbitrary and does not reflect a salient distinction between countries at different levels of development.

There are possible avenues for redefining the present operational cut-off. IDA itself has suggested looking at other criteria beyond income per capita. Possible complements could be the UNDP Human Development Index, the UN Economic Vulnerability Index, or a similar index. Another approach would be to re-instate the original 'historical' cut-off. This simple but elegant solution is not only justified by the historical precedent, but also finds support in the ultimate stated objective of concessional windows to provide a durable way out of dependence on external resources for development finance needs. Our BMZ study (Garroway & Reisen, 2014) points to the empirical fact that few countries with income per capita below USD 2,000 have non-poor populations that can afford redistribution at the national level to cover the poverty gap. This capacity for redistribution – proposed by Ravallion (2010) – is measured by the marginal tax rate on the non-poor population necessary to close the poverty gap. It is an independent, highly relevant justification for raising the IDA operational cut-off back to its historical level.

Smoothening transition periods

The multilateral concessional windows can also soften the transition from soft financing by making 'blend' status a more explicit step in graduation. Smoothing already happens in practice through the use of blended and hardened terms, but it is not part of an explicit phased and transparent approach. A widened transitional window for concessional resources could be made available to countries whose incomes fall between the current threshold and a higher threshold, perhaps the historical cut-off. Again this is justified by the finding that roughly USD 2,000 per capita serves as a dividing line between countries that can feasibly reduce poverty through redistribution and those that would face prohibitively high tax rates on the domestic non-poor.

The IDA itself has proposed three criteria for access to transitional support: (a) GNI per capita below the historical threshold; (b) a significant poverty agenda, as measured by poverty levels and other social indicators; and (c) a significant prospective reduction in available financing after graduation. Such support could be made available for new graduates that meet these three criteria and would help smooth the transition of graduating countries. Given the eventual objectives of mobilising domestic finance adequately, allocation under the transitional window might also be earmarked toward public spending for social inclusion and redistribution as well as improved fiscal federalism, for instance through higher fiscal transfers from rich to poor states.

Strengthening sub-sovereign allocations

IFIs could also increase direct funding in grants or credits to local governments or even nongovernmental organisations in regions with per capita incomes below country-level eligibility thresholds, even if the country's average income level is above the threshold. Apart from the rural-urban inequality in populous large emerging countries, such as Brazil, China, India or Indonesia, new threats such as disaster-related impoverishment also have distinct within-country geography. Again, like the earmarking of transitional resources, the sub-sovereign allocations could also be aimed at cooperation on inclusive policy processes such as budget allocations, and sustainable urbanisation to improve prospects for more inclusive development. Some MIC governments might interpret such cooperation as excessive interference into domestic political processes. But such concerns might be less for multilateral rather than bilateral donors. Within the multilaterals' space, this type of cooperation is well-suited for agencies where MICs have more voice in governance.

It also may be worthwhile to explore to what extent the European Union (EU) experience can inform multilateral concessional lending. EU Structural Funds and the Cohesion Fund are financial instruments of EU regional policy, intended to narrow disparities among regions and Member States. Since 2000, more than 500 billion euros in Structural Funds, mostly via the European Regional Development Fund, have been channelled to local projects in EU countries via national intermediary institutions.

Opening the soft windows for global public goods

Another major political decision relates to the role of multilateral concessional finance in provisioning global public goods, especially related to climate change adaptation and disaster management. An important side-effect of mainstreaming climate change into development cooperation will be the need for multilateral donors to integrate vulnerability to environmental and global risks into their allocation criteria of concessional flows. An alternative to withdrawing concessional finance from MICs would be to use the soft windows to co-finance regional and global public goods. The mandate of the soft windows could be adapted to focus explicitly on infrastructure with upfront cost but long-term developmental benefits as a way to help sustain global economic growth and human welfare. Tracer sectors could be climate change adaptation and disaster risk prevention and management.

Indeed eleven of the prospective 2025 IDA graduates that we identified in our BMZ study already have greater than USD 100 million prospective annual disaster damage costs (Garroway & Reisen, 2014). Asian MICs, India and Bangladesh, top the list. Climate-related disaster risk management should be integrated into poverty eradication efforts; otherwise, ending poverty may not be within reach. The soft windows could thus contribute to the new agenda of the Sustainable Development Goals while maintaining their anti-poverty mandate.

The option value of waiting on soft window reform

The option value of preserving the concessional windows is considerable in a world with global governance failures that prevent first-best policy solutions. The provision of global public goods requires the institutional infrastructure that these windows can deliver. Shrinking the soft finance windows prematurely would mean losing the considerable option value of waiting. It implies losing effective financial and technical services and know-how on a scale and with a quality that matter globally or regionally. It would also forego network externalities that represent a valuable global asset. Moreover, shrinking the multilateral soft windows would imply – for better or for worse – that MICs would also need to speed up the establishment of new development banks, such as the New Development (‘BRICS’) Bank and the Asian Infrastructure Investment Bank, without benefiting from knowledge and ‘certification value’ that existing concessional windows have already acquired (Reisen, 2015).

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