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MODERNISING THE DAC'S DEVELOPMENT FINANCE STATISTICS

DAC Senior Level Meeting,
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This document is submitted for DISCUSSION under agenda item 2 of the SLM Agenda [DCD/DAC/A(2014)3].

SLM participants are invited to agree on the steps outlined in paragraph 29.

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MODERNISING THE DAC'S DEVELOPMENT FINANCE STATISTICS

1. By the end of 2015, the international community is expected to endorse a new sustainable development agenda. Signs are that it will be a single and universal agenda, focussing on eradication of absolute poverty, but also addressing broader environmental, economic and social sustainability challenges. Agreement will have to be sought on a process to monitor the agenda's implementation, including a new financial framework likely to be decided upon at a UN conference on the follow-up to Monterrey and Doha. The DAC has a small window of opportunity – approximately 18 months – to develop a proposal for a more accurate, comprehensive and inclusive system for measuring and monitoring official external development finance post-2015, and by doing so, raise the profile and impact of OECD's work on development finance (See DAC Chair's letter of 10 January 2014 to DAC Ministers and Heads of Agencies). **Beyond 2015, we may have no other major opportunity to modernise our measurement system before 2030.**

2. At its 4-5 December 2012 High Level Meeting, the DAC **acknowledged the need to modernise its development finance framework** to better reflect the new global development landscape by agreeing on the following steps:

- Elaborate a proposal for **a new measure of total official support for development**;
- Explore ways of representing both donor effort and recipient benefit of development finance; and
- Investigate whether any resulting new measures of external development finance (including any new approaches to measurement of donor effort) suggest the need to modernise the ODA concept.

3. In discussing the concessionality of loans, Ministers agreed to establish, at the latest by 2015, **a clear, quantitative definition of "concessional in character", in line with prevailing financial market conditions**. They also agreed the definition should meet a number of principles, including: withstand a critical assessment from the public; avoid creating major fluctuations in overall ODA levels; and be generally consistent with the way concessionality is defined in multilateral development finance.

4. Until now, DAC work has included consideration of what might comprise a new measure of total official support for development (TOSD) and options for modernising ODA (including redefinition of concessionality and possible revision of the DAC List of ODA Recipients)[1], while the recipient perspective will be addressed in the coming months. Discussions at the Senior Level Meeting (SLM) on 3-4 March 2014 will provide directions for further work. The objective is to present proposals for modernising the system for discussion at the SLM scheduled for 6-7 October 2014 and for approval at the next DAC HLM, scheduled for 15-16 December 2014.

5. The HLM mandate also stipulates that this work is to take place "in close collaboration with other interested international agencies, in particular the United Nations, and also the IMF and World Bank". To ensure that DAC outcomes are well placed to support post-2015 goals, the Secretariat is working closely with those parts of the UN leading on the post-2015 process, including the Financing for Development

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[1] Discussions held in DAC meetings of 22 October 2013, 3 December 2013, 27 January 2014 and 10 February 2014, and the Working Party on Development Finance Statistics (WP-STAT) on 19-20 November 2013. See DCD/DAC(2013)21, DCD/DAC(2013)26, DCD/DAC(2013)33, DCD/DAC(2013)36, DCD/DAC(2014)3, DCD/DAC(2014)4 and DCD/DAC(2014)7.

Office of the UN Department of Economic and Social Affairs. Furthermore, it is actively liaising with international experts comprising the advisory Expert Reference Group, representatives of civil society organisations, partner countries, and South-South and Arab providers, to ensure that any new statistical measures meet the needs of the international development community.

6. It should be noted however that bilateral providers of development co-operation beyond the DAC do not always identify themselves with the way development finance is measured and/or discussed at the DAC. Therefore, engagement efforts with these countries are essential and, although ongoing, they have been intensified since the December 2012 HLM mandate. Initial proposals on how non-DAC countries' perspectives on development finance measurement could be fed into DAC discussions were presented to the DAC on 10 February 2014[2]. Further analytical work and outreach with these countries will take place, both bilaterally and in collaboration with leading regional and multilateral organisations.

7. At the SLM on 3-4 March 2014, members will be invited to take stock of progress in the implementation of the HLM mandate and provide political directions for the work over the next six months. Members will be invited to discuss the **narrative outlining the goals and principles to underpin the reform of the statistical system** and a number of **key questions relating to the new measure of total official support for development, ODA modernisation, concessionality and the DAC List of ODA Recipients**.

A. Why do we need to modernise our external development finance framework?

8. A recurring theme of recent meetings of the DAC and discussions with senior officials and Expert Reference Group members has been the need for a solid narrative outlining the goals and principles of the post-2015 statistical system. These include **restoring the credibility of ODA measurement, mobilising more resources for the post-2015 agenda and increasing their impact through better leveraging of private resources**. Consensus is emerging also on key principles to underpin the reform – these include **comprehensiveness, simplicity, accountability and transparency**. A revised measurement system and associated targets must:

- reflect the increased diversity among developing countries, and be relevant to the different financing needs this creates, not least between LDCs and middle income countries experiencing rapid growth;

- reflect the broadening of the global development agenda, the convergence of the poverty and sustainability agendas, and the increasing importance of shared global challenges;

- reflect the changing development financing landscape, both in terms of new actors and new instruments, and in terms of the changing importance of the different sources of development finance;

- valorise official efforts that are not included in ODA, thus reducing the near-exclusive focus on ODA, but also clarify the changing role of ODA within this new development financing landscape; and

- present a more comprehensive picture of external development finance from the recipients' perspective, including finance from longstanding South-South providers, emerging providers and private philanthropy.

[2] Cf. DCD/DAC(2014)6.

A transparent, reliable and up-to-date external development finance framework would promote efficient resource allocation and help partner countries validate the actual delivery and use of development funds.

Providing the right incentives and leveraging more private finance

9. The main objective of modernising the development finance framework is to adapt systems and concepts to the contemporary realities of development finance. This includes capturing new instruments, fairly valuing budgetary efforts, and ensuring that incentives promote the most efficient uses of development resources, given the differentiated needs of developing countries.

10. On the one hand, the development agenda is changing rapidly, with a greater emphasis now being put on financing economic growth through infrastructure, private sector development and job creation. Indeed, the success story of emerging economies, in particular China, has demonstrated that economic growth is a powerful driver of poverty reduction. The development of new financing instruments to meet this need is highly welcome.

11. On the other hand, many vulnerable countries are largely excluded from the global economy, having no access to international capital markets, receiving very little foreign direct investment and being weakly integrated in global value chains. They are facing persistent poverty and remain very dependent of ODA[3]. Yet since 2010, the share of ODA to LDCs and countries in greatest need has been declining.

12. The current statistical system has provided incentives for some donors to dramatically increase their lending with little or no direct budgetary cost. This is seen as being more cost-effective – indeed, one dollar of ODA provided as a grant amounts to the equivalent budgetary cost, while in the case of a loan, one dollar of budgetary effort can potentially generate ten or more dollars of ODA disbursements (at the price of negative ODA in future as the loans are repaid). In times of fiscal restraint, this represents a serious risk as it may give rise to growing distortions in ODA allocation within sectors and among recipient countries. At the same time, the system does not encourage the use of market-based financial instruments (e.g. guarantees and equity) which could leverage more public and private investment, in particular in better-off developing countries. **The DAC statistical system needs to be updated in order to measure donor effort in an instrument-neutral manner and support better targeting of ODA and other development finance towards the post-2015 sustainable development goals.**

Restoring the system's credibility

13. A second objective is to strengthen the credibility of the system to address growing criticism of the ODA measurement over the past decade.

14. Differences in members' practices with respect to the concessionality of ODA loans have cast doubt on the ODA measure as a reliable indicator of donor effort. Some members provide all or nearly all their ODA through grants and technical assistance, while others extend loans advantageous to the borrower, but which may entail little or no budgetary effort. **A quantitative concessionality criterion, leaving no room for interpretation, is needed to help restore the credibility of ODA as an indicator of donor effort.**

15. ODA is also not designed to measure recipient benefit. Some critics have referred to a large share of ODA being over-priced (e.g. technical co-operation, debt relief) or not helping poor people in developing countries (e.g. in-donor expenditures). While these ODA components may not result in flows to partner countries, from the donor perspective they do represent a genuine budgetary effort. Still,

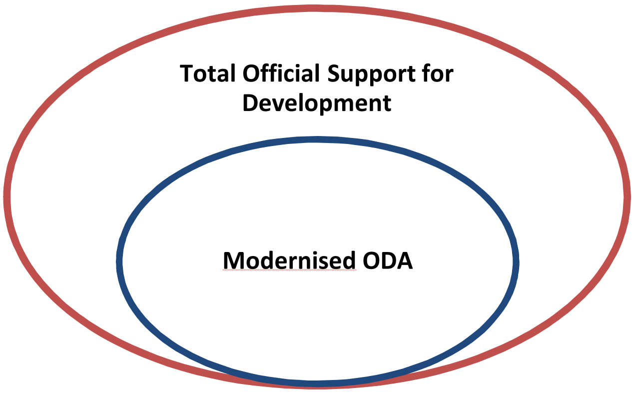
[3] For instance, ODA represents 70 % of external flows and 44 % of fiscal revenues of Least Developed Countries.

maintaining the integrity of the ODA measure necessitates a standardisation of the reporting with regard to items with questionable impact on developing countries.

B. How to do it?

16. The four annexes to this paper set out progress to date on several strands of work to build a new post-2015 statistical system for development finance. This progress is briefly summarised below, followed by suggestions for further action. All strands of work build on the fundamental architecture envisaged in the 2012 HLM decisions: a new measure of Total Official Support for Development, and a modernised ODA concept within it (Figure 1).

Figure 1. The two-circle approach



A new measure of Total Official Support for Development

17. Annex 1 points out that UN discussions on post-2015 sustainable development goals are pointing towards the adoption of a single agenda, based on the concept of sustainable development reaffirmed at Rio +20. This provides impetus for the DAC to implement the HLM agreement to elaborate a new measure of TOSD beyond ODA. The DAC statistical system should support the creation of a more comprehensive and inclusive framework for external development finance that comprises not only the promotion of the economic development and welfare of developing countries, including poverty eradication, but also helps record support for global public goods and policies, such as adapting to and mitigating climate change (which is widely understood as putting global development at risk) and development enablers such as peace and security.

18. Furthermore, the establishment and recognition of a broader measure may help relieve the pressure on the ODA concept, by providing adequate recognition of all public efforts to support the broader development agenda. The associated political context is such that the international community may not easily accept any moves to inflate recorded ODA by way of accounting changes, nor will ODA providers accept changes that result in significantly less ODA being recorded against the 0.7% target.

Sharpening the inner circle: a modernised ODA measure

19. Annex 2 makes the case that **any changes to ODA must support its credibility and be designed to help catalyse more resources and their effective use for the future**. Issues of

concessionality, targeting and scope are paramount. A modernised ODA measure should also **better reflect the budgetary effort of development co-operation and have relatively little impact on total ODA levels**, in line with DAC Ministers' recommendation to avoid creating major fluctuations.

20. The suggestion to revise ODA to measure budgetary effort, and count only the grant equivalent (instead of the full face value) of non-grant instruments [option 2 in DCD/DAC(2014)3 and see next section on conessionality], would provide for a more accurate assessment and comparison of donor effort and burden-sharing. It would minimise perverse incentives between grants and loans in ODA allocation, encouraging the most efficient uses of concessional resources given the nature of the project and a country's level of development.

21. Over the long term, it would provide a better indicator of donor budgetary effort for development co-operation because the repayment of past loans would not lead to reduced amounts of ODA. Indeed, the current system – counting loan disbursements *minus* repayments on earlier loans – involves serious problems: i) volatility in ODA levels, ii) a lack of correlation between the government's decision regarding the budgetary effort and the ODA volume generated the year the decision has been taken, and iii) artificially large outflows and inflows, especially in years of major debt forgiveness.

22. To further strengthen the credibility of the ODA measure, members could consider ways of streamlining and harmonising the reporting of budgetary expenditures that do not result in resource flows to developing countries (refugee costs, imputed student costs).

23. The modernised ODA measure, combined with an outer circle comprising TOSD (integrating the capital of loans, risk mitigation instruments and equity mechanisms) would highlight the important contribution of official agencies in financing economic growth and leveraging private investment. Proper recognition of their efforts within a revised statistical system could provide powerful incentives for their development.

A new definition of concessionality

24. There are several alternative ways in which the HLM mandate to arrive at a "clear quantitative definition of 'concessional in character', in line with prevailing financial market conditions", can be realised. Annex 3 outlines the two most promising alternatives, based on discussions to date, viz.:

- Move towards a harmonised multilateral definition of concessionality, based on recent work by IMF and the World Bank, using a fixed discount rate closer to present financial market conditions than the present 10%; or

- Move towards a differentiated, risk adjusted, discount rate, reflecting the actual cost of borrowing/risk of lending.

With either alternative, there is the question whether the resulting grant element should be used as at present to determine which loan flows are recorded as ODA, or converted to a "grant equivalent" amount upfront.

25. Recent discussions in the WP-STAT and the Expert Reference Group have inclined towards risk-adjusted, differentiated rates and counting grant equivalents rather than actual flows on loans that meet a threshold. This is thought to provide the most accurate assessment of risk and effort. However, less radical solutions are possible, such as using the recently-introduced IMF rate of 5% used in debt sustainability calculations for Low Income Countries.

A new graduation system or a better focus for concessional flows

26. With the rapid changes in development financing, the role of ODA is also changing. It is a paradox that in this situation, the share of ODA going to the countries where it remains a main source of financing (largely the LDC group), is declining. At the same time, questions are also being asked about the fact that the present list of ODA recipients includes some of the largest and fastest growing economies of the world. Annex 4 outlines two options for dealing with these challenges. A first option is to accelerate the graduation process. Simulations indicate that with the present threshold of USD 12 615, about 30 countries could graduate by 2030. An option could be to lower the income threshold to USD 7 115, which is the income level at which countries start the graduation process from non-concessional World Bank ("IBRD") lending. This would remove 18 countries from the List, currently receiving 1.7% of global net ODA.

27. An alternative would be for DAC members to keep the List of eligible countries and the graduation system as at present, but to voluntarily target a significant share of their ODA (e.g. 50%) to a specific group of countries, such as those defined by the UN General Assembly as "countries in special situations". Many DAC members, especially the smaller countries, already provide a very substantial share of their country allocable aid to LDCs[4].

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28. It is important for the DAC to show progress in addressing the current development finance measurement challenges. This will enable the donor community to contribute in a positive way to the debate on financing for post-2105 goals next year with the following three vital elements to the post-2105 development debate:

- A more credible and understandable ODA measurement with a definition focussed on the grant equivalent;
- A better prioritisation of ODA allocation with a greater focus on countries the most in need; and
- A more comprehensive and inclusive approach of financing for development with a new concept of TOSD to help meet the needs of the international community in monitoring the sustainable development agenda after 2015.

29. Taking account of the progress outlined above, **the SLM is therefore invited to agree that**:

1) In the light of the Dec 2012 HLM decisions, the system for measuring development finance needs to be reformed to restore the credibility of the ODA measurement, mobilise more resources for the post-2015 sustainable development agenda and increase their effectiveness, while at the same time remaining straightforward, politically palatable and easily understandable by policy makers and the public;

<u>TOSD</u>

2) The new measure of TOSD mandated by the HLM should clearly distinguish between official flows and those private flows mobilised by official action;

[4] DCD/DAC(2013)21, page 8.

3) The official flows within TOSD should include non-ODA finance of peace, security, climate, and other global challenges, on a basis to be further developed by the DAC and its Working Party on Development Finance Statistics;

4) Methodologies to assess the share of private developmental flows mobilised by official action should be further investigated, taking account of the emerging post-2015 sustainable development agenda.

ODA

5) The WP-STAT should examine how reporting on in-donor costs may be standardised to improve the legitimacy, transparency and comparability of the data between donors; it should present a concrete proposal to the DAC by the end of 2014;

6) The DAC should work towards the establishment of a clear quantitative definition of concessionality in character for use in the ODA context, as detailed in Annex 3; in particular, with the assistance of the WP-STAT, further investigate the feasibility of risk-adjusted grant equivalents (while not excluding other options); and report back to the SLM, in time for its October 2014 meeting.

7) The DAC should further explore ways in which an increased share of ODA could be channelled to countries most in need, e.g. by considering adopting a voluntary target for concentrating ODA on those countries.

ANNEX 1 – A NEW MEASURE OF TOTAL OFFICIAL SUPPORT FOR DEVELOPMENT

1. First discussions on the new measure of total official support for development (TOSD) have indicated that members welcome the development of a broader aggregate – supplementary to ODA – to capture various development finance mechanisms not yet reported on in a systematic and consistent way across members. A more comprehensive picture of all resources relevant for development is required, to help underpin the post-2015 sustainable development agenda which – according to the High Level Panel – is expected to "… address the universal challenges of the 21st century: promoting sustainable development, supporting job-creating growth, protecting the environment and providing peace, security, justice, freedom and equity at all levels".

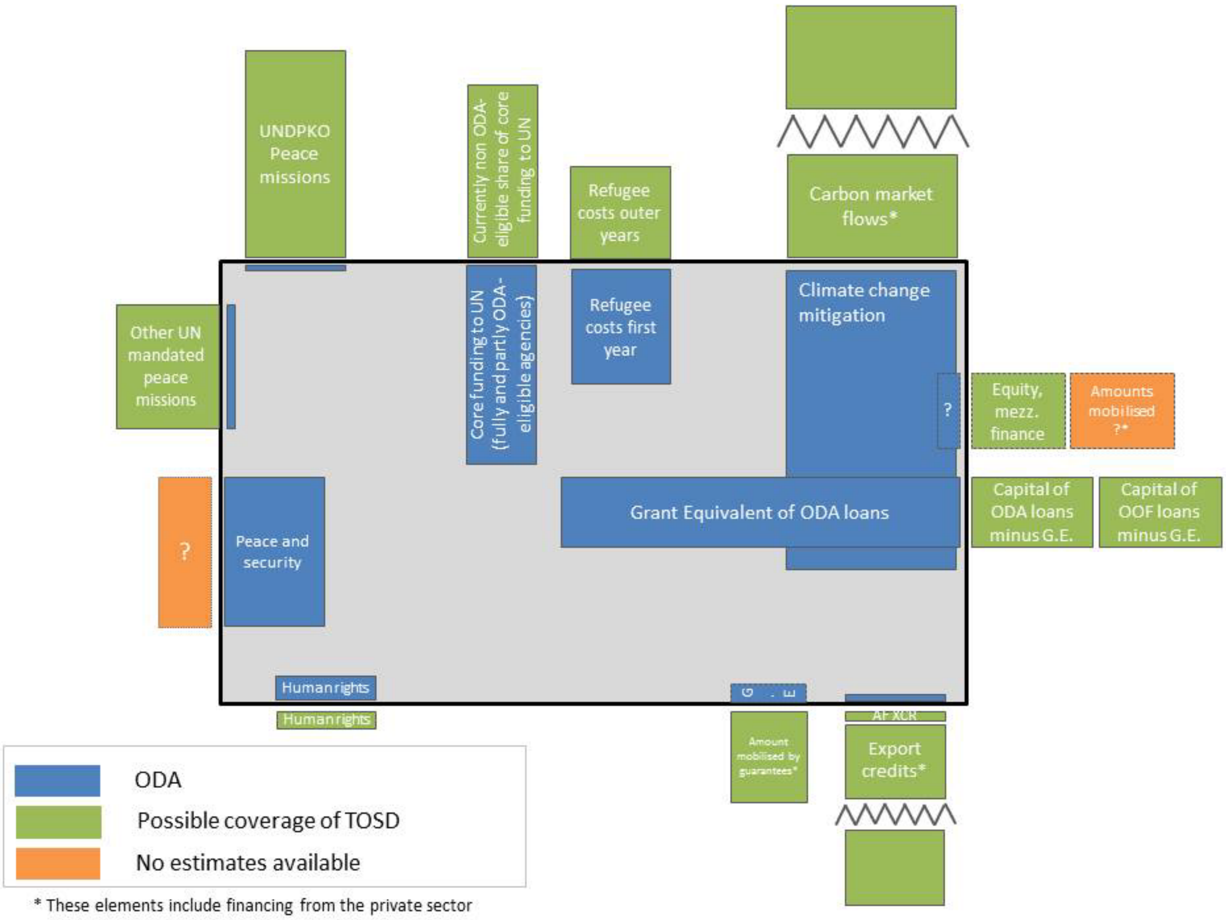
2. Figure 1 below outlines the new measure based on members' preliminary views on what expenditures it could include[5]. With a view to elaborating a concrete proposal on TOSD (alongside possible adjustments to ODA measurement) over the next few months, this note explores the possible boundaries of such a measure with regard to i) market-like instruments and resources leveraged from the private sector; ii) peace and security expenditures; and iii) support to global public goods and policies.

Instruments leveraging resources from the private sector

3. Several members have expressed their support for including in the post-2015 statistical system finance mobilised from the private sector through market-like instruments while reporting as ODA the budgetary effort involved in their use (consistent with the measurement used for concessional loans). They have highlighted however that "amounts mobilised" should be included in TOSD – or in an additional separate measure – only if causality between the official effort and the funds mobilised can be demonstrated. This may be the case for guarantees where a direct link between the instrument and the private capital mobilised exists (guarantee agreement). The leveraging effect of equity or mezzanine finance may be more difficult to establish. Still, members have requested the Secretariat to undertake further analysis in this area, examining the pros and cons and the practical feasibility of various options. Moreover, they have encouraged collaboration with the multilateral development banks, IFC, MIGA and the development finance institutions (DFI) community on methods to measure leveraging and consider the issue of double-counting (e.g. when several DFIs invest in the same equity fund).

[5] First suggestions on expenditures to be included in TOSD were presented in DCD/DAC(2013)36 and DCD/DAC(2014)7, discussed at the DAC on 3 December 2013 and 10 February 2014 respectively.

Figure 2. Modernised ODA and TOSD



Note: The grey and blue areas represent the volume of ODA (calculation based on scenario 2, ODA data for 2012). The elements outside this area represent non ODA-eligible expenditures that have been suggested for inclusion in TOSD (Secretariat's estimates from various sources).

4. Members have cautioned, however, against blurring the concept of "development" and noted the need to carefully define the outer boundaries of TOSD with regard to market-like instruments. One suggestion is to define TOSD as finance extended with a developmental purpose with an additional measure consisting of amounts mobilised. This would imply inclusion of loans and equity by development banks and DFIs and exclusion of guarantees and most export credits (possibly with the exception of associated financing)[6].

5. It will also be important to maintain the distinction between official flows and actions, and the private resources they may mobilise. In a first stage, TOSD may need to define the scope of official resources to be counted. Once this is done, methodologies for defining the private flows mobilised can be further investigated; these may, however, vary widely depending on the nature of the instruments and incentives involved.

[6] The current definition of official development finance excludes export credits.

Peace and security

6. Peace and security is expected to be a core dimension of the post-2015 development framework, considered as an "enabler of development". This might justify including in TOSD security expenditures currently excluded from ODA but considered by the international community as critical for establishing pre-conditions for development. In particular, 93% of multilateral contributions to UN peacekeeping expenditures are not ODA-eligible as they involve deployment of military equipment and services. However, the UN itself is reviewing the developmental contribution of its peace operations. This may suggest the need for the DAC to revise the ODA coverage of contributions to the operations. Depending on the outcome of such a review, there may be a case for a wider coverage of peace and security expenditures in TOSD. The possibilities of including other UN mandated peace keeping operations in the measure need to be explored.

Support to global public goods

7. The post-2015 development framework will address a number of global challenges, such as climate change and refugees, but also the more general global normative work of the UN and other international organisations. Including in TOSD expenditures aimed at combatting climate change or supporting refugees from developing countries, also beyond the first year, could facilitate allocation of funding for these purposes. Which elements to include here, may need to be finally considered once there is a final agreement on the elements to be included in the post 2015 development framework

ANNEX 2 – MODERNISING THE ODA MEASURE

1. ODA has increasingly come under criticism both from outside and inside the DAC. For some the concept is too broad, for others it is too narrow, and growing critiques have also targeted the way loans and debt forgiveness are counted.

2. Recent discussions in the DAC, the Working Party on Development Finance Statistics (WP-STAT) and the informal Expert Reference Group have confirmed the need to modernise ODA in a way that **strengthens the integrity of the measure** and **encourages the use of ODA for mobilising more (public and private) resources for development, and their efficient spending**. It is understood that there is a clear risk that ODA will lose its relevance if it is not sufficiently adapted to the changing modalities and objectives of development finance in a post-2015 world.

3. Different choices exist with regard to necessary adjustments to the accounting methodology and the coverage of different ODA sub-categories. Three possible scenarios were outlined in DCD/DAC(2014)3 and discussed at the 27 January 2014 DAC Meeting. **This paper highlights a number of key questions emerging from these scenarios and seeks SLM participants' guidance for further work.**

Dimensions of Choice

Measurement of loans

4. Maintaining ODA's credibility requires revising the measurement of loans. The following options have been discussed in the DAC:

1. Only count the budgetary expenditures of direct subsidies injected in loans;
2. Only account for the grant equivalent of loans[7];
3. Continue the flow measurement but clarify the concessionality assessment.

5. Members have so far expressed most support for the grant equivalent option and requested it be further examined, noting that it should be applied also to other non-grant financial instruments where feasible.

[7] Grant element multiplied by the face value of the loan.

Measurement of other non-grant development finance

6. Several non-grant financial instruments, such as guarantees, mezzanine finance or equity, have the potential to address the huge financial gap by leveraging significant additional (public and private) resources for development. The current ODA measurement does not incentivise their use. Mezzanine finance or equity are either not ODA-eligible or eventually result in net negative net ODA because of higher returns or profitable sales arising from additional risk inherent in these instruments. Guarantees are not captured at all since they do not constitute a flow.

7. There is an emerging agreement about the catalytic potential of such instruments and many believe that they need to be better valorised not only in the new measure on TOSD but also within ODA. Consistent with the approach to the measurement of loans, ODA could include either the direct expenditures incurred by donors, the grant equivalents (where feasible) or the face value of selected types of investments. Accounting for the direct expenditures incurred by donors, the grant equivalents (where feasible) or the face value of selected types of investments would help incentivise the use of non-grant financial instruments with significant leveraging potential.

Measurement of in-donor costs

8. The in-donor expenditures included in ODA have been subject to criticism. However, discussions at the DAC have indicated that there is little appetite for removing in-donor costs from ODA, although members generally agree that the Reporting Directives need to be clarified to improve the legitimacy, transparency and comparability of the reporting. As regards in-donor refugee costs, several members have suggested that renewed efforts should be made to harmonise reporting.

Aligning to the post-2015 sustainable development goals

9. In addition to the questions above, several members have indicated that there may be a need to reassess the ODA eligibility of certain items considered as essential development enablers under the emerging sustainable development agenda. The appropriate ODA coverage of items such as peace and security depends on the final post-2015 sustainable development framework, although the DAC discussion on 10 February 2014 reinforced that the current peacebuilding and state building principles remain central to the way in which issues of ODA and security and justice are handled. Some members have also pointed out that it will be difficult to establish the relevance and importance of a new TOSD measure unless it includes significant items not already counted in ODA.

ANNEX 3 – ESTABLISHING A CLEAR, QUANTITATIVE DEFINITION OF "CONCESSIONAL IN CHARACTER"

Introduction

1. A transaction is reportable as ODA only if it is "concessional in character and conveys a grant element of at least 25 per cent (calculated at a rate of discount of 10 per cent)". The 2012 DAC High Level Meeting noted "multiple views on the interpretation of 'concessional in character'" in relation to ODA loans. It therefore agreed to "establish, as soon as possible, and at the latest by 2015, a clear, quantitative definition of 'concessional in character', in line with prevailing financial market conditions."

2. Loan concessionality can be expressed in three main ways: long repayment periods, delaying the first repayment, or offering a low interest rate. The first two give the borrower more time; the third reduces the amount he has to pay. The combined effect of all three can be measured in a grant element calculation. To make such a calculation, a neutral or reference rate must be selected as a benchmark. The choice of this rate determines whether, and to what extent, the loan is concessional.

3. It will be noted that the ODA definition already contains a quantitative test – 25% grant element, using a 10% discount rate. However, the HLM decision implies that it did not consider this test was an adequate "quantitative definition of concessional in character", at least given "prevailing financial market conditions". There has, in fact, been much criticism that the 10% discount rate is too high given the current global interest rate environment. The HLM recognised this by stipulating that the new definition should "withstand a critical assessment from the public".

Dimensions of choice

4. One simple test of "concessional in character" could be to stipulate a maximum interest rate. However, this would fail to integrate any concessionality expressed through giving borrowers more time to repay. Discussions in the DAC Working Party on Development Finance Statistics (WP-STAT) and the Expert Reference Group (ERG) have therefore focused on a possible new grant element test.

5. Three main choices need to be made for a new grant element test to serve as a "clear quantitative definition of concessional in character":

- Should the discount rate be fixed, or differentiated by lender, borrower, year, term etc.?
- If differentiated rates are preferred, should these rates be risk-free, or risk-adjusted?
- Should the resulting "grant element" be used as at present to determine which loan flows are recorded as ODA, or converted to a "grant equivalent" amount upfront?

6. A fixed discount rate has the advantage that two loans at the same terms always bear the same grant element, regardless of donor, recipient, currency, year or other factors. The current grant element test uses a fixed rate of 10%, and the IMF recently introduced a fixed rate of 5% for use in debt sustainability calculations for low income countries[8]. But differentiated rates can reflect the costs of borrowing and/or the risk of lending. They are used in the OECD's assessments of the concessionality of tied aid and export credits.

7. Discussions in the WP-STAT and Expert Reference Group have tended to favour differentiated rates. In that case, the next question is whether the rates should be "risk-free", or adjusted to reflect the risk that the borrower may default. "Risk-free" rates, as paid on AAA-rated government bonds, avoid possible arguments about borrower creditworthiness, and whether this is being improved by guarantees, insurance, or the repayment priority ("seniority") of the loan. But risk-adjusted rates better reflect the lender's likely final costs in making the loan. By valuing upfront the risk of default on official loans, they remove the need to report eventual forgiveness of these loans as new aid effort. This would deal with a frequent criticism that DAC debt forgiveness reporting is too generous.

8. Discussants have so far favoured "risk-adjusted" rates. The next question is whether the resulting grant elements should determine whether to record the flows on a loan as ODA – as at present – or whether the "grant equivalent" of the loan should itself be recorded. Recording actual loan flows reflects what the recipient actually receives and repays, while the recording of grant equivalents better reflects the donor effort. Discussants have tended to favour the latter option, which avoids the "sudden death" exclusion of loans that just fail to meet the grant element threshold and the present artificial incentive to bring grant elements up to 25%.

Conclusion

9. The trend in discussions has been towards risk-adjusted, differentiated rates, and counting grant equivalents, rather than actual flows on loans that meet a threshold. This is considered to provide the most accurate assessment of risk and effort. It also appears practicable, as a draft system for establishing the necessary rates was already proposed by four members in 2012.

10. However, it must be acknowledged that this would break with the present flow-based measurements[9], and would imply a major review of debt relief reporting. Less radical proposals are also possible. For example, using risk-free differentiated rates (such as the Differentiated Discount Rates used for assessing tied aid and export credits) would enable retention of debt relief reporting, on a somewhat more defensible basis. Using a fixed rate, but one lower than 10%, would disturb the existing system to an even smaller extent, while still responding to the need for greater realism in the concessionality assessment.

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[8] The IMF rate was roughly the average USD CIRR for the last ten years, with some allowance for long loan maturities in LICs. It is fixed until completion of the review of the LIC debt sustainability framework in 2015.

[9] Flow data would still be collected so as to present accurate data on developing countries' resource receipts.

ANNEX 4 – OPTIONS FOR FOCUSING WHERE ODA IS NEEDED THE MOST: REVISED ODA GRADUATION CRITERIA AND TARGETING

Introduction

1. At recent meetings, the DAC expressed interest in the possibility of further focusing concessional finance on countries in greatest need. Currently, the DAC does restrict ODA eligibility to countries below a certain per capita income threshold[10]. The UN, however, has a target on how much should be directed to the Least Developed Countries (LDCs)[11]. A further focusing can be based on two main arguments: i) new sources of finance are becoming available and the relative amount of ODA globally is declining, but many countries still lack access to the new sources of finance and remain highly aid-dependent; ii) ODA growth to many highly aid-dependent countries is slowing down, while it is speeding up for Middle Income Countries (MICs), mainly because of an increase in loans reported as ODA. A further focusing would also be supported by the global discussion, which is coalescing around a post-2015 goal of eradicating absolute poverty by 2030, including through a sustainable growth path for developing countries. This note presents three options recently discussed by the DAC[12]. The first option shortens the present DAC List of ODA Recipients (the "List") by introducing a lower per capita income threshold. The second option is to make no change to the current income threshold criterion. The final option introduces a new target for the share of ODA that DAC countries might direct to LDCs and other countries in special situations.

Option 1: Revising the List

2. The List could be further restricted by lowering the current threshold. An alternative would be the income level at which countries start the graduation process from non-concessional World Bank ("IBRD") lending (currently set at USD 7 115). Eighteen countries now on the list would have been excluded in 2012. Together, they received about 1.7% of net ODA. Brazil, Mexico and Turkey account for the bulk. Adopting this option could enhance consistency between bilateral and multilateral development finance and remove the paradox that a country continues to be eligible for ODA at income levels that would trigger consideration of its graduating from non-concessional IBRD lending. However, there was little support among DAC members for restricting country eligibility for ODA. Several members suggested that this could reduce the incentives to encourage MICs to participate in addressing global challenges.

Option 2: Maintaining status quo

3. Even if the threshold for ODA eligibility remains where it is today, the List will become shorter as countries' per capita income continues to rise above the high-income threshold. This graduation from ODA eligibility will occur because of their relatively high overall and per capita growth rates (many developing countries are averaging well above those prevailing in most DAC countries). Recognising the

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[10] Presently, the DAC List is comprised of all low and middle income countries and territories (hereafter only referred to as "countries"), but excluding G8 members, EU members, and countries with a firm date of accession to the EU. To give stability to the List, countries are only removed on income grounds once they have exceeded the "high income" threshold of USD 12 615 (in 2012) in three successive years. The DAC revises the List every three years, with the next revision due in 2014. The present List is shown at Appendix1.

[11] The current LDC targets, set at the LDC IV conference at Istanbul in 2011, are complex and depend on donors' existing levels of ODA to LDCs. Their effect is to set ODA/GNI targets for aid to LDCs of 0.15%, 0.2% or more for DAC countries. See the Istanbul Programme of Action at http://www.un.org/wcm/webdav/site/ldc/shared/documents/IPoA.pdf, page 37.

[12] See DCD/DAC(2014)4 and DCD/DAC(2013)29.

limitations of long-term projections, simulations based on IMF data suggest that the List is likely to be much shorter – nearly 30 fewer countries – in 2030 than it is today. The simulations also reveal that it matters little whether the existing income threshold or the one proposed in Option 1 is used. In both cases, the List will be much shorter in 2030 than today. Hence, making no change in the List and let countries graduate as they continue to develop is an alternative. For reference, more than 50 countries have already been removed from the List over the last four decades.

Option 3: A possible new target

4. A complementary course of action could be to target aid to a sub-group of countries on the List. DAC members could give greater priority to achieving the existing UN target of 0.15% - 0.20% of ODA to GNI for LDCs. There is room to improve as collectively DAC members only reached 0.09% in 2012. This UN target for LDCs, however, has not attained the same level of international recognition and prominence as the 0.7% of ODA to GNI.

5. A simpler and possibly more effective approach would be to consider a target based on a member's ODA volume rather than GNI. In 2012, DAC member countries provided 40% of their ODA to LDCs. This percentage includes a member country's ODA going through both bilateral and multilateral channels and is summarized in Appendix B[13]. For example and for illustrative purposes only, if a target of 50% of ODA to LDCs was agreed upon, it would likely be viewed and understood as a sign that the DAC intends to further focus concessional aid to the neediest countries on the List. To have attained this illustrative target in 2012, an additional USD 12.7 billion would have had to be shifted from non-LDCs on the List to LDCs.

6. Other formulations of countries to be targeted are possible. For example, the UN General Assembly has defined "countries in special situations" as LDCs and Land Locked Developing Countries (LLDCs). Another UN proposal would add Small Island Developing Countries to the LDCs and LLDCs. However, "special situations" do not necessarily imply low income. Botswana, Kazakhstan, and Armenia would be included as they are landlocked, and Cape Verde, Antigua and Barbuda, and Cuba would be included as they are considered small island states. None of these countries met the income threshold of being LDCs.

7. States labelled as fragile and conflict affected could also be considered for targeting. This would mean that non-LDCs like Egypt, Iraq and Kosovo would be added. However, countries classified as fragile or conflict affected LDCs are much more likely to change from year to year than the LDCs, increasing "volatility" in which countries would be counted from year to year. Determining how to classify a country as fragile and conflict affected has also aroused, at times, political sensitivities[14].

[13] Calculated as the sum of total net bilateral ODA and imputed multilateral ODA to LDCs divided by total net ODA, assuming half of all amounts unallocated by country, excluding in-donor costs, are de facto allocated to LDCs.

[14] The UN has no list of fragile and conflict affected states. The list used by the OECD for its analysis of financial flows to fragile states is neither an official DAC list nor based on an official definition. It is put together every year. Since 2011, the list of fragile states and economies assembled by the OECD results from a compilation of two lists: the World Bank-African Development Bank – Asian Development Bank Harmonised List of Fragile Situations, and the countries on the Failed States Index developed by the Fund for Peace which are in the "alert" and "warning" categories (i.e. index above 90).

APPENDIX 1
DAC List of ODA Recipients
Effective for reporting on 2012 and 2013 flows

Least Developed Countries	Other Low Income Countries (per capita GNI <= USD 1005 in 2010)	Lower Middle Income Countries and Territories (per capita GNI USD 1 006-USD 3975 in 2010)	Upper Middle Income Countries and Territories (per capita GNI USD 3 976-USD 12275 in 2010)
Afghanistan	Kenya	Armenia	Albania
Angola	Korea, Dem. Rep.	Belize	Algeria
Bangladesh	Kyrgyz Rep.	Bolivia	*Anguilla
Benin	Tajikistan	Cameroon	Antigua and Barbuda
Bhutan	Zimbabwe	Cape Verde	Argentina
Burkina Faso		Congo, Rep.	Azerbaijan
Burundi		Côte d'Ivoire	Belarus
Cambodia		Egypt	Bosnia and Herzegovina
Central African Rep.		El Salvador	Botswana
Chad		Fiji	Brazil
Comoros		Georgia	Chile
Congo, Dem. Rep.		Ghana	China
Djibouti		Guatemala	Colombia
Equatorial Guinea		Guyana	Cook Islands
Eritrea		Honduras	Costa Rica
Ethiopia		India	Cuba
Gambia		Indonesia	Dominica
Guinea		Iraq	Dominican Republic
Guinea-Bissau		Kosovo[1]	Ecuador
Haiti		Marshall Islands	Former Yugoslav Republic of Macedonia
Kiribati		Micronesia, Federated States	Gabon
Laos		Moldova	Grenada
Lesotho		Mongolia	Iran
Liberia		Morocco	Jamaica
Madagascar		Nicaragua	Jordan
Malawi		Nigeria	Kazakhstan
Mali		Pakistan	Lebanon
Mauritania		Papua New Guinea	Libya
Mozambique		Paraguay	Malaysia
Myanmar		Philippines	Maldives
Nepal		Sri Lanka	Mauritius
Niger		Swaziland	Mexico
Rwanda		Syria	Montenegro
Samoa		*Tokelau	*Montserrat
São Tomé and Príncipe		Tonga	Namibia
Senegal		Turkmenistan	Nauru
Sierra Leone		Ukraine	Niue
Solomon Islands		Uzbekistan	Palau
Somalia		Vietnam	Panama
South Sudan		West Bank and Gaza Strip	Peru
Sudan			Serbia
Tanzania			Seychelles
Timor-Leste			South Africa
Togo			*St. Helena
Tuvalu			St. Kitts-Nevis
Uganda			St. Lucia
Vanuatu			St. Vincent and Grenadines
Yemen			Suriname
Zambia			Thailand
			Tunisia
			Turkey
			Uruguay
			Venezuela
			*Wallis and Futuna

*Territory.
(1) This is without prejudice to the status of Kosovo under international law.
Source: DCD/DAC(2014)4, p. 7 Annex A.

APPENDIX 2
DAC members' ODA to LDCs (bilateral ODA, imputed multilateral and regional estimate)

	Total net ODA	Total ODA to LDCs (bilateral, imputed multilateral and regional estimate)	Total ODA to LDCs / Total net ODA	Total financial gap to reach 50% of net ODA
Australia	5 403	1,945	36%	756
Austria	1 106	279	25%	274
Belgium	2 315	824	36%	334
Canada	5 650	2 546	45%	279
Czech Republic	220	59	27%	50
Denmark	2 693	1 256	47%	90
Finland	1 320	593	45%	67
France	12 028	2 995	25%	3 020
Germany	12 939	4 833	37%	1 637
Greece	327	50	15%	113
Iceland	26	15	58%	-
Ireland	808	467	58%	-
Italy	2 737	716	26%	653
Japan	10 605	5 129	48%	173
Korea	1 597	628	39%	171
Luxembourg	399	176	44%	23
Netherlands	5 523	2 241	41%	521
New Zealand	449	151	34%	74
Norway	4 753	2 015	42%	362
Poland	421	83	20%	127
Portugal	581	180	31%	110
Slovak Republic	80	20	25%	20
Slovenia	58	14	24%	15
Spain	2 037	568	28%	450
Sweden	5 240	2 141	41%	479
Switzerland	3 045	976	32%	547
United Kingdom	13 892	5 995	43%	951
United States	30 687	13 913	45%	1 430
Total DAC	**126 939**	**50 809**	**40%**	**12 725**
EU Institutions	17 479	4 750	27%	3 990
Total DAC	**144 418**	**55 559**	**38%**	**16 714**