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Commonwealth Perspectives on OECD-DAC Post-2015 Statistical Reform

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Introduction

Preparations are underway for the United Nations Third International Conference on Financing for Development, to be held in Addis Ababa, Ethiopia between 13 and 16 July 2015. Delegates will reaffirm commitments to development financing made in the first and second conferences, held respectively in Monterrey, Mexico (2002) and Doha, Qatar (2008), and review implementation. They will assess new and emerging issues arising from the evolving landscape of development co-operation and agree on the financing framework to underpin the UN post-2015 development agenda to be adopted in September 2015.

The official UN preparatory process commenced in September 2014 and will run until June 2015. During this period, the President of the UN General Assembly will be engaged in informal consultations with member states, the private sector and civil society. The summaries of these consultations will serve as the basis of the conference's official outcome document. Drafting sessions on the outcome document will be held in January, April and June 2015 (UN 2014). The outcome document will follow those from the first two conferences, the 2002 Monterrey Consensus and the 2008 Doha Declaration on Financing for Development.

Apart from the inputs of member states, the UN outcome document is expected to be shaped primarily by contributions from the World Bank, International Monetary Fund (IMF), World Trade Organization (WTO), UN Conference on Trade and Development (UNCTAD) and the Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee (DAC).

This discussion paper looks at the OECD-DAC contribution, a set of proposals for reforming the OECD statistical system. These proposals will be particularly important in helping to shape the development financing incentives of OECD-DAC (and possibly other) donors, for at least the next 10 years. The paper provides a brief assessment of OECD-DAC's most recent proposals, which will be particularly useful for the designated negotiators of Commonwealth member states in the UN financing for development discussions.

Specifically, the objectives of the discussion paper are to:

- Update Commonwealth countries on the current status of OECD-DAC's work to reform the OECD-DAC statistical system.
- Assess the emerging OECD-DAC proposals and their anticipated impact on the financing for development

architecture as well as on development flows to Commonwealth countries.

- Stimulate discussion within the Commonwealth and among OECD-DAC members.
- Prepare UN representatives of Commonwealth states for negotiations at the UN's Third International Conference on Financing for Development.

Background to the OECD-DAC reform

Cognisant of the rapid change in global financing conditions and the increasing complexities in a shifting financing landscape, OECD and OECD-DAC ministers, along with key development partners,[1] met in London in December 2012. The purpose of the meeting was to reflect on the Millennium Development Goals (MDGs), reaffirm aid effectiveness and other commitments and discuss ways of maximising development financing.

The reform seeks to maximise ODA impact and modernise the measurement and monitoring of development finance

According to the OECD-DAC High Level Meeting (HLM) Communiqué (OECD 2012), they recognised the progress made on the MDGs and the role that investment in official development assistance (ODA) had played in helping developing countries reach certain targets. Ministers also drew attention to emerging challenges, including growing world inequality and the implications of such impediments for poverty reduction and global economic stability.

OECD-DAC ministers reconfirmed their agreement to provide 0.7 per cent of their gross national income (GNI) to developing countries, highlighting the importance of maintaining a focus on poverty. They also expressed approval for the UN approach of including a focus on sustainable development as well as on climate change.

Ministers took note of the changing financing landscape, specifically the shift in global wealth and the consequent breakdown of the division between providers of development finance. The meeting highlighted the increase in South–South co-operation as well as triangular co-operation, which are now playing important roles in complementing traditional development finance.

Recognising these changes, ministers agreed to explore more deeply the potential of the financing for development landscape in terms of opportunities for catalysing ODA and maximising its impact, and for utilising different sources of finance. Similarly, they acknowledged the need to modernise the measurement and monitoring of external development finance. To this end, OECD-DAC was instructed to reform its statistical system.

With the main aim of ensuring that ODA is directed to where it is needed most and can catalyse other flows and promote accountability, ministers instructed the DAC to:

- Elaborate on a proposal for a new measure of Total Official Support for Development (TOSD).
- Explore ways of representing both donor effort and recipient benefit in development finance.
- 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.
- Undertake this work in close collaboration with other interested international agencies.

1 These international partners included: the IMF and World Bank; the UN Development Programme (UNDP) and other UN representatives; the African Development Bank (AfDB), Asian Development Bank (ADB) and Inter-American Development Bank (IADB); and co-Chairs for the Global Partnership for Effective Development Cooperation. High-level representatives from Brazil, China, India, Indonesia and South Africa were also present as observers.

With respect to the reporting of ODA loans, particularly the interpretation of the term 'concessional in character', ministers agreed on a number of key principles that ODA measurement should meet. These principles require that ODA reporting should:

- Withstand a critical assessment from the public.
- Avoid creating major fluctuations in overall ODA levels.
- Be generally consistent in defining 'concessionality' in multilateral development finance.
- Maintain the definition of ODA and seek only to clarify the interpretation of loans that qualify as ODA.
- Prevent notions that ODA loan schemes follow a commercial logic, including the principle that financial reflows should be reinvested as development resources.

In this spirit, OECD-DAC ministers instructed OECD-DAC to:

- Establish by 2015 a clear, quantitative definition of 'concessional in character' that is in line with prevailing financial market conditions.
- Recognise development loans extended at preferential rates as making an important contribution to development, whether or not 'concessional in character' under a future post-2015 definition.

Review of the OECD-DAC proposals

The OECD-DAC ministerial mandates initiated the following four main strands of work:

- Better representation of donor effort and recipient benefit.
- ODA modernisation, should the former mandate require it.
- Establishment of a clear and quantitative definition of 'concessional in character'.
- Development of an improved targeting method for ODA that ensures assistance goes where it is most needed.

This brief review looks at OECD-DAC's work on the OECD ministerial mandates and presents the institution's perspectives and proposals as at the end of October 2014.

Introducing Total Official Support for Development (TOSD)

Currently, ODA captures flows to countries on the DAC list of ODA recipients and to multilateral development institutions as provided by official agencies, including state and local governments, or by their executive agencies.

Each transaction is administered with the promotion of the economic development and welfare of developing countries as its main objective. They are concessional in character and convey a grant element of at least 25 per cent (calculated at a discount rate of 10 per cent).[2]

Development efforts that do not pass the ODA test of having economic development and welfare as their main objective are not counted in ODA. However, some donor support efforts that are not counted in ODA do have countries' wellbeing as the primary objective, albeit at a more global level. Two prime examples are support for certain aspects of peace and security[3] and climate change adaptation and mitigation.

This kind of donor effort is precisely what TOSD is meant to measure. For example, only around 7 per cent of donor support for peace and security is captured in ODA so the other 93 per cent would be captured in a measure of TOSD, should it be introduced. OECD-DAC believes this would be useful for reporting and monitoring developments on the new global framework amalgamating the

2 See OECD (2008)
3 93 per cent of multilateral contributions to UN peacekeeping expenditures are not ODA eligible (OECD 2014a).

agendas of the MDGs, sustainable development and climate change. TOSD is also perceived as useful for incentivising donors to increase their support for development enablers (peace and security) and global public goods (climate finance), even though these transactions are not being recorded in ODA.

TOSD could be an incentive to donors to increase their support in areas like peace and security and climate finance

Finance mobilised from the private sector through market-like instruments should also to be recorded in a measure of TOSD. While the budgetary effort involved in these transactions will be recorded in ODA, the total amount mobilised will be recorded in TOSD. However, the OECD stipulates that such instruments should only be recorded in TOSD if causality between the official effort and the total funds mobilised can be demonstrated. This may be the case for guarantees with a direct link between the instrument and the private capital mobilised, but will be much less so for the leveraging effect of equity or mezzanine finance[4], which are more difficult to establish (OECD 2014b).

Initially, TOSD was presented as a 'catch-all concept' covering all donor transactions aimed at economic development and improving the welfare of developing countries. However, the concept has been evolving. This is because the DAC has recognised that some expenditure may not be eligible for inclusion in TOSD, such as the equity transactions mentioned above, and that while TOSD would be based on capturing financing flows, ODA could be modernised to capture grant equivalents thereby presenting issues for overall accounting. As such, the current DAC proposal is to introduce TOSD as an additional measure to ODA rather than as an encompassing one.

Modernising ODA to better represent donor effort and recipient benefit

The work of exploring ways of better representing donor effort and recipient benefit has been driven by the notion that better alignment of the two measures would improve reporting and create better donor incentives. Since the 2012 High Level Meeting, the DAC has put forward the following options for achieving the goal (Benn and Gaveau 2014):

- Only recognise as ODA expenditure on development that results in a flow of resources to developing countries.
- Only recognise as ODA funding that reflects true donor effort. This would involve reporting on an accrual basis and acknowledging only the grant equivalent of loans. It would also include recognising the grant equivalent/contributions of market-based instruments (such as guarantees) that are used to facilitate development loans.[5]
- Recognise gross disbursements, which is an option similar to existing ODA measurement but with adjustments (e.g. recognising market-based instruments) to ensure the catalysing of ODA.

At the time of writing, the DAC reported a preference for the grant equivalent conceptualisation of ODA. The principal argument supporting adoption of the grant equivalent

4 A hybrid of debt and equity financing that is typically used to finance the expansion of existing companies.

5 Donors' use of public guarantees to support loans for developing countries can help to shore up total development financing. A grant equivalent method of ODA accounting as envisioned by OECD-DAC would involve capturing as ODA the grant/benefit extended to developing countries. This would be measured as the difference between the lending rate received due to support from public guarantees and the lending rate that would otherwise have applied at prevailing market rates.

conceptualisation is that it would be helpful in capturing accurately donor effort. Unlike the cash flow method, it would reflect only current donor commitments and in turn, help developing countries to match this with their ODA receipts/recipient benefit.

In the current system, once the grant element of a development loan is at least 25 per cent (as calculated by the discounting of reflows at a 10 per cent discount rate to maturity) it is judged to be ODA and the gross loan disbursement is recorded. Therefore, it is possible that significantly higher values of ODA are presently attributed to OECD lenders than would be recorded using a grant equivalent calculation.[6]

Current sentiments are heavily skewed towards harmonisation of OECD and IMF/World Bank discount rates

Initially, the DAC suggested the introduction of risk-adjusted discount rates in order to capture the cost of development financing as well as to reflect the risk of lending to developing countries, as opposed to the current 10 per cent discount rate utilised by the OECD for assessing loan concessionality. This was a further attempt to better capture and align donor effort and recipient benefit, but it has proved to be quite contentious, as explained below.

Establishing a clear quantitative definition of 'concessional in character'

The question of which discount rate is appropriate for accurately capturing loan concessionality and, by extension, how to value development loans in ODA has long been an issue for debate. The OECD, the IMF and the World Bank currently use different discount rates for calculating loan concessionality The OECD uses a 10 per cent risk free discount rate[7] and the IMF and World Bank employ a 5 per cent fixed discount rate. Adding to the confusion, some developing countries have other methods of interpreting loan concessionality.

In line with the High Level Meeting mandates, the DAC outlined options for a clearer and quantitative definition of 'concessional in character' – three options for revising the OECD discount rate to calculate the grant element of loans and two for measuring development loan contributions to ODA (OECD 2014c). These options are as follows:

Discount rate

- Move towards a more harmonised definition of concessionality, by aligning the OECD discount rate with the IMF/World Bank discount rate. The IMF/World Bank rate is set by reference to a 10-year average of monthly US dollar commercial interest reference rates (CIRRs) and includes a term premium, reflecting the generally long tenors of development loans to low-income countries (LICs).
- Apply currency-specific OECD differentiated discount rates (DDRs), which represent lenders' funding costs more accurately as they are differentiated by currency and tenor and updated annually.
- Introduce risk-adjusted discount rates. While the IMF/World Bank and the DDRs are 'risk-free discount rates', the risk-adjusted discount rate would take into account both the lenders' cost of funds and the risk incurred in lending to a particular country (risk premium). They would thus capture the full costs associated with individual loans.

6 *In the current system, the loan reflows are negated over time so that at maturity the level of ODA arising from a development loan eventually declines to zero.*

7 *The OECD discount rate of 10 per cent represents the opportunity costs incurred when diverting resources from domestic investment to aid.*

Measurement method

- Introduce a grant equivalent method of calculation. The rationale behind this option, according to the DAC, is that it would measure concessionality as a continuum and therefore represent a more accurate measure of donor effort. For example, the more concessional a loan is, the more ODA credit would be attributed.
- Maintain a cash flow basis for use in the current system where the gross value of concessional loans is recorded.

Recalling the High Level Meeting requirements on establishing a clear and quantitative definition of 'concessional in character', it is not surprising that current sentiments are heavily skewed towards harmonisation of OECD and IMF/World Bank discount rates. Implementation of DDRs or adjusted DDRs would violate four of the five requirements stipulated by the HLM.

Developing countries are very critical of risk-adjusted rates, primarily because of their complexity and potential effect on ODA volatility (OECD 2014d). Additionally, since DDRs and adjusted DDRs would have to be updated annually, as well as vary widely depending on countries' debt trajectories, they would limit comparability across countries. Lastly, adjusted DDRs would be comparable to market rates and thus could lead to the view that ODA follows a commercial logic.

As mentioned earlier with respect to ODA measurement, favour for the grant equivalent option has gained the most momentum. Hence, the emerging strategy from OECD-DAC for assessing future loan concessionality appears to be by way of a grant equivalent calculation derived on the basis of the IMF/World Bank risk free discount rate.

Ensuring funds go to countries most in need

At the 2012 High Level Meeting, OECD-DAC ministers emphasised the need to maintain a focus on poverty. This essentially translates to ensuring an adequate flow of funds to the least developed countries (LDCs), which are the poorest with access only to grant funding. The question is how to safeguard ODA to LDCs, against a backdrop of a decline in OECD-DAC aid resources. The DAC has put forward the following options for consideration:

Revise the OECD-DAC list

The DAC suggested revising the list of ODA-eligible countries by lowering the current income threshold to US$7,115, the income level at which countries start the graduation process from non-concessional lending provided by the International Bank for Reconstruction and Development (IBRD), which is part of the World Bank Group. The DAC argues that this could enhance consistency between bilateral and multilateral development agencies and remove the paradox that a country continues to be eligible for ODA at income levels that should prompt consideration of its graduation from non-concessional IBRD lending.

Maintain the status quo

As an alternative, the DAC suggests maintaining the current system. OECD-DAC estimates that at the current income thresholds a number of countries will graduate from the list in due course as their per capita incomes continue to rise due to their relatively high per capita growth rates. Under the current system, ODA would naturally, over time, be focused on the most needy countries, as reflected in their low per capita incomes.

Introduce a new target

The third option proposed by the DAC is to select a new target for focusing ODA. One suggestion is for OECD-DAC members to give greater priority to achieving the existing UN target of 0.15–0.2 per cent of ODA to gross national income (GNI) for LDCs. DAC donors have so far achieved just 0.09 per cent of GNI for LDCs. Another suggestion is to base the target on ODA volume rather than on a

ratio to GNI. For example, 50 per cent of ODA could be targeted towards LDCs, which would shift a proportion of ODA away from non-LDCs thereby refocusing ODA to those with most needs. The DAC also considered targeting countries in 'special situations', with no particular regard to income classifications. As defined by the UN General Assembly, countries in 'special situations' are LDCs, land locked developing countries (LLDCs), small island developing states (SIDS) and countries in post-conflict situations.

Current thinking favours introducing a new target based on ODA volume rather than on a ratio to GNI, with the objective of directing aid to LDCs. Specifically, the DAC proposal is for donors to safeguard at least 50 per cent of ODA for LDCs.

A new target based on ODA volume rather than on ratio to GNI, is favoured for directing aid to LDCs

Commonwealth perspectives

The Commonwealth Finance Ministers Meeting (CFMM) in Washington, DC in October 2014 made a strong call for the international community to meet existing ODA commitments in the context of the OECD-DAC reforms. They emphasised that the reforms should not detract from this commitment and the need to maintain support and focus on poverty eradication in the light of the possible introduction of a new measure of Total Official Support Development (TOSD).

The CFMM was informed by a background paper prepared by the Economic Policy Division (EPD) of the Commonwealth Secretariat (2014), 'OECD DAC Proposals: Implications for Commonwealth Countries'. They supported further work by the Commonwealth Secretariat to formally feed Commonwealth perspectives into OECD-DAC high-level deliberations and provide ongoing policy research and technical support as the OECD-DAC reform exercise proceeds.

The Commonwealth Secretariat background paper focuses on the implications of the following proposals:

- The introduction of a measure of TOSD.
- Modernisation of ODA through a grant equivalent conceptualisation.
- Harmonisation of OECD and IMF/World Bank discount rates for assessing loan concessionality.
- The introduction of a new ODA target aimed at delivering at least 50 per cent of total ODA to LDCs.

The background paper identifies the potential for both opportunities and risks for developing countries, primarily with respect to issues of access to concessional finance by non-LDC countries, and the management of debt and debt sustainability in developing countries.

The opportunities

Current progress on a reform of the OECD-DAC statistical system suggests the following possible benefits for developing countries:

- An improved framework for monitoring financing for development.
- An ODA measure that overcomes some past criticisms by attempting to more accurately reflect donor effort in relation to recipient benefit.
- A possible increase in the scale of development financing, albeit non-concessional.
- Gains in international co-ordination with respect to harmonisation of OECD and IMF/World Bank discount rates for valuing loan concessionality.

The revision of the OECD-DAC statistical system to include a measure of TOSD that captures donor

support for development enablers, global public goods and other non-ODA means of financing (e.g. market-like instruments), should help to improve OECD statistical reporting and development finance reporting more generally. This would be especially true if TOSD were to also capture development financing from non-OECD providers, which by characterisation would not otherwise be reported under ODA or other official flows (OOFs).[8] TOSD could also help to incentivise the continued provision of donor resources for non-ODA priorities, and to assist with aligning the current OECD-DAC statistical framework with the more complex financing landscape and broader post-2015 development agenda objectives.

Should the grant equivalent concept of ODA be implemented, it is expected to better capture and align measures of donor contributions with countries' records of their official development aid receipts. It would also help to more accurately reflect current political commitments of donor countries, which is obscured when ODA is measured on a gross disbursement basis, as in the current system. Loan contributions to ODA are only reduced through amortisation over a maturity period of at least 30 years. This means that over the maturity period of one development loan at least three different government administrations would have been in office, each of which could have very different views and policies on development financing. Measures of ODA cannot, therefore, truly reflect governments' political commitments to development financing.

Aligning the OECD and IMF/World Bank discount rates for assessing loan concessionality could bring about desired international financial co-ordination and facilitate easier cross-country comparison with respect to loan concessionality. It could also be a positive contribution to developing country debt management.

Specifically, the use of the common discount rate in the valuation of loans obtained from official sources would facilitate more efficient debt management.[9] By extension, it would also improve the simplicity and accuracy of low-income country debt sustainability analysis. Under current market conditions, the OECD discount rate is exaggerating the grant element in ODA loans because it is not aligned with current and future market rates. Hence, given that the IMF/World Bank discount rate is closer to prevailing market conditions, harmonising it with the OECD rate would allow for a more accurate representation of countries' concessionality gains. This is important for estimating the present value of debt, which is a key variable in the estimation of low-income country debt sustainability.

Another benefit of reducing the OECD discount rate in line with that of the IMF and World Bank is the limiting of perverse incentives. As it stands, the current OECD discount rate provides incentives for donor countries to increase ODA through loans rather than grants. This is because of the high discount rate relative to the market rate afforded to credit worthy donor countries. It means they can easily borrow at extremely low interest rates and still on-lend to countries at well below the current OECD discount rate, thereby easily satisfying the 25 per cent grant element requirement. It is argued, therefore, that development aid through these means does not constitute a true contribution by donors to development.

The risks

The background paper identifies potential risks if the current OECD-DAC proposals were to be adopted. These include:

8 *'Other official flows' (OOFs) are official sector transactions that do not meet the ODA criteria, for example: grants to developing countries for representational or essentially commercial purposes; official bilateral transactions intended to promote development but having a grant element of less than 25 per cent; official bilateral transactions, whatever their grant element, that are primarily export-facilitating in purpose.*

9 *Note that most regional development banks (RDBs) also employ the IMF/World Bank discount rate.*

- A possible proliferation of private financing through increased use of market-like instruments, which could endanger developing countries' debt sustainability.
- A possible shift in incentives away from delivering the 0.7 per cent ODA to GNI target to achieving a target based on TOSD.
- Increasingly vulnerable debt sustainability in Commonwealth developing countries if the introduction of a lower discount rate in combination with a grant equivalent methodology of concessionality calculation incentivises donors to increase non-concessional lending.
- A possible allocation imbalance with respect to grant funding, particularly between LDCs and non-LDCs, and negligence of other development priorities such as the financing of global public goods.

At first glance, the introduction of TOSD, with its potential benefit for increasing developing countries' access to a larger pool of aid resources, would be welcomed, especially in the current financially constrained global environment. However, it would come with the risk of donors increasing their use of market-like instruments to finance development. This means that the composition of donor receipts by developing countries could very well be skewed towards *less* concessional rather than *more* concessional finance. The obvious implication for developing countries is an increased state of indebtedness, given the likelihood of a more costly financing environment. Low-income countries – the main beneficiaries of ODA resources – have recently been showing heightened ratings of debt distress, despite receiving heavily indebted poor countries (HIPC) debt relief. Therefore, these countries will continue to depend on *more* concessional rather than *less* concessional sources of finance.

Similarly, the proposals present risks to the future debt sustainability of developing countries when considering the combined effects of implementing both a grant equivalent method of ODA calculation and a lower IMF/World Bank discount rate. It is clear that the grant equivalent methodology will result in less ODA per loan attributed to donor countries, should conditions remain the same. Further, harmonising the OECD discount rate with the lower IMF/World Bank discount rate will require OECD-DAC donors to lend at traditionally lower interest rates in order for development loans to qualify as concessional and to be recorded in ODA.[10] The only advantage for donors would be that under the grant equivalent conceptualisation their loans would no longer be required to carry a grant element of at least 25 per cent in order to be recognised as ODA, thus removing any ceiling above which donors could lend relative to the new discount rate.[11]

Taken together, adoption of the two proposals may result in a call for donors to increase their efforts.

Donors may react in either of two ways. At interest rates close to the discount rate, donors can expand the number, size and maturity of future ODA loans to increase the level of concessionality and contributions to ODA. The other reaction would be to lend at interest rates well below the harmonised discount rate to increase the size grant element of the loans. Because the grant equivalent

10 *Since the OECD discount rate will be lowered from 10 per cent to 5 per cent if harmonised, for loans to be concessional donors will have to lend at interest rates below 5 per cent in the future. Whereas a loan at 6 per cent interest may have been concessional under the current system, it would not be under a new system with the new lower discount rate.*

11 *With a grant element requirement of at least 25 per cent under a harmonised discount rate of 5 per cent, and assuming fixed face values and maturities, donors would have to lend at rates well below 5 per cent in order to achieve the grant element requirement. However, without the grant element requirement, any rate below 5 per cent under the grant equivalent method will be deemed as concessional.*

methodology removes the grant element requirement, which allows donors to lend at relatively higher interest rates, donors are more likely to choose the former option.

Hence again, although an increased quantum of finance would surely be welcomed by developing countries, it is clear that if not managed well any reaction to these proposals that results in increased on-lending of less concessional finance (by traditional standards) will present potential negative implications for developing countries' debt sustainability.

There is wide agreement that ODA should be focused on reducing poverty and directed towards LDCs

OECD-DAC should think carefully about further reducing the inconsistency between the OECD and IMF/World Bank concessional lending arrangements. At present, it is quite possible that low-income countries – which are increasingly becoming highly indebted – could be restricted from accessing OECD-DAC concessional loans because they would fail to satisfy the IMF/World Bank grant element requirement of at least 35 per cent concessionality. This inconsistency would be further exaggerated under a grant equivalent methodology, since loans would only be required to carry some subsidy and not a specific grant element.

With respect to allocation of ODA post-2015, there is wide agreement that ODA should be focused on reducing poverty and directed towards LDCs, the countries with less access to finance. However, on the issue of how to safeguard funds for these countries, in particular the proposal to ring fence 50 per cent of the total volume of ODA for LDCs, there are serious aid allocation implications for non-LDCs.

The benefits of implementing a 50 per cent LDC/ODA target are minimal. That is, the extra funds created by diverting grant funding away from non-LDCs will not result in a significant ramping-up of ODA for those countries most in need. In fact, as the Commonwealth Secretariat background paper shows, without a substantial increase in the total volume of ODA the introduction of an alternative target will not be of substantial benefit. The current proposal for better targeting ODA will put at risk development in other countries and could lead to an imbalance in the financing of the new global development agenda.

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