INTERNATIONAL DEVELOPMENT ASSOCIATION'S SUSTAINABLE DEVELOPMENT FINANCE POLICY: PROPOSED ADJUSTMENT OF THE SET-ASIDE MECHANISM

I. INTRODUCTION

1. **Approved by IDA's Executive Directors on June 9, 2020, the Sustainable Development Finance Policy (SDFP) became effective on July 1, 2020.** The policy aims to incentivize countries to move towards transparent and sustainable financing, among others to make debt more transparent, and to further enhance coordination between IDA and other creditors in support of the countries' reform efforts towards a sustainable development finance. This is especially important now, given the critical importance of addressing debt vulnerabilities in the many IDA countries that have seen a recent rise. The policy has two pillars: the (i) Debt Sustainability Enhancement Program (DSEP); and the (ii) Program of Creditor Outreach (PCO).

2. **The first year of the SDFP implementation is taking place during an unprecedented global crisis for IDA countries.** As highlighted in the January 2021 Global Economic Prospects Report, the crisis has reversed the downward trend in global poverty in many low-income countries for the first time in a generation, putting key development goals even further out of reach. In many IDA countries, rising debt stock levels are adding challenges to existing debt vulnerabilities. Nonetheless, in times of crisis, debt transparency is more important than ever, as is creditor coordination. In this context, the SDFP is supporting countries' reform efforts to strengthen debt transparency, sustainable fiscal policies, and debt management capacity. The SDFP also aims to help countries invest more efficiently and build their capacity to identify and manage fiscal risks from natural disasters and contingent liabilities stemming from different sources, including public credit operations and public-private partnerships (PPPs) on infrastructure development projects. These areas remain highly relevant in the context of the current crisis.

3. **The SDFP was designed for a three-year IDA cycle agreement, which means it now needs to be amended to reflect the decision reached during the IDA Day meeting on February 8, 2021 to advance IDA20 by one year, and hence shorten the IDA19 cycle.** The objective of this note is to propose revisions to the set-aside and discount mechanism in the current SDFP framework that can be implemented starting July 1, 2021 (i.e., the final year of the IDA19 cycle).[1] The revisions focus on making the set-aside and discount mechanism replenishment cycle-neutral, while also maintaining the incentive structure of that underpin the implementation of the Policy and Performance Actions (PPAs). The changes are intended to be applied in future replenishments.

4. **The note consists of 2 Sections.** Section II discusses proposed revisions to the SDFP set-aside mechanism; and Section III summarizes conclusions and proposes issues for discussions by Participants.

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[1] An SDFP Progress Report will be prepared for Board review in Q1 of FY22. In addition, a report on early lessons from SDFP Implementation will be prepared for Participants by October 2021.

II. PROPOSED REVISIONS TO THE PPA SET-ASIDE MECHANISM

5. **This section describes the proposed revisions to the SDFP to ensure its effective implementation as IDA20 is advanced by a year.** As discussed in the *Financing Options for IDA Countries* paper (January 23, 2021),[2] the revisions aim at maintaining incentives, continuity, and neutrality of the PPA implementation and assessment cycle. Revisions will focus only on the set-aside and discount mechanisms, and no other changes to the SDFP are envisioned at this time.

6. **With the proposed revisions, the SDFP set-aside mechanism will be made replenishment cycle-neutral, running continuously across cycles rather than coming to a hard stop at the end of each cycle.** A replenishment cycle-neutral set-aside mechanism implies that under the current framework, an IDA country that does not satisfactorily implement the PPAs in the second year of the replenishment period will not be able to recover a set-aside; while under the proposed new framework this would be allowed, subject to satisfactory implementation of PPAs. That means that under the proposed new framework, unsatisfactory implementation of PPAs in any particular FY would generate a set-aside, which can be recovered if the PPA is satisfactorily implemented in the following fiscal year (FY). This will also provide incentives for countries to achieve the PPAs in the final year of an IDA cycle, as explained in more detail below.

7. **If, however, a country's PPA continues to be unsatisfactorily implemented for two consecutive FYs, irrespective of when this takes place in a replenishment cycle, then this would lead to a permanent loss of the set-aside, which amounts to a discount**. In the context of the transition from IDA19 to IDA20, this implies that a country with unsatisfactory implementation of its FY21 PPAs will be subject to a set-aside of 10 or 20 percent of the following FY's allocation (i.e., FY22). If the country will satisfactorily implement its FY21 PPAs in FY22, then it can recover the set-aside the following year (in FY23). Similarly, a country with unsatisfactory implementation of its FY22 PPAs will have 10 or 20 percent of the following FY's allocation (i.e., FY23) set-aside. This set-aside could be recovered if the country satisfactorily implements these PPAs during FY23 and so on. In summary, set-asides are applied following one year of unsatisfactory implementation of a PPA and can either be recovered by meeting that PPA the following year or become permanent discounts if that PPA is not met within two years, maintaining continuity regardless of the replenishment cycle. Figure 1a and 1b provide a visual representation of the set-aside mechanism under the current and proposed new framework.

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[2] The paper was marked as confidential and not disclosed.

Figure 1a: Current Set-Aside Mechanism

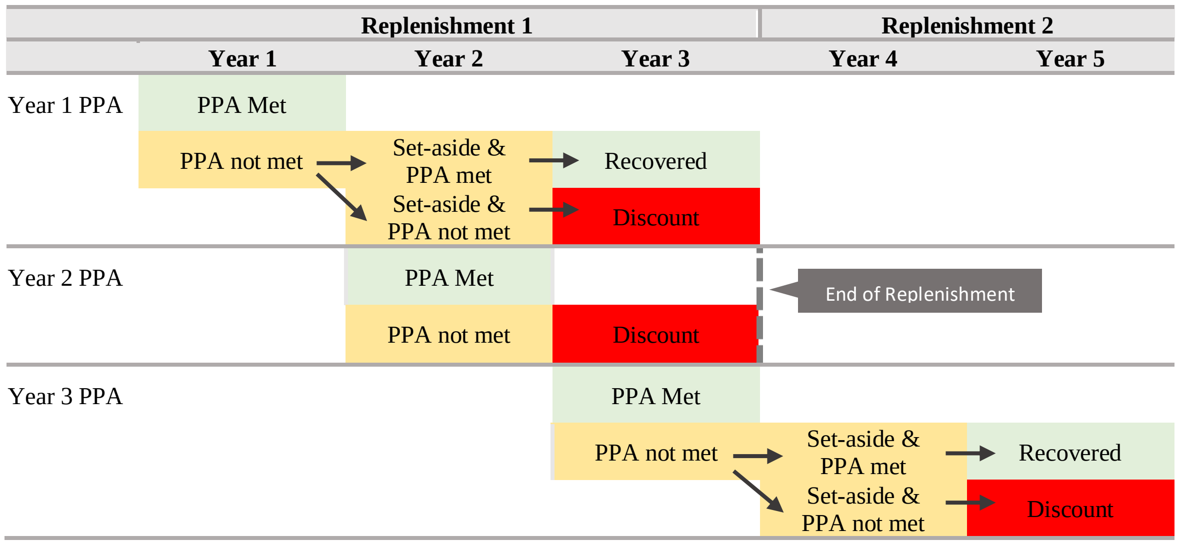
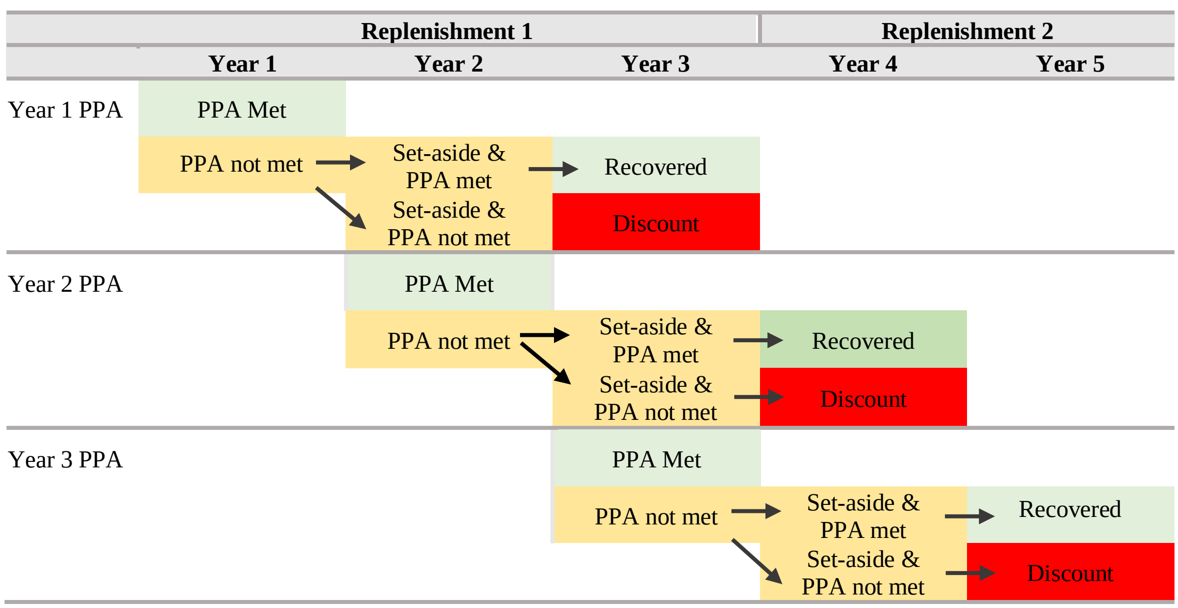


Figure 1b: New Set-Aside Mechanism



A. Implications on IDA Allocations

8. **Performance against the agreed PPAs will continue to have implications for IDA allocations as described in the SDFP paper.**[3] Countries that do not satisfactorily implement their

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3 *http://documents1.worldbank.org/curated/en/967661593111569878/pdf/Sustainable-Development-Finance-Policy-of-the-International-Development-Association.pdf*

PPAs will not be able to access all of their Country Allocations, with 10 or 20 percent set-aside.[4] Countries (other than Small States) with allocation set-asides are subject to more restrictive rules for frontloading and reallocations of IDA resources.[5] Countries that satisfactorily implement their PPAs will have access to their entire regular Country Allocations (including Fragility, Conflict and Violence [FCV] envelope top-ups for eligible countries). These countries, like other countries that are not subject to the SDFP, are also eligible for frontloading and intra-regional and inter-regional reallocations.

9. **Countries that do not satisfactorily implement their PPAs during any particular FY will have 10 or 20 percent of the following FY Country Allocation set-aside**. That set-aside is however not final; countries that do not satisfactorily implement their PPAs in a particular FY can recover the set-aside amount if they satisfactorily implement the agreed PPAs in the following FY. Under the current (original) framework, an important exception to this rule would be applied if a country does not satisfactorily implement PPAs in the second year of a replenishment cycle, the country then could not recover the set-aside amount, so that all IDA resources would be allocated within the replenishment period. As detailed below, this exception will be removed under the new proposed set-aside framework. Under the new mechanism, a set-aside for the final year of the IDA cycle resulting from unsatisfactory implementation of PPAs in the previous year could be recovered in the following FY, subject to satisfactory implementation of PPAs. *Annex 1* illustrates how the new set-aside mechanism will function under different scenarios.[6]

10. **Beyond the level of Country Allocations, other aspects of the IDA resource allocation framework will be adjusted to ensure consistency with the objectives of the DSEP.** Access to the Scale-Up Window (SUW) will continue to be restricted to countries that are not at high risk of external debt distress. In addition, for countries under the Low Income Countries Debt Sustainability Framework (LIC DSF) at *moderate risk* of debt distress, or MAC DSA countries assessed by Management as having elevated debt risks, access to SUW in any given year will be limited to countries that have achieved satisfactory progress in the implementation of their PPAs (i.e., countries with neither a set-aside nor a discount in that year), irrespective of when this takes place in a replenishment cycle. Access to the Regional Window will be implicitly reduced since the lower availability of PBA resources will limit the country's incentive to use part of their national allocation towards these projects. Given their purpose, access to the Crisis Response Window (CRW), the Private Sector Window (PSW), and the Window for Host Communities and Refugees (WHCR) will not be affected by the SDFP.

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[4] Whether the reduction is 10 or 20 percent depends on the debt risks: countries with a LIC-DSA at moderate risk of debt distress and countries with a MAC-DSA where Management assesses risks are significant will have a 10 percent reduction; countries with a LIC-DSA at high risk or in debt distress will have a 20 percent reduction.

[5] Countries with set-asides other than Small States are not eligible for frontloading. Small States with set-asides, while eligible for frontloading, will be allowed to frontload limited resources, compared to Small states without set-asides. Countries with set-asides or discounts are not eligible to receive reallocations should additional resources become available as a result of not being used by other IDA-eligible countries.

[6] In Annex 1, the example of *Country A* illustrates a case of successful PPA implementation; the second case (i.e. *Country B*) represents the example of a country facing a set-aside in the second year of a replenishment cycle, and its ability to recover the set-aside by successfully implementing PPAs in the following year; the case of *Country C* illustrates a scenario in which unsatisfactorily implementation of PPAs for two consecutive years leads to a discount in allocations. Finally, the example of *Country D* shows how unsatisfactorily implementation of PPAs in several years can lead a country to face both a set-aside and a discount in the same year.

11. **Discounts will be redistributed through the PBA system.** Subject to maintaining IDA's long-term financial sustainability (e.g., due to a sharp increase in loan-loss provisions), discounts in country allocations that are lost irrevocably to an individual country as a result of the two consecutive FYs of unsatisfactory implementation of PPAs will be redistributed to other IDA countries through the PBA formula. All IDA countries that are not subject to discounts in their allocations (i.e., IDA countries either at low risk of external debt distress or that demonstrate satisfactory progress in implementing their PPAs) will benefit from this redistribution.

12. **With the proposed adjustment, countries will have a strong incentive to achieve the PPAs in the final year of the IDA cycle.** The proposed approach improves countries' incentives to implement PPAs in the third and final FY of a replenishment cycle compared to the current (original) mechanism. This is because countries that do not satisfactorily implement their PPAs in the second FY of a replenishment cycle would have been subject to an immediate and irreversible discount in allocation instead of a set-aside, primarily to ensure that all IDA resources are allocated and utilized within the same IDA replenishment period. The shortening of IDA19 by one year, which makes FY22 its final FY, presents an opportunity to adjust the original set-aside mechanism to address the issue of lack of continuity in the incentive structure mentioned above.[7]

13. **With the proposed adjustment, the set-aside mechanism will remain consistent across IDA replenishment cycles to ensure continuity of incentives for countries to satisfactorily implement their PPAs.** While maintaining the need to allocate and utilize resources within a given replenishment period, the proposed change to a replenishment cycle-neutral mechanism means that IDA funds set-aside from a country in one cycle may be recovered by that country in the next IDA cycle through an increase in its notional PBA allocation. To be more specific, the resources set-aside from a country's allocation in the final FY of an IDA replenishment cycle (e.g., FY22) would be added to the general Country Allocation resources and redistributed to all countries in order to maintain the need to use up all resources in a given replenishment. The same amounts will be deducted from the general Country Allocation resources in the following replenishment (i.e. FY23) to enable such a country to regain access to the set-aside resources provided it satisfactorily implements its PPAs for that year (Figure 2). Therefore, the overall IDA19 commitments for an individual country could be lower than their initial IDA19 envelope by the amounts of the set-asides in FY22. On the other hand, that country's IDA20 commitment can increase by the amounts of FY22 set-asides should it regain access to those resources in the following FY of implementing PPAs.

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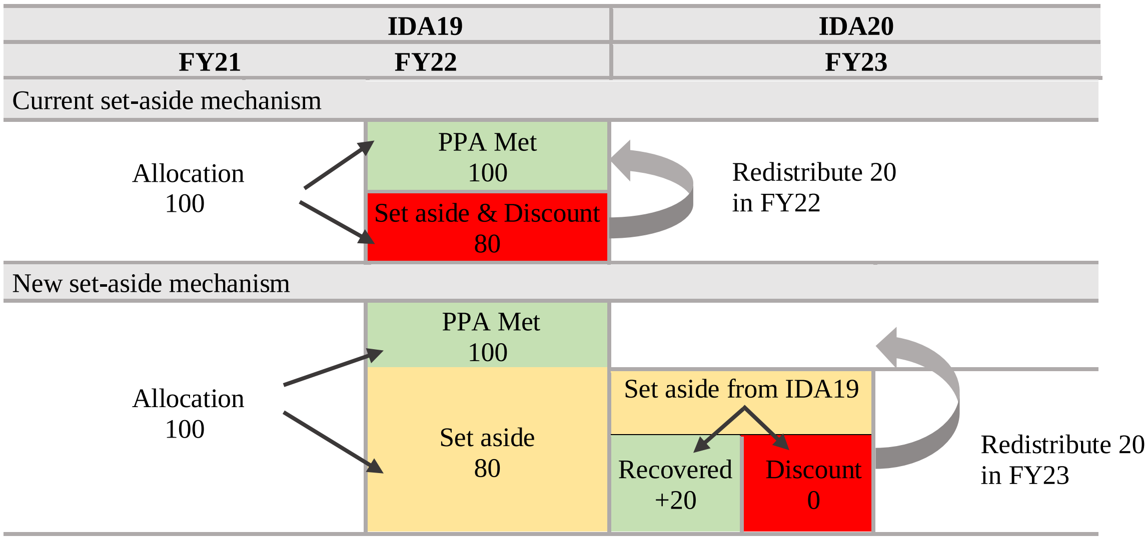
7 However, it is important to note that given IDA's resource performance-based allocation (PBA) system, countries will retain a strong incentive to perform satisfactorily their PPAs.

Figure 2: Illustrative Set-Aside Mechanisms and Carry over Across IDA Cycles



III. ISSUE FOR DISCUSSION

14. **Do participants agree with the proposed revisions to the set-aside mechanism in view of the decision to advance IDA20?**

ANNEX 1. EXAMPLES OF POSSIBLE SET-ASIDE SCENARIOS UNDER THE PROPOSED MECHANISM FOR AN IDA COUNTRY AT HIGH RISK OF EXTERNAL DEBT DISTRESS[8]

Country A				
Y1	**Y2**	**Y3**	**Y4**	**Y5**
Y1 PPAs established	Y1 PPAs met (country can frontload)			
	Y2 PPAs established	Y2 PPAs met (country can frontload)		
		Y3 PPAs established	Y3 PPAs met (country can frontload)	
Notional annual allocation *$500M*	*$500M*	*$500M*	*$500M*	*$500M*

3-year envelope $1.5bln

Country B				
Y1	**Y2**	**Y3**	**Y4**	**Y5**
Y1 PPA established	Y1 PPAs not met and ***set-aside applies*** (country can't frontload)	Y1 PPAs met and set-aside is released		
	Y2 PPAs established	Y2 PPAs met (country can frontload)		
		Y3 PPAs established	Y3 PPAs met (country can frontload)	
Notional annual allocation *$500M*	*$400M*	*$600M*	*$500M*	*$500M*

3-year envelope $1.5bln

Country C				
Y1	**Y2**	**Y3**	**Y4**	**Y5**
Y1 PPAs established	Y1 PPAs met (country can frontload)			
	Y2 PPAs established	Y2 PPAs not met and ***set-aside applies*** (country can't frontload)	Y2 PPAs not met and ***discount applies***	
		Y3 PPAs established	Y3 PPAs met (country can frontload)	
Notional annual allocation *$500M*	*$500M*	*$400M*	*$500M*	*$500M*

3-year envelope $1.4bln

8 Notional allocations are assumed at $500 million per year for every country. Countries at high risk of debt distress that do not satisfactorily implement a PPA in a given year would be subject to a set aside of 20 percent of the following year's allocation. In this illustration 20 percent represents $100mn.

Country D				
Y1	**Y2**	**Y3**	**Y4**	**Y5**
Y1 PPA established	Y1 PPAs not met and ***set-aside applies*** (country can't frontload)	Y1 PPAs not met and ***discount applies***		
	Y2 PPAs established	Y2 PPAs not met and ***set-aside applies*** (country can't frontload)	Y2 PPAs not met and ***discount applies***	
		Y3 PPAs established	Y3 PPAs met (country can frontload)	
Notional annual allocation *$500M*	*$400M*	*$400M*	*$500M*	*$500M*

3-year envelope $1.3bln