

Output-based aid

Supporting infrastructure delivery through explicit and performance-based subsidies

Increasing access to basic infrastructure and social services is critical to reducing poverty and achieving the Millennium Development Goals (MDGs). However, increasing access is a challenge because of the gap between what it costs to deliver a desired level of service and what can be funded through user charges. Subsidies have often played a role in funding this gap, for a variety of socio-economic reasons: There may be limited ability to afford a particular infrastructure service, especially among specific disadvantaged groups. The service may have “public good” characteristics making it difficult to collect user charges. And there may be important positive economic externalities where the benefits of one individual’s consumption are felt much more widely in society, for example in the case of health and sanitation.

However, given the political commitment by a number of countries to increase aid flows, but at the same time the mounting concerns of aid effectiveness, it is critical that subsidies be linked to the actual delivery of services, or “outputs.”

One way to do this is through **Output-Based aid (OBA), a strategy for using explicit performance-based subsidies to deliver basic services—such as water, sanitation, electricity, transport, telecommunications, education, and health care—where policy concerns would justify public funding to complement or replace user fees.** Two key features distinguish OBA subsidies from some other forms of publicly funded subsidy: OBA subsidies are explicit, and they are performance based.

OBA interventions are explicit because they ensure explicit recognition of *why* the subsidy is being provided, *who* is receiving the subsidy and who is providing it, and *what* is being subsidized—both the activity and the financial sums involved. Historically, infrastructure service delivery in both industrial and developing countries has often involved “implicit” rather than explicit subsidies. These implicit subsidy approaches are poorly

targeted and often inefficient. They tend to benefit better-off, mainly urban customers, while leaving poorer people with no service at all. Subsidized infrastructure services may be priced well below what customers are both able and willing to pay. Moreover, these subsidies can divert scarce public resources from other valuable uses to which they might be put.

The OBA approach is performance-based because it strongly links the payment of service providers to their delivery of specified services, or outputs. This payment on outputs transfers performance risk to the service provider. The provider largely self-finances the service, receiving reimbursement mostly after the verification of successful delivery. By contrast, in other approaches donors or governments (or both) pre-fund “inputs,” so there is commensurately less transfer of performance risk to the service provider.

OBA can help improve aid effectiveness by:

- *Increasing accountability.* The transfer of performance risk to the service provider maintains pressure to deliver the pre-specified outputs.
- *Improving transparency.* Explicit recognition and identification of subsidy flows reduces scope for corruption.
- *Increasing value for money.* Competitive award of OBA subsidies, together with the transfer of performance risk to the service provider, can increase the value for money.
- *Reducing economic distortions.* Explicit recognition and identification of subsidies can help reduce the economic distortions that subsidies tend to introduce.

Further, OBA approaches are a mechanism to implement public-private partnership (PPP): effective use of donor funding and the public budget via OBA-type

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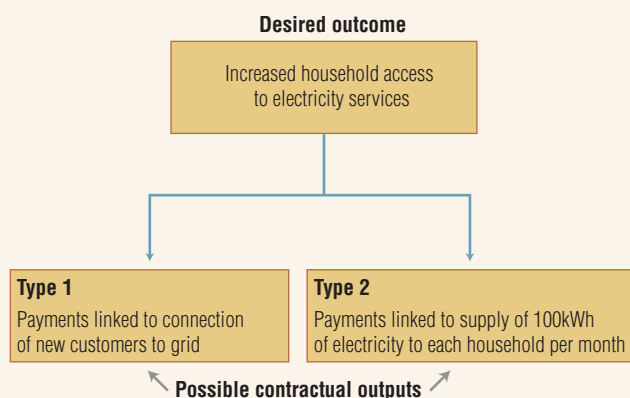
mechanisms can mobilize private capital and efficiencies for increased service delivery to the poor.

Key principles of design

Each application of OBA will differ at least slightly from others. Since 2000, when OBA was officially launched, some 30 projects (mostly World Bank) have been developed that include an OBA-type component. But many of these projects are at an early stage of execution. So evidence supporting the use of OBA approaches as a tool for improving aid effectiveness is still being collected, as are lessons for designing such approaches. But wherever OBA is applied, there are arguably three key principles of design to consider:

- *Ensuring intelligent subsidy design.* This involves sharpening the targeting of subsidies (where desired) so that they reach the intended beneficiaries and not others (box 1); providing just the right amount of subsidy to effect the desired response and minimize market distortions (box 2); and maximizing the sustainability of any subsidy intervention that does not hinder long-term development or prevent the achievement of goals in other areas.
- *Developing a performance regime.* Performance risk can be transferred to service providers by introducing subsidies within a competitive regime or by developing specific, performance-based subsidy contracts. A big challenge in designing performance-based regimes is determining what outputs to link the payment of subsidies to—that is, which outputs will deliver the desired outcomes. For example, if the OBA scheme depicted in figure 1 took place in a rural part of Sub-Saharan Africa where rates of access to electricity are very low, either type 1 or

Figure 1: Outcomes and outputs in a hypothetical OBA scheme in electricity



type 2 outputs—or even both—might be appropriate. But if the scheme took place in, say, one of the Central Asian republics, where most customers are

Box 1 To target or not to target? Two OBA schemes in water

Targeting subsidies can be difficult, typically because of the costs involved. Indeed, in many situations it could be argued that the costs of targeting simply are not worth it. Still, as examples from Cambodia and Paraguay show, some measures can help ensure that subsidies go to the intended recipients.

In a water and sanitation project in provincial and peri-urban areas of Cambodia, it was decided that OBA subsidies would be targeted directly to individual households: poor households deemed eligible would receive a connection (from a competitively selected private operator) that would be funded through a grant from the International Development Association. Once four pilot OBA towns were identified, the local communities played a big part in selecting the households that would receive connection subsidies. A household survey was developed within the communities to collect data, and village representatives and commune council members determined poverty criteria. Based on these criteria and the results of the survey, the communities themselves identified the poor households that would receive the subsidy. An independent consultant later randomly verified the selection. Of the 13,000 households in the four towns, the 3,000 poorest households would receive a subsidized connection.

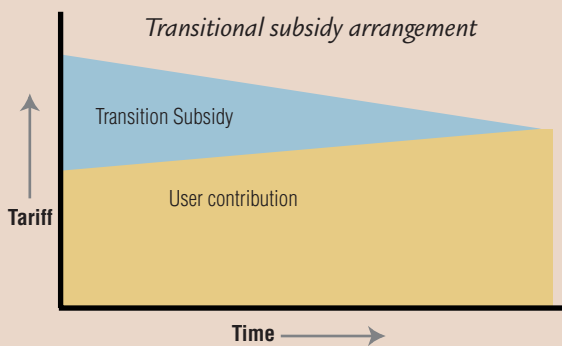
An OBA project in Paraguay relied on *aguateros* (small-scale water entrepreneurs) and local construction companies to provide water services to poor rural communities. The providers, selected through a competitive process, would receive part of their payment from users and the other part from a World Bank-financed subsidy fund. In the Paraguay project, rather than individual households, unserved rural areas and small towns where most residents are poor were selected to receive the subsidies. In addition, the very poorest customers were given the option to provide labor in digging trenches as part of their payment to the service provider.

Source: Mumssen 2004 and Drees 2004.

Box 2 Getting the design right for subsidies

The size and type of subsidy required to fund services in the absence of user fees can vary greatly. For simplicity, three types of situations can be distinguished:

- Those requiring a *one-time* subsidy, often to support initial connection costs.
- Those requiring a *transitional* subsidy, for example, to smooth an increase in tariffs to a level that recovers full costs (see figure).
- Those requiring an *ongoing* subsidy, for example, to support a lifeline tariff.



already connected to the national or municipal electricity grid, tying subsidies to a type 2 output would probably be much more appropriate.

- *Creating a competitive dynamic or tension.* Creating competitive pressures is important in ensuring value for money, by minimizing the subsidy required or maximizing the benefit from a given subsidy amount (box 3). It will be critical in schemes involving public and private sector incumbents, where competition may need to go beyond subsidy award, even if this competition is “threatened” rather than actual.

In reality, creating “perfect” OBA schemes that incorporate all these elements will be extremely difficult. Nonetheless, they can be seen as a starting point when developing schemes, even when real-world practicalities require a step back from the theoretically desirable. Moreover, OBA is only one way of applying subsidies; there may be other legitimate approaches. Nor should it be expected that just because something fits the broad definition of OBA, it should be entitled to specific donor support. The types of projects qualifying for

donor-funded OBA support will very likely form a smaller subset of OBA schemes, reflecting the priorities of the donors involved. Finally and importantly, tacking an OBA scheme onto a bad project—one that is poorly designed—will not make it a good one.

Other design considerations

All OBA schemes thus far have involved private providers and nonincumbents. But in many situations infrastructure services will be provided by an **incumbent or a public utility**, and it will not be feasible—often for political but sometimes also for economic reasons—to institute an alternative model, at least in the short term. Clearly, introducing competition where there is only one supplier of the desired services is more problematic. More analysis as well as OBA pilots are needed to demonstrate the potential gains of OBA with incumbents or public providers. But the types of measures that might be used to help mitigate problems arising from a lack of competition are those commonly used by regulators to improve efficiency where there are incumbents, including identifying and contracting out contestable activities, employing yardstick or benchmark approaches, imposing effective regulatory mechanisms, and introducing the threat of competition or a Swiss challenge.

Box 3 Introducing a competitive dynamic in an OBA scheme in telecommunications

In OBA schemes the potential for improving aid effectiveness—by achieving value for money and targeting intended beneficiaries—can be further improved by introducing a competitive dynamic in awarding or determining the subsidy. In a rural telecommunications project Peru used a least-subsidy bidding approach, in which telecommunications operators bid for the minimum government subsidy they required to deliver pay phone service in targeted areas. Winning bidders received a non-exclusive concession defining their rights and obligations. Results thus far show that the investment mobilized has been much greater than the subsidy provided. Moreover, in a pilot project the winning bidder requested a subsidy 41 percent lower than that estimated by the sector regulator and 74 percent lower than a previous amount requested by the incumbent provider.

Source: Cannock 2001.

Another key design challenge is mitigating **payment risk**. For an infrastructure project supported by output-based aid, cash flows are subject not only to risks related to tariff payments by customers but also to risks related to subsidy payments by the government or government entity. In many countries government payments are considered unreliable and so are assigned a low credit rating by financial markets and investors. In these cases the quality of OBA payments needs to be enhanced—that is, lifted to a higher level to become creditworthy—such as by a partial risk or partial credit guarantee.

Administration and monitoring of schemes is also critical. The disbursement of funds must be considered reliable, with mechanisms to mitigate payment risk. Escrow accounts and offshore banking might be considered. Monitoring arrangements—for example, to ensure that outputs are satisfactorily delivered—need to be made, taking into account local capacity.

Next steps

Subsidies are back on the table as a legitimate policy tool for infrastructure development. Full evidence of the effectiveness of OBA as an aid instrument still needs to be collected, but initial results look positive. OBA is a means to enhance public-private partnership: Better-designed subsidy mechanisms with credible pay-

ment and monitoring systems clearly will attract and mobilize the private sector. In addition, well-designed OBA approaches can improve the performance and governance of public utilities and help strengthen the partnership between communities and nongovernmental organizations. However, more projects are needed to demonstrate the potential results—particularly on a larger scale. Designed properly, OBA can become a key mechanism in improving the delivery of infrastructure services to the poor, helping to achieve the Millennium Development Goals.

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About the Global Partnership on Output-Based Aid

The Global Partnership on Output-Based Aid (GPOBA) is a multidonor trust fund administered by the World Bank. Its purpose is to fund, demonstrate and document output-based aid (OBA) approaches to supporting the sustainable delivery of basic services to those least able to afford them and to those without access to such services.

How can GPOBA help? GPOBA can assist in the design and development of pilot OBA projects, and can help identify and disseminate emerging knowledge on issues related to OBA approaches through studies, publications, workshops, and conferences. GPOBA can also contribute to the funding of subsidized payments for the provision of services under OBA schemes.

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